Ushijima & Partners
Compliance / Corporate Dispute / Crisis Management / Handling of Misdoings Newsletter

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How to deal with securities litigations (claims for damages based on false statements in annual securities reports, etc.) after the discovery of accounting fraud?

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1. Introduction

On August 8, 2023, the Japanese Industrial Partners (JIP), a Japanese domestic investment fund, and other domestic alliances launched a tender offer (TOB) in Toshiba. If the TOB becomes successful, Toshiba is expected to be delisted by the end of the year. Taking this opportunity, Toshiba will make a fresh start with the aim of eliminating the confusion of its management caused by the discovery of accounting fraud.

Toshiba was ordered to pay a record-high administrative monetary penalty (“AMP”) of more than 7.37 billion yen for the Toshiba accounting scandal discovered in 2015. In addition, a large number of shareholders alleged to have suffered damages due to a decline in the stock price, and filed a series of litigations claiming for damages in a nationwide court (“Toshiba-related lawsuits”). It is reported that the total amount claimed by the plaintiff shareholders in Toshiba-related lawsuits, including the lawsuits that have already been concluded, amounts to approximately 180 billion yen. (*1)

Some courts have recently rendered judgments granting some claims by the shareholders in Toshiba-related lawsuits (Tokyo District Court Judgment on May 13, 2021, Fukuoka District Court Judgment on March 10, 2022, Takamatsu District Court Judgment on March 28, 2023). These judgments also draw attention because they have made new decisions on the issues that have not been discussed in previous securities litigations, as well as issues that have been discussed in few cases.

Once a listed company such as Toshiba has been found to have window dressing and accounting fraud, there is a risk that it will be subject to criminal liability, payment orders of the AMP and other administrative dispositions, and it will be delisted. In addition, there is a risk that a large number of shareholders who allege to have suffered damages from a decline in stock prices due to stock transactions based on annual securities reports, etc. containing false statements may file lawsuits in nationwide courts.

Since the amendment of the Securities and Exchange Law in 2004, shareholder lawsuits (lawsuits seeking compensation for damages caused by false statements in annual securities reports, etc.) have been on the rise. The Company and its officers will assume the potential risk of incurring enormous damages from such litigations and must respond to such lawsuits over a long period of time. In addition to focusing on resolving individual litigation (by settlement, judgment, etc.),

the Company is required to respond carefully in anticipation that the resolution of such litigation may affect the outcome of related litigation brought by other shareholders.

This newsletter explains the characteristics securities litigations, including Toshiba-related litigation, which are recently in upward trend, and how to deal with such securities litigations.

*1: The Nihon Keizai Shimbun article on March 23, 2023

2. Characteristics of securities litigation

(1) The Special Provisions on Civil Liability are provided for in the Financial Instruments and Exchange Act.

In the event that there is a false statement in the disclosure documents such as the annual securities report, shareholders who have suffered damages from such false statement may pursue the tort liability under the Civil Code (Article 709 of the Civil Code, etc.) against the submitting company and its officers, etc.

However, in order to pursue tort liability under the Civil Code, shareholders must prove the damages and causal relationship, etc. Since the stock price of a listed company fluctuates due to various factors, it is extremely difficult for shareholders to prove the damages suffered by false statements and the amount thereof. As a result, in the past, there were not so many cases of lawsuits filed by shareholders who suffered damages due to a decline in stock prices caused by false statements in the annual securities report, etc.

Amendment to the Securities and Exchange Law in 2004 established special provisions on civil liability to reduce shareholder burden of proof of liability of the submitting company in the secondary market from the viewpoint of protection of shareholders (investors) and deterrence of misdisclosure. The amendment made it easier for shareholders to file a lawsuit against the submitting company, etc. (*2) to seek damages. As a result, the number of cases of securities litigations filed by shareholders has increased when accounting fraud has been discovered. The special provisions on civil liability stipulated in the Securities and Exchange Law have been passed on to the current Financial Instruments and Exchange Law (“FIEA”) after partial amendments, such as requiring negligence of the submitting company in the secondary market. (*3)

Article 21-2 of the FIEA stipulates the right to claim damages from the submitting company of a person who has acquired shares in the secondary market. As a special provision on tort liability under the Civil Code, the said article stipulates that the plaintiff shareholder is not responsible for the proof of intention or negligence of the submitting company, which is the defendant, but instead, the submitting company, which is the defendant, assumes the burden of proof that there was no intention or negligence; as such, the burden of proof has been changed (para.2 of the same article). In addition, the FIEA provides for a presumption of the amount of damages and causal relationship (para.3 of the said article), which reduces the burden on the plaintiff shareholders to prove. On the other hand, the upper limit of the amount of damages is also set for claims based on Article 21-2 of the FIEA (the main clause of para.1 of the said article, and para.1 of Article 19).

