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# Transformation of the Management Liability Regime in Japan:

# In the wake of the 1993 Revision

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# I. Introduction

Few would disagree that the reform on the derivative action system in 1993 was one of the most influential events in the history of the Japanese corporate governance regime. Shareholders' derivative action, which had been dormant since its introduction in 1950, was suddenly activated. No other revision has been more criticized by the business community. Few revisions have been more controversial in academic circles.

It was, however, a little enigmatic as to why this reform took place at all. It has been well recognized in recent economic literature that corporate governance systems in each state are full of "complementarities."[1] When a system is marked by strong and widespread complementarities, it may be difficult to change. Changing only a few of the system components, rather than a fully coordinated move of the whole system, may have negative effects.[2] Although economic analyses often focus on complementarities among non-legal elements or between legal and non-legal elements of the corporate governance system, they also exist between legal rules. Kanda and Fujita (1998), for example, argued that complementarities among legal rules are the key to understanding the variety and the evolution of the corporate law in each country. Their argument puts forward the following predictions:

(1) The legal rules are stable where strong complementarities exist among them. Even if a specific rule looks inefficient, it does not easily disappear under these conditions.

(2) Legal rules are unstable where strong complementarities do not exist. Numerous corporate law reforms in postwar Japan have occurred in areas where relatively weak complementarities exist.

(3) Even where strong complementarities exist, change could occur if an extraordinary force simultaneously changes a set of rules as a whole. Such changes would take place within an unusual political environment – Japanese corporate reform following World War II, under the direction of GHQ, is a notable example.

Although Kanda and Fujita (1998) observe that the development of Japanese

1 See, for example, Aoki (2001). For formal mathematical treatments of complementarities, see Milgrom and Roberts (1990) and Milgrom and Roberts (1995). For the application of the concept to Japanese firms, see Milgrom and Roberts (1994).

2 Milgrom and Roberts (1995).

corporate law has basically followed the pattern suggested above, the 1993 Revision of the Commercial Code, which includes the reform of derivative actions, was a notable exception for their hypothesis.[3] The 1993 Revision took place in an area where one of the strongest complementarities exists, and a single but significant rule was changed without accompanying rules that also have complementarities. It was, and still is, difficult to understand how such a phenomenon could ever occur.[4]

However, the story did not end there. Management liability regime under Japanese corporate law has experienced continuing change since 1993. It is a little unfortunate that a lot of corporate governance literature focuses on the 1993 reform in an isolated manner and simply ignores the subsequent changes. This article traces the aftermath of the 1993 Revision.

The article begins with the 1993 Revision on derivative action (Part II). While the Revision is relatively well known,[5] a brief explanation here might be helpful. Empirical studies on the reform are also reviewed. Part III examines the further developments of procedural rules for derivative action. They can be regarded as a direct response to the 1993 Revision. The reform of the exoneration procedure for management's liability, another direct response to the revision follows (Part IV). Finally, we will see the changes in substantive rules on management liability (Part V). Part VI is the conclusion.

## II. The 1993 Revision as an Unexpected Shock

### A. Derivative Action under Japanese Law, before the 1993 Revision

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3 Kanda and Fujita (1998), p 474, footnote 46. The three predictions in Kanda and Fujita (1998) may be supplemented with the following: When a change of part of the components in corporate law does take place in an area where strong complementarities exist, subsequent changes in legal rules will follow.

4 Motoyoshi Nishikawa, one of the leading actors in the corporate law reform process representing the industry, recalls that people in industry regret that they easily accepted decreases in litigation fees without introducing such systems as exoneration of management liability, litigation committees, business judgment rules, requirements for "fair and equitable" representation and D&O insurance. See, Jurist No. 1277, p 91 (2004).

5 See, for example, West (1994) and Milhaupt and West (2004).

Derivative actions had been incorporated into Japanese corporate law by way of the 1950 Revision, together with other elements of the American system, including the board system and authorized capital. The number of derivative actions, however, had been surprisingly modest until the 1990s.[6] Although the small number of derivative actions has sometimes been erroneously attributed to the general anti-litigation sentiment among the Japanese people,[7] the litigation fee became recognized as the real determining factor.

Under the Japanese litigation system, plaintiffs must pay the litigation fee upon filing a lawsuit,[8] and the fee is calculated based on the "amount of the claim."[9] It was thought, in court practice, that the "amount of the claim" in the case of derivative action is the amount of the management's alleged liabilities to the company, and not the economic benefit of the plaintiff (i.e., individual shareholders) should they win. This means that shareholders had first to pay large sums of money, before they could file a derivative action claim for substantial damages.[10] Although this interpretation was later decided to be incorrect by the Supreme Court,[11] the court practice had been a grave obstacle for derivative action in Japan for many years.

