# Understanding Recent Trends Regarding the Liability of Managers and Directors in Japanese Corporate Law

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## I. INTRODUCTION

The topic assigned to me in this symposium is "Civil Liability of Management and Shareholder Derivative Suits". In thinking about the topic, there are three familiar questions:

(1) how enforcement interacts with substantive legal rules,
(2) whether transplantation of legal rules from Western countries has been successful, and
(3) when, how, and why legal rules change.

A companion of these three questions is the well-known inquiry into whether legal rules are converging around the world. In this article, I revisit the first question in connection with the recent developments in this area in Japan.[1] Section II briefly describes recent developments in this area. Section III considers the question of interactions between enforcement and substantive legal rules. In Section IV, I offer my preliminary conclusion. I limit the discussion in this presentation to that of large publicly held corporations.

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1 As regards the second question, see H. KANDA / C.J. MILHAUPT, Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law, in: American Journal of Comparative Law 51 (2003) 887.

## II. RECENT DEVELOPMENTS

### *1. Case Law Developments*

Directors owe a "duty of care" to their respective companies (Art. 254(3) of the Commercial Code [hereinafter ComC] applying Art. 644 of the Civil Code). In Japan, outside directors are not very common, so typically, managers and directors are all former employees, and it is thus not inappropriate to view managers and directors as the same in discussing their civil liability to the company.

In recent years Japanese courts have recognized a sort of Business Judgment Rule ("BJR"). However, the Japanese BJR is quite different from that in the United States. In the United States, the BJR is a rule that prescribes that courts refrain from interfering with managerial decisions *ex post* when (i) the decision is made without a conflict of interests and (ii) the decision is an informed one. By contrast, in Japan, courts review all aspects of managerial decision-making, including the content of the decision as well as the environments within which the decision is made. Japanese courts refuse to declare the civil liability of directors if they find that all facts show that directors are not negligent or should not be blamed. So for example, in Japan, if directors did not notice an employee's misbehavior, they are generally not held liable. Even if the board of directors makes a bad decision, directors are generally not held liable if they did not notice specific wrongdoing in connection with the decision.

The results are similar in both countries, but one reason for Japan's underdevelopment of the U.S. style formulation seems to be that outside directors are not as common in Japan as in the U.S., which makes it difficult to require, as a matter of legal doctrine, that decisions be made without conflict of interests. Another reason for this difference might be that judges in Japan may be more respected than those in the U.S., and political pressure to exclude judicial intervention in managerial decisions has not been strong in Japan.

On the basis of the recognition of this BJR, there are two issues that have been debated in recent years. The first issue is whether managers and directors can rely on others, such as the company's internal control system and external financial auditors. A few cases suggest that managers can rely on the company's internal control system and other similar mechanisms within the company, and that if they act in reliance on these mechanisms, they will be held not to be negligent, and thus found not to bear civil liability to the company.[2] The second issue is whether managers and directors can assert any defense if they violate laws and regulations. In a well-known case, a major securities firm attempted to compensate stock trading losses that its large business customer incurred. The Supreme Court declared that even if the company violates Anti-Monopoly Act rules, they cannot be held liable if they are found not to be negligent, and that if it is

2 Tokyo District Court Judgment of April 25, 2002, in: Hanrei Taimuzu 1793 (2002) 140.

not well established at the time of a board decision that the activity at issue is in violation of the Anti-Monopoly Act, then the directors cannot be found negligent.[3]

Since the beginning of the 1990s, the number of shareholder derivative actions has increased drastically. While plaintiffs lose in most cases, except when the courts find a clear violation of laws or regulations (with the exceptions described above), the amount of damages sought by plaintiffs tends to be quite large. In this respect, the controversial *Daiwa Bank* case, in which a huge amount of damages was awarded by the court of first instance[4], and which was subsequently settled, raised concern in the business community. This concern resulted in a statutory change, restricting the amount of liability, in the 2001 amendments mentioned below. In addition, Japanese corporate law does not have any specific provisions about indemnification. Companies often try to support directors in shareholder derivative actions, and the Supreme Court declared that companies may engage in "ancillary participation" (a special system defined in civil procedure) on the side of directors when a decision made by the board is at issue.[5] The 2001 amendments imposed an additional condition for such participation: consent of all statutory auditors.