A shareholder may choose any laws at his discretion as the basis for making a claim for damages caused by false statements in annual securities reports, etc., among the Civil Code, the FIEA, and other laws which can be the basis therefor. Claims made under the FIEA have the advantages of reducing the burden of proof as mentioned above. On the other hand, the maximum amount of compensation by the submitting company is also specified. Therefore, if a shareholder pursues the responsibility for tort under the Civil Code simultaneously with the claim made under the FIEA, there is room for claiming compensation for damages in an amount that exceeds the maximum amount of compensation under the FIEA. In practice, shareholders often make claims under the FIEA and civil torts at the same time.

*2: The FIEA stipulates special provisions on civil liability to the submitting company as well as its officers, distributors, auditors, and former underwriters. This newsletter, however, primarily keeps in mind the pursuit of civil liability against the submitting company, which often becomes a defendant in practice.

*3: In addition to pursuing civil liability under the Civil Code and the FIEA, there is room for pursuing civil liability against the submitting company under Article 350 of the Companies Act.

(2) A Lot Of Shareholders Can Be Plaintiffs

In listed companies, there are typically large shareholders such as domestic and overseas institutional investors and financial institutions, as well as a large number of individual shareholders. As these shareholders may file lawsuits at the location of the head office of the company as well as at the shareholder's own location, securities litigations may be filed for a particular accounting fraud case in courts throughout the country. In addition, when accounting fraud cases are discovered, lawyers who act as counsel for the plaintiffs often solicit a large number of individual shareholders to submit a lawsuit against the submitting company, etc.

In the event that securities litigations are brought by a large number of shareholders in courts around the country, it is necessary to deal with them carefully in accordance with each individual shareholder's status because the nature of each shareholder, changes in the number of shares held, and the timing of share acquisitions and disposals will also vary from shareholder to shareholder.

In addition, shareholders may file lawsuits at any time until the right to claim damages based on false statements expires under the statute of limitation. Therefore, there is a potential risk that even shareholders who have not yet filed securities litigations may file new lawsuits at any time until the right to claim for damages held by such shareholders expires under the statute of limitation. In the meantime, if a lawsuit filed by another shareholder reaches a certain resolution, such as a settlement or judgment, there is a possibility that the shareholder who was looking at the situation may file a new lawsuit. In addition, since the contents of settlements and judgments with one shareholder may, in effect, serve as the basis for resolution in other litigations with other shareholders, it is necessary to carefully consider the effects on other shareholders when trying to resolve a litigation through settlement.

(3) The method of calculation of the amount of damages often becomes a major issue.

Securities litigations are characterized by a settlement or judgment in which at least some of the shareholder's claims are admitted and in which the shareholder's claims are rarely rejected in their entirety. This is because when accounting frauds are discovered, shareholders often file securities litigations after the FSA has issued an order for payment of an AMP following investigation by the Securities and Exchange Surveillance Committee. Therefore, it is often difficult for companies to reverse the existence of false statements found by the Securities and Exchange Surveillance Commission, which is a specialized institution, in securities litigations in practice.

Accordingly, the company should consider whether there is room for contesting the existence of false statements first. If this is difficult, in securities litigation, the main issue is how to calculate the amount of damage suffered by shareholders due to the false statements. In order to minimize the amount of damage determined by the court as small as possible, the company will consider rebutting and proving the specific method of calculation of damage.

Several precedents have been issued by the Supreme Court as the leading cases that indicated the method of calculation of damages suffered by shareholders based on false statements in annual financial reports, etc. However, although the Supreme Court provides a framework for calculation, there are still a number of issues in which the Supreme Court has not made a decision regarding the specific method for calculating damages, and many of them are being contested in lower courts. In addition, each shareholder has specific circumstances regarding, among others, the timing of the stock transactions and the recognition of false statements. Therefore, the company that is the defendant in the securities litigation needs to consider individual handling according to the specific circumstances of each shareholder.