## B. The 1993 Revision as an Unexpected Shock

The 1993 Revision of the Commercial Code effectively set a ceiling for the

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6 Milhaupt (2003) reported that Japanese shareholders brought a total of approximately 20 derivative actions during the period of 1950 to 1990.

7 Since changes to rule regarding the payment of litigation fees dramatically increased the number of litigations, it is now apparent that the costs of litigation – rather than the cultural background – had been the key obstacle.

8 Although the loser of the suit ultimately bears the litigation fee, the initial financial burden is on the plaintiff.

9 Article 3 of the Law on the Fee of Civil Lawsuits.

10 For an example of the calculation of a litigation fee, see West (1994).

11 Asai v Iwasaki et al, Kosai-Minshu [High Court Reporter] v 46, p 20 (Tokyo High Court, May 30, 1993) decided that the litigation fee for the derivative action was ¥8200. Tokyo High Court thought that a derivative action was a lawsuit with respect to non-property claims and calculated the litigation fee on that basis. An appeal to the Supreme Court was denied (Asai v Iwasaki et al, Kinyu-Shoji-Hanrei [Financial & Commercial Cases], v 1105, p 15 (Supreme Court, October 10, 2002).

litigation fee[12]. The revised Article 267(4) of the Commercial Code provides that a derivative action "shall be deemed to be lawsuits with respect to non-property claims for the calculation of the amount of the claim." The amount of non-property claims was, pursuant to Article 4(2) of the Law on the Fee of Civil Lawsuits, deemed to be ¥950,000 and the litigation fee was fixed at ¥8, 200, regardless of the amount of alleged liability.

Although a similar proposal had been advocated by some academics,[13] it was a little surprising that such a reform had been achieved so easily and without resistance from the industry. Whatever the reason driving the Revision, it was effective enough, and the number of derivative actions has risen considerably since 1993.[14]

## C. The Economic Impact of the Revision

### *(1) Introduction*

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12 Although it is often described that the 1993 Revision changed the rule for litigation fees, it, according to the Asai v Iwasaki supra note 11, simply confirmed the correct interpretation of the previous law.

13 See, Takeichi (1998).

14 The number of the derivative suits pending at district and high courts. I am grateful to Shoji-Homu Co. for the data.

| Date | District Courts | High Courts | Total |
|---|---|---|---|
| December 31, 1993 | 76 | 10 | 86 |
| December 31, 1994 | 129 | 10 | 139 |
| December 31, 1995 | 148 | 14 | 162 |
| December 31, 1996 | 150 | 13 | 163 |
| December 31, 1997 | 172 | 15 | 187 |
| December 31, 1998 | 186 | 14 | 200 |
| December 31, 1999 | 202 | 18 | 220 |
| December 31, 2000 | 187 | 20 | 207 |
| December 31, 2001 | 166 | 23 | 189 |
| December 31, 2002 | 141 | N.A* | N.A |
| December 31, 2003 | 150 | N.A | N.A |
| December 31, 2004 | 126 | N.A | N.A |
| December 31, 2005 | 102 | N.A | N.A |

*Due to the change of the Supreme Court's policy on statistical data, only the number of cases pending in district courts is available since 2002.

Was the reform good news for corporate governance in Japan? Has the performance of Japanese companies improved due to increased pressure from shareholders? Proponents of the unique governance system of Japanese firms might argue that the high costs of litigation had effectively suppressed shareholder activism and had also protected the unique system ("J-model") under which management is relatively independent of the shareholders' interests.[15] From this viewpoint, the 1993 Revision had a seriously detrimental impact. On the other hand, a series of recent empirical studies assert that firms show more excellent performance in those legal systems with greater shareholders' rights[16]. It might be argued that the reform, in the long run, would improve the performance of Japanese firms.

The answers to these questions are inconclusive. This is in part because a long recession of the Japanese economy followed the 1993 Revision and the macro economic influence made the impact of the revision rather untraceable. If the impact on firms' performance in general is not available, one should focus on other kinds of data.

*(2) The effect of the filing of derivative actions*

A line of literature studies the impact of the filing of derivative action after the 1993 revision and suggests that litigation simply destroys the value of firms. West (2002) and Fukuda (2001) using the method of "event study," have found there has been a very small – perhaps even a slightly negative – impact on the return of a company's stock due to the filing of derivatives. The results seem plausible when one takes into account the low probability of successful suits and the limited amounts recoverable in such cases. The result is hardly surprising. Studies in the United States had already shown similar findings[17].

