

# Directors' liabilities

In light of a series of judgements for increased damages endorsed by the Supreme Court, Yoshinori Ono of Nishimura & Asahi offers an introduction to the position and responsibilities of directors under the Companies Act

In a series of recent decisions, the Japanese Supreme Court has supported the decisions of the lower courts, which ordered company directors to pay significant claims for damages for failing to comply with their corporate responsibilities. In *Janome Sewing Machine Co, Ltd* (Supreme Court decision of October 2 2008), five ex-directors were ordered to pay ¥58.3 billion (\$609 million) in damages to the company arising from the directors yielding to extortion demands from an organised crime operative. In *Duskin Co, Ltd* (Supreme Court decision of February 12 2008), two ex-directors were ordered to pay ¥5.3 billion for failing to disclose past sales of food contaminated with unlawful chemicals that were later discovered in an official inspection. In *Hokkaido Takushoku Bank* (Supreme Court decision of January 28 2008), 14 ex-directors were ordered to pay ¥10.1 billion due to their negligence in connection with various loans that had become uncollectible.

Given this clear change in the trend of court precedents endorsed by the Japanese Supreme Court, it is important that directors of Japanese

companies, as well as other relevant parties such as shareholders, have a precise understanding of the position and responsibilities of directors under the Japanese Companies Act (CA).

## Position of directors and bodies of a stock company

Directors are appointed by a general meeting of shareholders (GMS) and entrusted with the management of the company. Directors become members of the board of directors (BOD), which makes decisions regarding the company's business activities.

The BOD also appoints one or more representative directors. The representative director represents the company to external entities and conducts business activities on behalf of the company in accordance with the decisions of the BOD.

Decision-making in daily business affairs is usually left to the representative director. However, the BOD may not delegate decision-making on important business affairs but must make such decisions by itself (CA Article 362).

The GMS also appoints company auditors, who audit the performance of duties by directors. A stock compa-

ny whose balance sheet indicates at least ¥500 million of capital or at least ¥20 billion of liabilities (defined as a large company under the CA) must appoint accounting auditors. If it is a public company under the CA, a large company must also have a board of auditors.

## BOD's duty of supervision

The BOD has a duty to supervise the performance of the representative director, who is in turn responsible for supervising the operations of the company. Therefore, each non-executive director has the duty to supervise, through the BOD, the performance of duties by the representative director. To facilitate the BOD's supervisory function, the representative director has the obligation to report on the performance of duties to the BOD at least quarterly. The BOD has both the authority and the obligation to dismiss any representative director whom it has found unfit.

## Duties of directors

### Duties of care and loyalty

A director has the duty of care of a prudent manager in performing his duties (CA Article 330).

In addition, the CA stipulates that "A director shall comply with laws and articles of incorporation and resolutions of the GMS and shall conduct his duties loyally for the stock company" (CA Article 355). This is understood as being the duty of loyalty. The Supreme Court has ruled that the duty of loyalty clarifies the duty of care and is not separate from or higher than the duty of care (June 24 1970).

Regarding a director's duties of care and loyalty, court precedents have adopted the so-called business judgment rule. This has allowed a director a certain degree of discretion in decision-making.

For example, in a case where the directors' performance caused damage to the company by unsuccessful over-

**"Regarding a director's duties of care and loyalty, court precedents have adopted the so-called business judgment rule"**

## Author biography

**Yoshinori Ono****Nishimura & Asahi**

Yoshinori Ono is a partner and a member of the cross-border transaction group of Nishimura & Asahi. His practice focuses on various cross-border matters including cross-border investment/licensing, joint ventures, M&A, corporate restructuring/insolvency, labour issues, real estate investment and cross-border dispute resolution. Yoshinori is a graduate of Tokyo University (LLB, 1981) and was admitted to practice law in Japan in 1986.

seas investment, the court approved such directors' discretion and denied the liability of the directors (the *Sogo* case, Tokyo District Court, September 28 2004). The court ruled that "Making business judgments for a company requires comprehensive judgment, which requires the ability to make technical, prospective and political judgments on various uncertain, fluid and complicated factors. Corporate activities aim at gaining profits and naturally involve certain risks." Regarding the criterion for judging whether there was a breach of the duties of care and loyalty, the court stated that "It should be based on whether or not the act is considered grossly unreasonable from the viewpoint of whether or not there were careless mistakes in the recognition of facts and whether or not the choice of action based upon such recognised facts was unreasonable, in light of the knowledge and experience that a normal manager in the company's industry should have under the circumstances surrounding the company at the time the action was taken."