3. Framework of judgment presented by the Japanese Supreme Court

(1) Overview

The Supreme Court provided a framework for making decisions on a number of issues concerning false statement in annual securities reports in the judgments of the Seibu Railway Case and Livedoor Case as described below, and these

judgments have had a significant impact on subsequent court practice as the leading case in securities litigation.

The judicial framework indicated by the Supreme Court in these judgments is diverse. The following explains the framework indicated by the Supreme Court, focusing on the method of calculating the amount of damages.

(2) The Seibu Railway Case (Supreme Court judgment on September 13, 2011, Minshu Vol. 65, No. 6, at page 2511)

The Seibu Railway Case is a case in which shareholders of Seibu Railway claimed for damages in tort on the grounds that shareholders suffered damages from delisting due to a false statement in the annual securities report, etc. that hides the fact that Seibu Railway violated the Standard of the number of shares held by the specific minority persons stipulated in the listing regulations of the Tokyo Stock Exchange.

Although the application of the Securities and Exchange Law (FIEA) was not an issue in this case, this is the first leading case in which the Supreme Court made a decision on the method of calculating the amount of damages suffered by shareholders due to false statements.

The framework for determining how to calculate the amount of damages indicated in the Supreme Court decision on the Seibu Railway Case was subsequently cited in the Supreme Court decision on December 21, 2012, No. 1386 of the Urban Corporation Supreme Court decision as well, in which claims for damages based on para. 1 of Article 21-2 of the FIEA were discussed, and this has had a major impact on the court practice since then.

In the Seibu Railway Case, the Supreme Court first found that the shareholders who became the plaintiffs in the case should not have acquired the shares unless there was a false statement. On this basis, the Supreme Court indicated that the amount of damages incurred by shareholders due to such false statement should be calculated as follows.

(i) For shareholders who have already disposed of shares

Amount of damages = (Acquisition price - Disposal price) - Amount of decline in market value not attributable to false statements

(ii) For shareholders who still hold shares

Amount of damages = (Acquisition price - Appraisal value at the conclusion of the oral hearing of the fact-finding instance) - Amount of decline in market value not attributable to false statements

The Supreme Court also held that the "decline in market value not attributable to false statements," which is deducted from the amount of damages, includes economic conditions, market trends, and the company's performance, etc.

On the other hand, it was not allowed to deduct for an excessive decline in market value due to the concentration of a so-called “fire sale” after the disclosure of false statements, from damages on the assumption that this would normally occur as a result of the discovery of false statements.

(3) Livedoor Case (Supreme Court judgment on March 13, 2012, Minshu Vol. 66, No. 5, at page 1957)

The Livedoor Case is a case in which shareholders of Livedoor claimed damages due to a false statement that the company was in an ordinary profit despite the fact that the company was in an ordinary loss in the annual securities report. This is the first Supreme Court judgment for the first time that the application of the presumption provision on the amount of damages stipulated in para. 3 of Article 21-2 of the FIEA (para. 2 of the same article before the revision of the FIEA in 2014; the same shall apply hereafter), and is treated as a leading case in securities litigation, alongside the Seibu Railway Case judgment.

Para. 3 of Article 21-2 of the FIEA stipulates that a person who acquires shares within one year prior to the announcement date of a false statement and continues to hold the said shares as of the said announcement date may claim for the amount equivalent to the difference between (i) “the average market value of the said shares during the one month prior to the

announcement date” and (ii) “the average market value of the said shares during the one month following the announcement date” as the amount of damage caused by the false statement.(*4)

Para. 6 of the said article (Para. 5 of the said article before the amendment of the FIEA in 2014; the same shall apply hereinafter) provides that in cases where it is found that all or part of the damages suffered by a shareholder was caused by circumstances other than the decline in the price of the said share that should arise from the said false statement, but it is extremely difficult to prove the amount due to the nature of the damages, the court may determine a reasonable amount of damages as the amount of damages for which the submitting company is not liable.

In the Livedoor Case, the Supreme Court determined that "damages" as set forth in para. 1 of Article 21-2 of the FIEA should be construed to include all damages that have reasonable causal relationship with false statements, as in the case based on the provisions of general tort, and determined that the damages set forth in para. 3 of the said article are not limited to the difference at the time of acquisition but include all damages that have reasonable causal relationship with false statements. Furthermore, the Supreme Court determined that "the decline in the value of shares that should be caused by the false statements" set forth in para. 6 of the said article refers to all declines that have reasonable causal relationship to false statements.