However, the decline of the company's value at the beginning of a derivative action, at least in theory, does not necessarily mean that such litigation should always be avoided. The principal had best, in some cases, enforce the agent's liability – even when the enforcement itself is not cost-effective – in order to give an optimal incentive to the agent[18]. This is a phenomenon that economic literature calls "dynamic inconsistency,"

15 Aoki (1990) points out that the relative independence of management has been one of the salient features of Japanese corporate governance.

16 Schleifer and Visny (1997).

17 Romano (1991).

18 Baird, Gertner and Picker (1994) p 117

where an optimal *ex post* action does not offer the optimal *ex ante* incentive[19]. A derivative action *may* be such an example.

*(3) The effect of the 1993 Revision on the stock price of firms whose managements were sued*

Is the incentive effect of possible derivative action plausible? Critics of the derivative actions might assert that the disciplinary effect is illusory. Hirose and Yanagawa (2002) tried to measure the disciplinary effects of the enhanced probability of derivative action. They analyzed the reaction of stock prices of the Nikkei 225 Companies to the 1993 Revision. Their study concludes that the Revision enhanced the monitoring function on management behavior. Their analysis found that the share prices of those firms whose directors were sued by derivative action shortly after the Revision showed a negative response to the 1993 Revision, compared to other firms. In addition, they compared (1) those firms whose directors lost a derivative action after the Revision and (2) those firms whose directors won. It was confirmed that the former showed a relatively deeper drop in their stock price when the 1993 Revision went into effect.

Although the increased probability of the derivative action, in theory, could (1) cause increased expected costs to the company resulting from the litigation and (2) enhance the disciplinary effect on the managements' future behavior, Hirose and Yanagawa (2002) interpret the negative reaction of the firms' stock price to be a proxy of the increased probability of subsequent derivative actions.[20] The reason is as follows: It is most likely that derivative actions analyzed in the article are related to management behavior prior to the 1993 Revision – which, of course, was not influenced by the change. Therefore, one can safely simply assume that the different reaction of stock price between firms whose managements were sued after the revision and other firms reflects the increased probability of the litigations and related costs to the company.

If shareholders' derivative actions work correctly (i.e., are directed against legally responsible managements who are likely to be sued), the stock market would expect the 1993 Revision to raise the probability of litigation against those companies whose directors acted improperly before the revision more sharply than others and the stock prices of such companies would drop accordingly. This was exactly the result that

19 As seminal works, see Kydland and Prescott (1977) and Barro and Gordon (1983).

20 West (2002) and Fukuda (2001) report a negative impact of filing derivative action on the firm's stock price.

Hirose and Yanagawa (2002) found in their study. Therefore, Hirose and Yanagawa (2002) conclude that the stock market expected that the responsible directors were more likely to be sued than others and in this sense the 1993 Revision enhanced the monitoring function over management's misbehavior.

Several reservations should be appended to the above conclusion. First, even if the Revision enhanced the monitoring function and thereby improved the firm's performance, as Hirose and Yanagawa (2002) argue, the effect may not outweigh the expected costs caused by wasteful litigations. Second, the conclusion was drawn on the hypothesis that those directors who lost a derivative action "misbehaved" prior to the Revision. This assumption relies upon an optimistic view that the substantive rules on management liability under Japanese corporate law are correctly imposed on behaviors that need to be deterred, and that the court does not err in applying those rules. As is shown in the latter part of this article, the substantive rules on management liability changed significantly after the 1993 Revision and this casts a strong doubt upon the assumption that the rules at that time were optimal.

### D. Summary

The number of derivative actions increased dramatically after the 1993 Revision. The revision drew the attention of corporate law researchers, who tried to measure its economic impact. For the reasons explained in this Part, the result is ambiguous. What is worse, there is another factor that would make the conclusion even more inconclusive. Although commentators have focused on the increased number of derivative actions, this cannot constitute a whole evaluation of the 1993 Revision. It is not only the number of litigations that the Revision caused; rather considerable and subsequent transformations have occurred to the management liability regime in the wake of the Revision. The following Parts trace those changes.

## III. Transformation in Procedural Rules on Derivative Actions

### A. Abusive Use of Derivative Actions

Soon after the 1993 Revision, many lawyers recognized the necessity of properly regulating worthless litigations. Although the possibility for the "abusive use" of derivative actions had often been mentioned (or even exaggerated) even prior to the

1993 Revision, the nature of the problem of possibly worthless derivative actions was not well understood until recently.