While we have seen many developments with regard to the duty of care of managers and directors, there are no distinctive case law developments in the area of "duty of loyalty". However, first, beginning in the 1980s, some courts did begin to apply the duty of loyalty provision (Art. 254-3 ComC) independently from other provisions in certain situations.[6] Note that director civil liability based on this provision uses the negligence rule in Japan (Art. 266(1)(v) ComC). Second, there are specific provisions, violations of which result in the strict liability of directors. The best known provision is Art. 265 ComC, which prohibits self-dealing by directors. Under this provision, directors were held liable in a case where the same person was the CEO of two companies and one of the companies sold land to the other company.[7] In contrast, directors were not held liable in a case where a loan was extended to the company's affiliate through a third party, on the ground that extending such a loan does not fall within the definition of self-dealing under Art. 265 ComC.[8] As discussed later, in my view, the point here is that the violation of Art. 265 produces strict liability (Art. 266(1)(iv) ComC) but the Osaka District Court avoided applying the strict liability test.

Japan has a somewhat unique provision, Art. 266-3(1) ComC, which provides that directors are liable to third parties for damages that result from their bad faith or gross negligence in performing their duties. This provision has produced the largest number of court cases in Japanese corporate law. Most cases, however, concern closely held

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3 Supreme Court Judgment of July 7, 2000, in: Minshû 54-6, 1767.

4 Osaka District Court Judgment of September 20, 2000, in: Hanrei Jihô 1721-3.

5 Supreme Court Order of January 30, 2001, in: Minshû 55-1, 30.

6 Tokyo High Court Judgment of October 26, in: Kinyû Shôji Hanrei 835 (1989) 23.

7 Supreme Court Judgment of October 20, 2000, in: Minshû 54-8, 2619 (though the major issue before the Supreme Court was a technical discharge issue).

8 Osaka District Court Judgment of January 30, 2002, in: Hanrei Taimuzu (1108) (2002), 248.

corporations where creditors have sued managers and other directors of de facto insolvent companies. Cases involving public companies are very rare, so I will not address these in this article.

### 2. *Practice*

One of the most remarkable trends in recent years is the reduction of board size. In 1997, Sony announced the reduction of the size of its board of directors from 38 to 10. In doing so, they created new positions called "officers" (which is not defined in the Commercial Code), and transferred quite a number of their former board members to such positions. To date, roughly 1,000 companies have followed this practice. The reason why so many companies have done this is because it is generally understood to enable the board to make decisions more speedily. Legally, the officers at issue here are not directors, and they are not subject to shareholder derivative actions (see Art. 267(1) ComC).

### 3. *Statutory Change*

#### a) *Politics of Company Law Reform*

Japanese company law was amended every year from 1999 to 2003, including three times in 2001. Why does it change so often? There are distinctive characteristics underlying this frequent change.

*Speed*
One characteristic that can be derived from recent corporate law reforms is speed. Many important and large-scale reforms have been made quite quickly. This can be understood because information technology and global competition make reforms necessary for Japanese companies to survive in fast-changing environments. Behind this speedy reform are certain mechanisms that did not previously exist in respect to the reformation of corporate law in Japan, such as the increased role of politicians and the impact of the Ministry of International Trade and Industry ("MITI") (currently the Ministry of Economy, Trade and Industry, "METI").