Based on this decision, the Supreme Court determined whether or not the various specific circumstances in dispute between the parties falls under "circumstances other than the decline in the price of shares that should arise from the false statement." In conclusion, the Supreme Court affirmed the ruling of the original instance court which approved a reduction of 10% from the presumed amount of damages under para. 3 of the said article.

In addition, in the Livedoor Case, the Supreme Court indicates framework for judgment on a wide range of issues, including the meaning of “material particular that is required to be stated and that the document's false statement, etc. concerns” (para. 4 of Article 21-2 of the FIEA (para. 3 of the said article before the amendment of the FIEA in 2014)), the method for calculating the amount of damages if a shareholder acquires and disposes of the shares at different values on multiple occasions, and the time when the obligation for compensation for damages is delayed.

*4: Although the provisions of the FIEA refer to such securities, this newsletter refers to such shares for convenience.

4. How to deal with securities litigations in practice?

(1) Introduction

If a shareholder brings a securities litigation, the company will first consider what allegation and proofs should be made with the aim of dismissing all claims brought by the shareholder. Even if the whole dismissal of the shareholder's claims is not allowed, the company will consider what allegations and proofs should be made in order to limit the amount of damages granted as much as possible.

The following explains the specific allegations and proofs to be considered by the company with respect to the existence of damages and the scope thereof that are often the main issues when securities litigations are filed by shareholders.

(2) Types of Damages in Securities Litigation

A shareholder who has suffered damages due to a false statement in an annual securities report, etc. shall attempt to allege and prove the existence of the damages and the amount thereof which has a reasonable causal relationship with the false statement to the submitting company, etc. In practice, shareholders are increasingly trying to allege and prove damages under either (i) the damages of the acquisition itself, (ii) the damages of the acquisition at a high price (the difference between the acquisition price and the fair value), or (iii) the damages under the presumption provisions of the FIEA or combining the above (i), (ii) and/or (iii), based on the aforementioned framework indicated by the Supreme Court judgments. (*5)

Even in the case of alleging and proving any of the damages mentioned in (i) to (iii) above, the conclusion should not be changed because all the damages that have a reasonable causal relationship with the false statement are ultimately subject to

compensation. However, since the matters to be alleged and proved or the burden of the allegation and proof vary depending on the individual case, it can be said that in actual litigation, the plaintiff shareholder often alleges the matters that can easily be alleged and proved as damages.

(a) (i) Damages of acquisition itself

The Supreme Court decision on the Seibu Railway Case found that the shares of Seibu Railway should have been delisted without a false statement, and that the plaintiff shareholders would not have acquired the shares of Seibu Railway, and damages based on the acquisition price of the shares were granted.

In the event that losses incurred by the acquisition itself are claimed to be damages, the plaintiff shareholder should allege and prove the damages based on the acquisition price, and the company, which is the defendant, should assume the burden of allegation and proof with regard to the portion of the decline in the market price (the portion that should be deducted from the amount of the damages) that does not have a reasonable causal relationship with the false statement, and therefore, it is said that the plaintiff shareholder can take advantage in proving the damages.

If the plaintiff shareholder alleges and proves the losses incurred as a result of the acquisition itself as damages, the company would first attempt to allege and prove that it cannot be said that the plaintiff shareholder would not have acquired the shares without a false statement. In addition, the company will allege and prove that the damages claimed by the plaintiff shareholder include the damages caused by circumstances unrelated to the false statements (decline in stock price). In this regard, the Supreme Court decision on the Seibu Railway Case allows deduction from the amount of damages on the grounds that a decline based on economic conditions, market trends, and the company's performance is caused by circumstances not related to the false statements.

(b) (ii) Damages of the acquisition at the high price (the difference between the acquisition price and the fair value)

The plaintiff shareholder may also claim that the acquisition of shares at an unreasonably high price caused damages (damages of the acquisition at the high price) because he/she would have been able to acquire shares at a lower price, even if it cannot be said that he/she could not have acquired the shares without a false statement.