The possibility of abusive litigations is not a phenomenon unique to derivative actions and it is, to some extent, unavoidable for any judicial procedure. However, it is worth noting that "abusive litigation" has a unique feature in the context of derivative actions compared to ordinary litigation. "Abusive litigation" ordinarily means an unreasonable filing of an action by the plaintiff, with intent to harass the defendant or to acquire unjustified benefits from litigation at the cost of the defendant. The main concern with worthless derivative action is not the harm to the defendant; rather, it is the interest of the shareholders as a whole that is at stake. In other words, the problem lies not in the conflict between the plaintiff and the defendant, but among potential plaintiffs (i.e., shareholders). This is why the derivative action needs additional consideration compared to ordinary "abusive litigations."[21]

Corporate law should offer a mechanism by which to achieve an optimal level of enforcement for management liability. If the incumbent management were to have exclusive discretion to dismiss derivative actions, the enforcement level would become too low; such is the very reason why derivative action exists. However, if an individual shareholder has unlimited discretion for enforcement, the decision made by each shareholder does not necessarily maximize the interest of the shareholders as a whole; they might simply behave irrationally, or they might have a private interest in bringing about a lawsuit that is not compatible with the interests of other shareholders. Indeed, it was reported that a substantial portion of increased derivative actions were motivated by something other than shareholder wealth maximization.[22]

The issue is even more aggravated by the fact that Japanese law was not equipped with mechanisms to deter the problems. For instance, unlike U.S. law,[23] Japanese procedural law does not require that the plaintiff of the derivative action "fairly and adequately" represent the interests of shareholders. There is no "special litigation committee" system under the U.S. law whose decision to dismiss the

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21 A commentary by the former Counselor of the Civil Affairs Bureau in the Ministry of Justice demonstrates that a proper understanding of the unique problem of worthless derivative actions was completely lacking (Yoshikai (1996)). [There is always the possibility of abusive litigation in every legal procedure, and it is inappropriate to build a preventive mechanism designed only for abusive litigation against directors.]

22 West (2002).

23 See, Federal Civil Procedure Rules 23.1.

derivative action is more or less respected by the court[24]. It was asserted that a certain mechanism should be incorporated into Japanese corporate law to correct decisions by an individual shareholder. How can this be achieved? We will see the courts' efforts in the following section.

## B. Court Order to Post a Bond: Current Court Practice

### *(1) Court Practice after the 1993 Revision*

To regulate worthless litigations, the courts began shortly after the 1993 Revision to rely on the order for posting a bond by the plaintiff. Articles 267(6) and (7) of the Japanese Commercial Code (Article 847 (7) and (8) of the Corporate Code 2005) provide that a court shall, upon the request of the defendant, order the plaintiff of the derivative action to post a bond as security when the defendant establishes the *prima facie* case that the derivative action was filed in "bad faith."[25] Defendants of a derivative action almost always seek said bond, and the order is often granted.

Current prevailing court practice dictates that the court should order the bond in cases where, (1) the plaintiff would be most likely to lose the merit, but he nevertheless dares to bring an action recognizing the likely results; and (2) the plaintiff filed the litigation action with the purpose of obtaining unlawful gain from the litigation.[26] The majority of cases have relied on the first of these two criteria when ordering the bond posting.[27] These requirements are derived from the Supreme Court Decision[28] that set forth the criterion where a malicious civil litigation constitutes a tort to the defendant. The assumption is that a court order to post bond against the plaintiff is

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24 The standard of review by the courts to the committee's decision varies among States. Compare the approach of the cases such as Zapata Corp. v. Maldonado, 430 A. 2d 779 (Del. 1981) [Delaware], Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y. S. 2d 920, 939 N.E.2d 994 (1979) [New York] and Alford v. Shaw, 320 N.C. 465, 358 S.E.2d 323 (1987) [North Carolina].

25 Article 106(2).

26 Morita v. unidentified respondent, Tokyo District Court, Hanrei-jiho v. 1504, p 121 (July 22, 1994).

27 Morohashi v. Suzuki, Tokyo High Court, 159 Shiryoban Shoji-homu 193 (May 30, 1997); Taguchi v. Kuji, Gifu District Court, 155 Shiryoban Shoji-homu 148 (January 16, 1997); Ito v. Suzuki, Nagoya Distict Court, 1473 Kinyu-homu-jijyo 47 (June 10, 1996); Ito v. Suzuki, Nagoya High Court, 1531 Hanrei Jiho 134 (March 7, 1995).

28 Hirohara v Nagano, 42 Saihan Minshu [Supreme Court Reporter (Civil)] 1 (January 26, 1988).

to secure the defendant's potential claim against the plaintiff for filing a wrongful lawsuit.[29]

Although this criterion is based in the adequate financial security of the defendants' (managements') claim against the plaintiff (a shareholder), it appears that the court, in realty, considers whether the derivative action in question serves shareholders' interest, rather than whether it constitutes wrongful litigation (i.e. a tort) against the defendant.[30] In other words, the court order for bond posting has served as a substitute for the requirement of "fair and adequate" representation in the United States.