Thus, in the performance of his duties, a director must pay attention to the company's interests, must exercise sufficient care at the level generally required of a manager and must carry out his duties based on reasonable risk analysis. If a director has followed these guidelines, he would not have, in principle, any per-

sonal liability for damages as a result of the business operations of the company.

**Duty of supervision**

As part of the duty of care, each director has the duty of supervision to ensure that acts of other directors and the representative director comply with the law and articles of incorporation (AOI) and are taken in a lawful and proper manner.

The Supreme Court has ruled that each director "has the duty to not only supervise matters referred to the BOD but also to supervise the representative director's performance of his duties in general and, if necessary, convene or request convocation of a BOD meeting and ensure through the BOD that directors perform their duties appropriately" (May 22 1973).

The question regarding this duty of supervision is the extent to which each director is obliged to supervise the representative director and other directors. If the company is larger than a certain size, directors are usually assigned different functions and it would be difficult for each director to supervise other directors in all their activities.

Therefore, if the internal control systems as described below have been put in place appropriately and have been operated in accordance with applicable rules and if no specific problem has been found, each director is allowed to trust that other directors have performed their duties in an

appropriate manner.

On the other hand, if any specific irregular problem has arisen, a director is obliged to investigate the problem promptly, question the appropriateness of the performance of business activities and duties of other directors and prevent any damage to the company.

**Duty to establish internal control systems**

As part of a director's duties of care and supervision, a director also has a duty to establish and maintain internal control systems. This principle was first revealed in *Daiwa Bank*, where the bank suffered enormous loss due to illegal acts by an employee of the bank's New York branch (Osaka District Court, September 20 2000). The court pointed out the director's duty to establish a risk management system (an internal control system) and acknowledged the liability of the director in charge (the New York branch manager) in the unprecedented amount of \$530 million, even though the law at that time did not have specific provisions to such effect. The CA, which came into effect in May 2006, provides that the BOD of a large company has a duty to make decisions regarding its internal control systems: that is, "systems to ensure that directors' performance of their duties comply with the law and AOI and other systems designated by the Ministry of Justice ordinance as necessary to ensure appropriate business activities of the stock company" (CA Article 362). Thus, each company is required to consider, decide and carry out specific systems that will effectively achieve the desired purposes, including prevention of unfair practices, risk management and appropriate performance of duties in accordance with the size, organisation and nature of the business activities of each company.

Once the internal control systems have been determined, directors are required to check that the systems function effectively and ensure that they are actually operated in an appropriate manner. The directors are also obliged to improve the systems promptly if any insufficiency or defect is found in the systems through feedback during daily operations.

#### Other duties

Directors are also subject to: (i) restrictions on competitive transactions; and (ii) restrictions on transactions involving a conflict of interest (CA Article 365).

### Directors' liabilities

#### Liability to the company

If a director has neglected his duties, he is liable to compensate the company for any damage incurred as a result of his neglect (CA Article 423). In addition, there are special provisions for directors' liabilities in connection with: (i) offering illegal profits in connection with the exercise of shareholders' rights (CA Article 120); (ii) illegal distribution of surplus and purchase of own shares (CA Article 462); (iii) share purchase from dissenting shareholders (CA Article 464); and (iv) liability for a deficit after distribution of dividends and purchase of own shares (CA Article 465).

### Exemption and mitigation of liabilities

#### Exemption of liability by consent of all shareholders

Directors' liabilities to the company for damages may be exempted by the consent of all shareholders. However, liability for the illegal distribution of surplus and purchase of own shares

may be exempted only up to the amount permitted to be distributed under Article 462.

#### *Ex post facto* mitigation of liability

Subject to the absence of the willfulness and gross negligence of the

director and to the consent of all company auditors, the liability under Article 423 may be exempted by special resolution of the GMS regarding the amount in excess of a minimum liability amount defined as below.

Representative director: minimum liability amount = total amount of (x) + (y).