*Role of Politicians*
In the past, all corporate law reforms were first considered at the Legislative Council's Commercial Law Division, which is an advisory body to the Minister of Justice. That division then submitted its proposals to the bureaucrats at the Ministry of Justice, who then prepared the relevant bills. The Cabinet then submitted the bills to the Diet. This is still the primary method through which corporate law reforms are made today. However, another route has emerged, whereby politicians (as members of the Diet) prepare and submit bills to the Diet without going through the Cabinet. In fact, the

introduction of the stock option system in the 1997 amendments to the Commercial Code was enacted using such path, which was the first time in Japan's history of corporate law reforms since World War II. The amendments in June 2001 (regarding liberalization of the regulation for repurchase of shares) and December 2001 (strengthening the statutory auditor system, introducing discharge of directors, and reforming shareholder derivative actions) and those in 2003 (regarding further liberalization of the regulation for repurchase of shares) were enacted in this way as well.

The background for this new trend is that, in each case, the Japanese business community wanted a speedy change and approached politicians, rather than referring the matter to the Legislative Council.

*Impact of METI*

Another important trend is that METI has had special statutes passed in the Diet that include special provisions for the Commercial Code. While this first happened more than ten years ago, two recent pieces of legislation show that this phenomenon continues today. The 1998 Act for Creating and Promoting New Businesses is a statute that supports new start-up businesses in Japan. Once a business obtains METI's authorization under the Act, it receives various favorable legal, tax, and other treatment. Such businesses enjoy special treatment that would not otherwise be permissible under the Commercial Code. The second statute, the 1999 Act for Special Measures for Rehabilitating Business, is designed to facilitate restructuring of large (as well as small) businesses. The structure of this act is similar to that of the Act for Creating and Promoting New Businesses. A business that has obtained authorization from METI enjoys special favorable treatment that would not be possible under the Commercial Code alone. It is important to note that special rules such as these have often been incorporated into the Commercial Code a few years after their enactment, and that it is through these special statutes that METI plays the leading role in bringing about changes in Japanese corporate law.

However, those special statutes do not have measures regarding the civil liability of managers and directors.

*Commercial Code Reform*

Through the amendments in December 2001, the Commercial Code introduced a new scheme that permits companies to restrict, under prescribed conditions, the liability exposure of directors. A company can now limit damages to amounts ranging from six years' worth of annual salary (including similar financial benefits) in the case of a representative director, to that of two years in the case of a non-executive director. It can do this through any of three methods: (1) an *ex post* resolution of a shareholders' meeting, (2) an *ex ante* charter provision, plus an *ex post* board decision (subject to lack of objection by at least 3 percent of the more shareholders), or (3) an *ex ante* charter provision, plus an employment contract between the company and the director (avail-

able only for outside directors). This scheme is only available for general negligence liability under Art. 266(1)(v) ComC, and does not apply to other specific liabilities that might arise as strict liability under Art. 266(1)(i) to (iv) ComC. These amendments also included technical changes concerning shareholder derivative actions, particularly recognizing settlement under prescribed conditions.

A draft proposal for future reform that was announced by the Ministry of Justice on October 29, 2003 includes a proposal that such strict liability be changed to negligence liability with the burden of proof put on directors. At the same time, the proposal asks for public comments on whether the system of shareholder derivative actions should be amended.

## III. Evaluation of Recent Developments : Interactions between Enforcement and Substantive Legal Rules

What do all of these recent developments mean? All countries have experienced developments, and those in Japan, as elsewhere, are the result of cultural, social, political and historical contingencies. Thus, the rules regarding the liability of managers and directors (and regarding shareholder derivative actions) seem to be developing quite uniquely in Japan. I am, however, inclined to argue that unique developments are producing non-unique results, and that the state of Japanese corporate law today is more, rather than less, similar to that of other countries' corporate law. The analysis to demonstrate this point is not simple. In this section, I focus on the interactions between enforcement and substantive legal rules.[9]

Any social system can be viewed as consisting of components or sub-systems, and legal rules are important components or sub-systems. Thus, for instance, a corporate governance system consists of a variety of components or sub-systems, such as a firm size component, a financial component, a labor component, a cultural component, and a legal framework component. With differing historical, cultural and legal peculiarities, the mechanisms and levels of enforcement are expected to vary from country to country, especially because of differences in the cost of enforcement relative to its value to enforcers.