*(2) A Proposal in the 2005 Revision*

Many commentators observe that the courts' practice of issuing bond orders has worked well within its limit.[31] Empirical research has found a positive reaction to the share price when the order is issued.[32] The result could be interpreted that the court order has effectively excluded worthless litigations.

On the other hand, there appears to be a discrepancy between the form and substance in this practice because the court order, by nature, is designed for the protection of the defendant; it is not intended to circumvent worthless litigations that are not compatible with the shareholders' interests.[33] This results in limitations to court orders. The court order, for example, cannot prevent litigations where the plaintiff has a considerable chance of winning, because the litigation by a winning plaintiff usually does not constitute a tort. However, the continuation of such litigation, even if the plaintiff could win, may not be wise in terms of benefits to the shareholders as a whole, considering litigation costs, possible damage to the reputation of the company and other circumstances.

The proposed Revision in 2005 intended a more straightforward solution. The revision confers upon the court the power to dismiss an action when the continuation of such an action leads to unreasonable costs or damage to the company. The law denies derivative action where: (1) the purpose of the litigation is either to derive benefits for the plaintiff or other person, or to damage the company; or (2) it is,

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29 As to the "abuse of rights" doctrine that provides the foundation for claims against the plaintiff, see, West (1994), pp 1468-70.

30 Fujita (1998).

31 Kabunushi Daihyo Sosho Seido Kenkyu-kai (2001).

32 West (2001) and Fukuda (2000).

33 See footnotes 22 and 23, and accompanying text.

with adequate certainty, expected that the litigation would cause serious damage to the interest of the company, would impose an excessive cost to the company, or the like (Proposed Corporate Code Article 847(1)). The first limitation refers to a general limitation for abusive litigation, and it is not unique to derivative actions. The second can be understood as a Japanese version of the "fair and adequate" representation requirement for the plaintiff of derivative actions[34]. If the proposal had been adopted, the courts could have considered explicitly whether the litigation is good for the company (i.e., shareholders as a whole), rather than whether it is a wrongful action for the defendant.

During the discussion in the Diet, the second limitation was deleted from the final bill as one of a packaged deal between political parties. It was argued that while the new Corporate Code marked considerable "deregulation," it was necessary not to lose the monitoring function of the derivative action against the management. Although not finally adopted in the 2005 Revision for political reasons, it is worth noting that the necessity for the circumvention of worthless derivative actions was recognized in the discussion of the Legislative Council of the Ministry of Justice.

### C. Company Intervention in Derivative Action for the Benefit of the Directors

#### *(1) Introduction*

Shareholders are required to demand that the company enforce management liability before they file a derivative action (Article 267(1)-(3) of the Commercial Code, Article 847(1), (3) and (4) of the Corporate Code 2005). Once the company rejects the shareholders' demand and the derivative action is subsequently filed, the board is likely to try to persuade the court that its decision not to sue the management was correct, and to challenge the shareholder's decision as being wrong. Such a challenge takes a form of company intervention in (or participation in) the derivative action.

34 The industry wanted an even more radical solution, namely, a "litigation committee" system (Japan Business Federation (Nippon Keidanren), Proposal for Revision of the Corporations Law: Securing International Competitiveness for Corporations, Respecting the Choices of Corporations, Shareholders, and Other Stakeholders (October 16, 2003)). The litigation committee, consisting of a body of independent parties, can decide whether a derivative action should be continued or removed for the benefit of the shareholders. The idea is apparently based on a similar practice in the United States (see, Klein and Coffee (2002), p 200-204). The idea was rejected during the discussion for the 2005 Revision as being premature.

Can a company intervene in the derivative action for the benefit of directors – and if so, to what extent? The rule was not clear until recently and lower court cases were divided[35]. There are two different issues to be addressed regarding this: (1) Does the company have standing in such an intervention; and (2) is there any restriction from the structure of derivative action if the board decides to intervene?[36]

*(2) Manpyo Decision in 2001*

A recent Japanese Supreme Court decision answered the first question in the affirmative, under certain limited circumstances.[37] Following the decision, the 2001 Revision responded to the second question, providing a detailed procedure by which a company could take part in the litigation process and assist the defendant directors.[38] Although not without limitation,[39] boards were authorized to challenge shareholders' claims as being inadequately grounded.