(x) =  $6 \times [(a) \text{ highest annual remuneration and bonuses} + (b) \text{ retirement allowance for directorship/number of service years}]$  (remunerations).

(y) = financial benefits from stock options under favorable terms (stock option benefits).

Director: total amount of (x)  $4 \times$  remunerations + (y) stock option benefits.

Outside director: total amount of (x)  $2 \times$  remunerations + (y) stock option benefits.

If the number of service years is less than the respective multiplier (six, four or two), the number of the multiplier will be used instead of the number of service years.

#### Mitigation of liability by provisions of the AOI and resolution of the BOD

Subject to the same conditions as those mentioned above, the liability under Article 423 may be mitigated by a resolution of the BOD (except the director(s) in question) if the AOI provide such mitigation. However, if the resolution has been passed by the BOD, it must either be publicly

announced or the shareholders must be notified. If shareholders representing at least 3% (this proportion may be reduced by the AOI) of the shareholders' voting rights other than those held by the director(s) in question raise an objection to the resolution, mitigation of the liability in question is not allowed.

#### Prior mitigation of liability

A company may provide in their AOI that it may enter into a contract with outside directors, which, under the same conditions as those mentioned above, sets the limits of liability at the higher of (x), the amount designated by the company within the amount stipulated by the AOI or (y), the minimum liability amount.

#### Directors' liability for third party damages

If a director has breached his duties with intent or gross negligence, he is liable to compensate any third party for damages incurred as a result of such breach (CA Article 429). This is a special statutory liability intended to protect third parties engaging in transactions with the company.

If a director has engaged in any of the following activities, he is liable to compensate any third party for damages incurred as a result of such activities, unless he successfully proves absence of negligence (a shift in the burden of proof to the director).

- Giving false notice about any material information that needs to be notified when making an offering of shares, stock options, corporate bonds or bonds with stock options, or making false statements in explanatory documents that are used for such offering.
- Making false statements regarding any material information in a financial statement, business report or supplementary schedules attached to any of these, or an extraordinary financial statement.

**“The Companies Act provides that the board of a large company has a duty to make decisions regarding its internal control systems”**

- Making a false registration or giving a false public announcement.

### Directors' criminal liabilities

Penal provisions of the CA that apply to directors include the crimes of: (i) special breach of trust; jeopardising company assets; (ii) using false documents; (iii) borrow-and-deposit; (iv) issuing extra shares; (v) bribery; (vi) bribery in connection with the exercise of the rights of shareholders; and (vii) providing benefits in connection with the exercise of shareholders' rights, among other things (CA Articles 960-979).

### Litigation to pursue liability of directors

If a company fails to pursue any of the liabilities of one of its directors, a shareholder may sue the director by exercising the company's rights on behalf of the company (CA Article 847).

A shareholder may sue: (i) any of the directors, accounting advisers, company auditors, executive officers, accounting auditors or liquidators to pursue such liabilities; (ii) any parties that received illegal benefits from the company in connection with the exercise of shareholders' rights to demand return of such benefits; or (iii) any investors who subscribed for shares or stock options at unfair prices to demand payment of the difference between the unfair prices and corresponding fair prices. However, no shareholder may take such action if he intends to gain illegal benefits for himself or a third party or cause damage to the company. A shareholder may take such action only if the company fails to file a lawsuit within 60 days of the shareholder's request to do so. However, the shareholder may immediately file a suit if any irreparable damage is likely to otherwise occur.

If the company fails to file a lawsuit within 60 days of a request to do so

by a shareholder and there is a request for disclosure from that shareholder or the director in question, the company must disclose in writing a reason for not filing a lawsuit and must also provide documents containing the details of the investigation and the company's judgment as to whether the director in question is liable.

If the defendant has produced *prima facie* evidence showing the bad faith

(intention to gain unfair benefits or awareness of a nonexistent cause of action, for example) of the plaintiff (shareholder), the court may order the shareholder to provide reasonable security. The company may, upon the consent of all company auditors, intervene in the lawsuit as assisting intervener on the side of the director.

A shareholder is entitled to request: (i) an injunction of a director's act that is illegal or in breach of the AOI (CA Article 360); and (ii) an investigation of a director's act that is illegal or in breach of the AOI by a court-appointed inspector (CA Article 358).