Although substantive legal rules must be enforced, variations in enforcement costs do not necessarily affect the value of the legal component of a system at issue if the component has substitutabilities or complementarities with other non-legal components. Thus, for example, in a given corporate governance system, components such as the structure of ownership might substitute for the legal framework. In such a case, differences in the cost of enforcement might not be relevant, so long as the structure of

9 The discussion in this section draws from G. HERTIG / H. KANDA, Rules, Enforcement, and Corporate Governance (draft, 1998), where specific examples are provided. The discussion in Section III is highly abstract.

ownership does not change. Similarly, variations in enforcement cost might simply reflect different complementarities. For example, bank monitoring might be improved by a lower level of enforcement of manager liability by shareholders.

On the other hand, within the legal framework component, enforcement necessarily interacts with substantive rules. Since substantive legal rules must be enforced, the cost of enforcement affects the value of any substantive rule. In this sense, enforcement has complementarities to substantive rules. This suggests, first, that other things being equal, substantive rules do not converge when the cost of enforcement is different among jurisdictions. Second, we can expect convergence in substantive rules when the cost of enforcement is low: courts and regulators will develop substantive rules without worrying about their enforceability. This also holds where substantive rules are self-enforcing. Third, I submit that rules change when enforcement is too costly. Indeed, when this occurs there is reason to think that market and other forces might arise to make substantive rules change to ones that are enforceable at lower costs.

Simple numerical examples might be helpful to illustrate these points. First, suppose that the cost of enforcement for Rule A in Country X is 50, that the cost for Rule B in Country Y is 80, and that these substantive rules, Rule A and Rule B, differ from one another. Additionally, assume that the value (defined as how efficient the rule is to the system concerned, aside from the cost of enforcement) of Rule A is 100 and that of Rule B is 120. Disregarding complementarities and the like, other things being equal, the situation in Country Y is worse because the combined value of the legal rule (the value of Rule A or B minus enforcement cost) is 50 in Country X and 40 in Country Y. However, if complementarities exist, this might not be so because the combined value of the rule in Country Y might be more than 40; say, 50. In that case, both countries might stay as they are, with different rules and different enforcement situations. Second, suppose that the cost of enforcement for each of Rule A and Rule B is zero, and that Country X, if it knows Country Y's situation, might change Rule A to Rule B. Third, suppose that the cost of enforcement for Rule B in Country Y is 10,000. We would then hardly believe that complementarities would offset the disadvantage of Country Y having the overly costly enforcement situation. In such situation, because enforcement of Rule B is too costly, Rule B might change. Similarly, if Country Z, having a different substantive rule (Rule C with a value of 110), has an excessively costly enforcement situation – say an enforcement cost of 10,000 – we might expect that Rule C would change too. Thus, since both Country Y and Country Z might change their rules to ones that would be enforceable at lower costs, the rules of the two countries might well converge.

Two further notes are necessary. First, my discussion above has assumed that enforcement mechanisms do not converge. This assumption, however, is not plausible, at least in theory. Like a legal rule, an inefficient enforcement mechanism might face pressure to change.

Second, my discussion above has examined how enforcement affects substantive rules. In theory, one can think of the reverse linkage between enforcement and substantive rules: how convergence of substantive rules affects enforcement. For instance, if certain substantive rules are similar in two jurisdictions, judges in one jurisdiction might borrow precedents from the other jurisdiction, so that similar substantive rules might result in quicker and cheaper court decisions. If so, convergence of substantive rules affects the level of enforcement. Similarly, when preparing a new enforcement mechanism, if a similar substantive rule is adopted, the jurisdiction might be able to prepare a new enforcement mechanism rather quickly and easily by importing it from elsewhere.