*(3) The 2005 Revision*

The 2005 Revision took another step. It provides that the company *always* has

35 Lower court cases are divided. Those cases that permitted intervention include Tokyo District Court, November 30, 1995, Hanrei-jiho v. 1556, p 137; Tokyo High Court, September 2, 1997, Hanrei-Jiho v. 1633, p.140 and Tokyo District Court, April 25, 2000, Hanrei-jiho v. 1709, p 3. Those where intervention was denied include Nagoya High Court, July 11, 1996, Hanrei-jiho v. 1588, p 145.

36 A system of derivative actions, by nature, is based on the assumption that the judgment of the board on whether to sue cannot be trusted. One might argue that this distrust might affect the judgment of whether the company (i.e., the board) can intervene in the litigation.

37 Manpyo Co Ltd v Yamamura, Saihan Minshu (Supreme Court Reporter [Civil]) v 55, p 30 (January 30, 2001) [allowing the company's participation in the derivative action for the benefit of the defendant, where the action was brought claiming that the decision of the board was unlawful].

38 The consent of the statutory auditor is required for the intervention for the benefit of defendant management (Article 268(8)).

39 In Manpyo Co Ltd v Yamamura, the Supreme Court states that the company's participation is possible in such a case where an action was brought claiming that the decision of the board was unlawful. The subsequent lower court cases interpret the requirement set forth by the Supreme Court rather liberally, permitting the participation relatively easily. See, for example, Miyazaki District Court, 1126 Kinyu-shoji-hanrei 30 (May 18, 2001); Fukuoka High Court, 1126 Kinyu-shoji-hanrei 25 (July 25, 2001); Tokyo District Court, 1790 Hanrei-jiho 156 (June 21, 2001).

standing in an intervention for the benefit of one party of the derivative action[40]. Limitations set forth by the Supreme Court were removed. Now, the defendant management can always enjoy the legal assistance of the company if the necessary procedures are taken.

### D. Summary

Changes to procedural rules relating to derivative actions are a direct result of the 1993 Revision. While few insist that the law should revert to the situation seen before 1993, we have seen a certain degree of swing-back of the legal pendulum following the 1993 Revision. We can safely say that all the changes following the 1993 Revision are based on the assumption that the individual shareholder's judgment to sue is often not necessarily to the benefit of shareholders as a whole. The optimistic idealism for law enforcement by private parties – which underpins the 1993 Revision – has turned over in a short period of time.

## IV. Transformation in Procedural Rules for Exonerating Management Liability

### A. Procedure for Exonerating Management Liability

In the previous part, we examined the reforms of procedural rules for derivative action. They are, in essence, reforms that expand the role of courts in managing litigation. While people in the business community certainly welcomed the reforms, they were not totally satisfied with them. The judgments by the court, they claim, may not always be trustworthy. Therefore, following the 1993 Revision, the business community repeatedly demanded that the requirement for the exoneration of management liability be relaxed. The Japan Federation of Economic Organizations (Keidanren), for example, published "Urgent Recommendations Concerning Corporate Governance" (September 16, 1997), which highlights the new system for exonerating management liability. The voice reached its height when one court decision ordered ¥80 billion in compensation – a surprisingly high amount by Japanese standards – against

40 Article 849(1) of Corporate Code 2005.

the directors of Daiwa Bank.[41] Although the case was finally settled at a fairly modest amount (¥250 million), the business community emphasized the danger of relying solely on the discretion of the court in managing derivative action. The decision was not completely supported even by academics, who are usually unsympathetic to management[42]. Politicians were quick to respond to these concerns, and that action resulted in the 2001 Revision, which we will examine next.

### B. The 2001 Revision

Prior to the 2001 Revision, management liability could be exonerated only by unanimous consent of the shareholders (Article 266(5) of the Commercial Code). The rule, in effect, made it impossible to exonerate management liability for a public corporation.

The 2001 Revision introduced an important exception to that rule: (1) management liability can be exempted by shareholders' super-majority voting (Article 266(7)); (2) management liability can be exempted by the board's decision, when authorized by the certificate of incorporation (Article 266(12)); and (3) the liability of outside directors can be exempted by the contract between a company and a director, when authorized by the certificate of incorporation (Article 266(19)).

There are several limitations to the special exoneration procedure.[43] First, the rule does not allow for total exoneration. Additionally, the liability cannot be reduced below (1) six years' remuneration for representative directors, (2) two years' remuneration for "outside" directors, or (3) four years' remuneration for others. The rule applies neither in cases of gross negligence on the part of the directors, nor liability arising out of unlawful distribution to shareholders, for self-dealing and for several other cases.[44] The industry continues to protest the limitations.[45]

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41 Kameda v Abekawa et al., Hanrei Jiho v. 1721, p 3 (Osaka District Court, September 20, 2000).

42 See, for example, Iwahara (2000a, b).

43 For exoneration beyond the limits – which is a traditional procedure – to take place, the unanimous consent of shareholders is required.