In this case, the plaintiff' shareholder may allege and prove that the reduction in the market value in excess of the difference between the actual acquisition value at the time of the acquisition and the assumed market value in the absence of any false statement is the damages which have reasonable causal relationship with the false statement. In this case, it is said that the plaintiff is at a disadvantage compared to the case of (i) damages incurred as a result of the acquisition itself in terms of the burden of allegations and proofs because the plaintiff shareholder should proactively allege and prove that the amount of the decline in the market share price exceeding the acquisition of the high price is damages having a reasonable causal relationship with the false statement.

On the other hand, the company will allege and prove that the damages claimed by the plaintiff shareholder includes the damages caused by circumstances unrelated to false statements (decline in stock price).

(c) (iii) Damages based on the presumption of the FIEA (para. 3 of Article 21-2 of the FIEA)

Para. 3 of Article 21-2 of the FIEA allows shareholders satisfying the requirements of the same paragraph to presume the amount of damages calculated by the following formula as the amount of damages caused by false statements.

Shareholders who acquire shares within one year prior to the announcement date of a false statement and continue to hold the said shares as of the said announcement date may calculate the amount of damages by the following formula

Amount of presumed damages = average market value of the said shares during the one month prior to the announcement date – average market value of the said shares during the one month following the announcement date (*6)

However, even where the presumption of the FIEA is applied, the amount calculated using the following formula is the maximum amount of the amount of damages (para. 1 of Article 21-2 and para. 1 of Article 19 of the FIEA).

(i) In case where the shareholder holds shares at the time of the claim for damages;

Maximum amount of damages = acquisition price – market price at the time of the claim for damages (Estimated disposal price if no market price is available)

(ii) In case where the shareholder has already disposed of the shares by the time of the claim for damages;

Maximum amount of damages = acquisition price - disposal price

In case where the plaintiff shareholder has claimed damages under the presumption of the FIEA (para. 3 of Article 21-2 of the FIEA), the company should allege and prove that all or part of the presumed damages were caused by circumstances other than the relevant false statement and request a reduction in the amount of damages (para. 5 of Article 21-2 of the FIEA). In such case, if the company succeeds in proving that all or part of the presumed damages have arisen due to circumstances other than the relevant false statement (economic conditions, market trends, performance of the company, etc.), the company may, at the discretion of the court, be granted a substantial reduction in the amount even if it cannot prove the specific amount of the decline due to such circumstances (para. 6 of the same article).

In addition, the amount of presumed damages may change significantly depending on the announcement date of the false statement. Therefore, the company should examine the relationship between the announcement date and the amount of presumed damages, and allege and prove an appropriate announcement date if necessary.

*5: Other than those items, a shareholder may claim damages based on the decline in the share price due to the discovery of the false statement.

*6: If there is no market price, it is applied by replacing the estimated disposal price.

(3) Statute of Limitation of Claims to Demand Compensation for Damages (Article 724 of the Civil Code and Articles 21-3 and 20 of the FIEA)

(i) In the event a shareholder intends to claim damages against the company under the relevant provisions of general tort under Civil Code (Article 709, etc. of the Civil Code), the shareholder's right to claim damages shall expire due to the statute of limitations when three years have elapsed since the shareholder became aware of the damages and the perpetrator (the same shall apply when twenty years have elapsed since the time of the tort) (Article 724 of the Civil Code).

(ii) In case where a shareholder intends to exercise his/her right to claim for damages against the company under Article 21-2 of the FIEA, the shareholder's right to claim damages shall expire due to the statute of limitations when two years have elapsed from the time when the shareholder became aware of the existence of a false statement in the annual securities report, etc. or when the shareholder was able to know it with reasonable care (the same shall apply to cases where five years have elapsed from the time of submission of the annual securities report) (Article 21-3 and Article 20 of the FIEA).

Accordingly, if the company receives a claim for damages from a shareholder based on a false statement in its annual securities report, etc. the company should examine whether or not the claim for damages asserted by the shareholder is within the relevant prescription period provided for in the Civil Code or the FIEA and, if necessary, it should allege and prove it.

5. Conclusion

Recently, the number of securities litigations filed by shareholders has been increasing, and decisions by the courts have been gradually accumulating based on the aforementioned leading Supreme Court precedents.

If a shareholder brings a securities litigation in a company where accounting fraud has been discovered, the handling of the lawsuit will require specialized knowledge of relevant laws and judicial precedents, etc., and the outcome of the lawsuit will vary greatly depending on how the lawsuit is handled. Therefore, the case should be handled cautiously.

(End)

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