## IV. PRELIMINARY CONCLUSION

What does the analysis in Section III suggest in evaluating recent developments in Japan with regard to the liability of managers and directors and shareholder derivative actions? At first look, the popularity of shareholder derivative actions seems to suggest that the cost of enforcement in this area has changed in the past fifteen years and is currently quite low in Japan. If so, my analysis suggests that substantive legal rules tend to converge toward those of other jurisdictions where such rules are enforced at low costs, as in the U.S.

Regarding outside or independent directors, *Professors Black, Cheffins and Klausner*'s work shows that they are almost never exposed to liability.[10] This is consistent with my analysis in Section III, in the sense that substantive rules in the U.S. and Japan are similar to one another. How does this relate to inside directors and managers? I think that the recent pressure in Japan to adopt the negligence standard as the test of judicial review is consistent with the current state of substantive legal rules in most states in the U.S. concerning duty of care cases. In contrast, rules regarding conflicts of interest seem to have different doctrinal formulations in the U.S. than in Japan. In the U.S., "entire fairness" is the standard of judicial review, while in Japan, the trend is to recognize the negligence rule, with the burden of proof being put on managers and directors. Here again, however, despite the different doctrinal formulations, the two rules seem to lead to similar results.

10 B.S. BLACK / B.R. CHEFFINS / M. KLAUSNER, Liability Risk for Outside Directors: A Cross-Border Analysis, University of Texas Law and Economics Research Paper No. 27 (2004).

ZUSAMMENFASSUNG

*Der Beitrag setzt sich mit der neueren Entwicklung im japanischen Gesellschaftsrecht auseinander, Organmitglieder großer, insbesondere börsennotierter Aktiengesellschaften für Fehlverhalten haften zu lassen. Seit Beginn der neunziger Jahre ist die Zahl der darauf gerichteten Aktionärsklagen drastisch gestiegen. Die hohen Schadenssummen haben im Jahr 2001 zu einer gesetzlichen Beschränkung der Schadenshöhe geführt. Die meisten Entscheidungen befassen sich bisher mit den Sorgfaltspflichten, die Organmitgliedern obliegen. Die Frage der Treuepflicht wurde hingegen erst am Rande erörtert. Als Antwort auf die Zunahme der Aktionärsklagen haben zahlreiche große japanische Unternehmen die Zahl ihrer Verwaltungsratsmitglieder erheblich verkleinert (*Sony *beispielsweise von 38 auf 10), um auf diese Weise die Haftungsrisiken zu verringern. Denn anders als Organmitglieder können leitende Angestellte nicht im Wege der Aktionärsklage zur zivilrechtlichen Verantwortung für Fehlverhalten herangezogen werden.*

*Neben zahlreichen Gerichtsentscheidungen hat auch der japanische Gesetzgeber die Entwicklung des Gesellschaftsrechts in den vergangenen Jahren massiv vorangetrieben. Auffällig ist die hohe Geschwindigkeit, mit der in diesem Bereich Reformvorhaben inzwischen umgesetzt werden.*

*Im dritten Teil seines Beitrages setzt sich der Verfasser mit der Frage auseinander, wie diese verschiedenen Entwicklungen zu interpretieren sind und insbesondere damit, ob eine Konvergenz der gesellschaftsrechtlichen Haftungsregime in den verschiedenen Industrieländern zu beobachten ist. Letzteres hänge entscheidend davon ab, wie die Rechtsdurchsetzung in den einzelnen Rechtsordnungen ausgestaltet sei, insbesondere welche Kosten damit verbunden seien. Soweit diese Kosten erheblich differierten, sei keine Rechtsangleichung zu erwarten; umgekehrt könne von einer Rechtsangleichung ausgegangen werden, wenn die Kosten gering sind. In Japan seien in den vergangenen 15 Jahren die Kosten für die Rechtsdurchsetzung im Bereich des Gesellschaftsrechts erheblich gesunken, was für eine Annährung an andere gesellschaftsrechtliche Haftungsregime spräche, bei denen – wie etwa in den USA – die Kosten ebenfalls gering seien.*

*(Die Redaktion)*