44 Articles 266(7), (12) and (19). See also, Article 266(17) and (18).

45 The Japan Business Federation (Nippon Keidanren) proposed two years' remuneration as proper limitation for all management (Proposal for Revision of the Corporations Law: Securing International Competitiveness for Corporations, Respecting the Choices of Corporations, Shareholders, and Other Stakeholders (October 16, 2003)).

The 2001 Revision also provided for the procedure by which to settle the litigation (Articles 268(5)-(7)). Before the Revision, there was controversy as to whether the plaintiff of the derivative action could settle, because a settlement, by its very nature, always includes an element of the exoneration of liability and the unanimous consent required for it.[46] The revision, requiring certain procedures for the company, authorized the settlement.

### C. Effects of the 2001 Revision

Although the new exoneration procedure sounds like good news for management, cynics might observe that the change driven by the 2001 Revision is rather illusory, and it works only as a "tranquilizer" for management rather than a real legal defense. First, the reduction of liability does not apply to cases where management acted with "gross negligence." Given the fact that business judgment rule protects directors well (see, Part IV. D), there are relatively few cases where courts impose liability on management without evidence of "gross negligence," and the procedure for reducing liability applies mainly to cases where management is not liable at all. Second, the requirement for the possible liability reduction is fairly cumbersome. When the reduction of management liability is approved at the shareholders' meeting or by the board, "the facts constituting the cause of the liability and the amount of damage for which the director is liable" should be disclosed (Articles 266(8)(i) and 266(16) of the Commercial Code, Article 425(2), 426(3) of Corporate Code 2005). The "facts constituting the cause" are usually specified in the formal judicial proceedings; therefore, exoneration would ordinarily occur during the trial in the court of appeals after the management is held liable at the first impression. Third, the reduction of liability by the board's decision is allowed only in cases where such "reduction is especially necessary in light of the facts constituting the cause of director's liability, the statues of the performance of its duties, and other circumstances" (Article 266(12), Article 426(1) of Corporate Code). These might be primary reasons as to why relatively few corporations amend their certificate of incorporation to enable the board to reduce management liability.[47]

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46 The Tokyo High Court permitted the settlement in March 31, 1994, after the district court held the directors responsible (Yoshitake v. Totani, Hanrei Jiho v. 1480, p 154 (Tokyo District Court, September 21, 1993)).

47 According to research by the Japan Corporate Auditors' Association in 2004, approximately 15%

Some suggest that the 2001 Revision could have a more complicated effect if we take the psychological aspects of the judges into account. The more modest the penalty is, the more easily courts find a sentence of guilty. It is sometimes claimed that the courts find it easier to find breaches of fiduciary duty than before. Unlike under the U.S. legal system, Japanese judges have little discretion as to the amount of liability when the management is held liable. The defendant is fully responsible for the whole of the damages, as far as the court recognizes "reasonable causation"[48] between the breaches of management's duty and the damage to the company. The amount of liability would be extremely huge in most cases for the derivative action, and the court involved have no means to discount it. Therefore, before the 2001 Revision, the judges had to ask themselves, "Did this director behave so badly that he should go bankrupt?" Now, following the 2001 Revision judges ask themselves, "Did this director behave badly enough to relinquish several years of salary?"

However, since no empirical evidence has been shown either way, we must conclude that the overall effect of the new procedure still remains untested.

### D. The 2005 Revision

The 2001 Revision on exoneration and settlement procedures was maintained in the 2005 Revision with the following amendment: Special exoneration procedures in the 2001 Revision did not apply to the director's liability arising out of unlawful dividends or other distribution of corporate assets to shareholders, property transfer to a shareholder in relation to its exercise of right, loan to any other directors, the self-dealing (Article 266 (1)(i)-(iv) of the Commercial Code). The 2005 Revision expanded the scope of exoneration procedure to the above situations with narrow exceptions[49].

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of the listed companies have adopted the amendment.

48 "Reasonable causation" is a term of art which roughly corresponds with "foreseeability test" for scope of the contractual liability in the U.S. law.

49 Shareholders' unanimous consent is required only for the following cases:

to exonerate the liability of the directors or officers who distributed the corporate assets to shareholders beyond the statutory limitation (Article 462(3));

to exonerate the liability of the directors or officers who transferred the corporate property to a shareholder in relation to its exercise of its right (Article 120(5));

to exonerate the liability of directors or officers who entered into self-dealing with the corporation

### E. Summary

The new procedure of exonerating management liability is another direct result of the 1993 Revision. Although the Revision is, as is suggested in Part D, a double-edged sword and the real economic impact is not as clear as it appears, many commentators see the reform as a swing-back of the 1993 Revision.