### Duty to comply with laws other than the CA

In addition to the CA, a director must also comply with other laws relevant to his duties (*Nomura Securities*, Supreme Court, July 7 2000).

Furthermore, directors have the obligation to establish internal control systems to ensure that the performance of their duties and the business of the company comply with laws and the AOI. Thus, each individual director does not have to have a thorough knowledge of all laws actually applicable to the company,

but directors must, as a joint duty of the directors as a whole, establish internal control systems that enable the company to understand and

comply with all laws applicable to the company, and each director has the duty to check and supervise these systems to ensure that they are functioning effectively.

Based on this duty of supervision, each director needs to understand, with

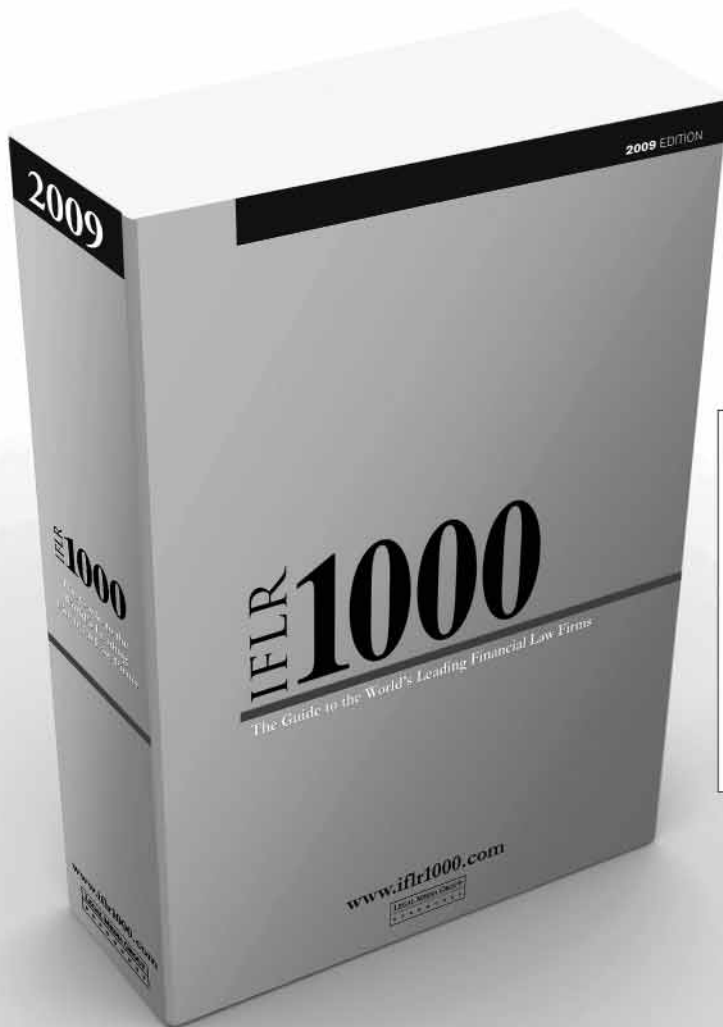
support from the legal department and the business department for which he is responsible, the legislative intent, regulated activities and an outline of the regulations of the main laws applicable to the company's corporate activities, including sanctions and damages that may be imposed in the case of violation thereof.

Generally speaking, such laws include so-called industry laws that stipulate regulations specifically applicable to the industry of the company, the Corporate Tax Law and other tax laws and the Criminal Code. In addition, the following laws should be included in the scope of the main laws:

- the Financial Instruments and Exchange Act;
- the Antimonopoly Act and the Subcontracting Act;
- the Unfair Competition Prevention Act;
- import and export regulations;
- consumer protection laws;
- environmental laws;
- labour laws;
- intellectual property rights laws;
- bankruptcy laws; and
- laws applicable in foreign countries where the company activities take place.

**“Directors also have the obligation to establish internal control systems to ensure that the performance of their duties and the business of the company comply with laws and the AOI”**

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**NISHIMURA  
& ASAHI**

Ark Mori Building 1-12-32 Akasaka,  
Minato-ku, Tokyo 107-6029 JAPAN

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