## V. Transformation of Substantive Rules Regarding the Basis of Liability

### A. Changing the Substantive Rules on Management Liability

One can see the reforms on procedural rules of derivative actions and exoneration of management liability as a direct response to the 1993 Revision. In addition to those responses, even more deeply-rooted changes have been taking place during the last ten years. In the following parts, we first see the recent changes in the statutes, and in current case law with respect to the substantive rules on management liability.

### B. Management's Strict Liability under Current Law

The most apparent change in substantive rules in recent corporate law reform is the abolition of strict liability in the field of management liability. The Commercial Code traditionally imposed a strict liability on management under several circumstances. Among the most important are the following.

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for his own benefit (428(2)).

The most important difference with the 2001 Revision is as follows: Taking the unlawful dividends ((1) above) as an example, the 2001 Revision does not allow the exoneration not only for the directors who paid the dividends or who proposed such dividends but also for all directors who supported such dividends at board meetings. In contrast, the 2005 Revision allows the special exoneration for the latter category of directors. Similar distinction applies to the cases of (2) and (3) above.

*(1) Liability Arising out of Distribution of Corporate Assets*

Japanese corporate law, like any other corporate law in the rest of the world, restricts the distribution of corporate assets to shareholders based on the figures on the balance sheet. Management are responsible if the company makes an unlawful distribution. What was unique to Japanese law is the nature of the liability of unlawful distribution. If a director submits a proposal for a distribution to the shareholders' meeting beyond the statutory restriction, he is held responsible without regard to his fault for such a submission (Article 266(1)(i)). Even if the figure on the balance sheet is incorrect and management reasonably relies on the report of the CPA – who overlooked the incorrect information – there is no excuse. In addition to the director who actually makes the proposal, other directors are also jointly and severally liable, unless they express an objection to the proposal.[50]

*(2) Liability Arising out of Self-dealing*

Another example is a strict liability resulting from self-dealing. If a director enters into a transaction with a company and the transaction causes damage to the company, he is responsible without regard to personal fault. Like the regulation in the United States, a self-dealing transaction requires approval by the board, but the approval still allows no exempting effect for the directors who trade with the company. The strict liability does not seem too harsh when a director achieves personal gain from the company as a result of the self-dealing in question. The rule, however, seems more questionable in cases where a transaction is between affiliate companies with an interlocking directorate. Directors could be strictly liable for the damage to the company, without regard to their exercise of due diligence in such dealing. In addition, like in the case of unlawful distribution, directors or officers other than those who participated in the transaction are also jointly and severally liable unless they express an objection to the transaction at the time it is approved by the board. A hypothetical case would be helpful to illustrate the point. Assume that the board of parent company A decided upon a bailout for its subsidiary B, and that one of A's board members, X, is a representative director of B. The bailout transaction is self-dealing for X, and s/he is strictly liable for the result of the transaction. In addition, all of A's board members who authorized X's self-dealing (the bailout) are jointly and severally liable together with X, unless they individually

50 Article 266(3) of the Commercial Code provided that when an act (in this case, the submission of a proposal for distribution to the shareholders' meeting) was based on a board's decision, the directors who voted for the decision were deemed to have performed such an act.

express objections to the board's decision. The rule would often be an unreasonable obstacle for a corporate restructuring.

These rules have been criticized for many years and several recent lower court cases have tried to avoid harsh results, almost ignoring the language and the structure of the Commercial Code; many believe that the decisions went beyond the interpretation of the current statute.[51]

*(3)The 2002 and 2005 Revisions*

The 2002 Revision took an important step toward the total reform of the basis of management liability. It introduced a new corporate governance system: the Committee System. Although the emphasis is often put on the composition of the board and the committee for the new system, it is also noteworthy that it adopts a different basis of liability for management. For instance, the Revision abolishes the special liability for directors, arising out of unlawful distribution.[52] It allows even for the officers who made the proposal of distribution to prove their non-negligence, in order to avoid their liability. The Revision also changes the rules for self-dealing to become a fault-based liability.[53]

The proposed 2005 Revision extends the new rule to corporations in general.[54] In short, strict liability has almost disappeared in the area of management liability during recent reform.

One might suspect that those substantive rules are being changed simply

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51 Sogo v. an unidentified respondent (Tokyo District Court December 8, 2000), Kinyu-homu-jijyo v. 1600, p 94 [denying the liability of outside directors resulting from unlawful distribution]; Hamasaki v. Usui (Osaka District Court January 30, 2002); Hanrei Taimuzu v. 1108, p 248 [denying the liability of the board members who decided on the bailout to the affiliated companies with interlocking directorates].

52 For officers who submitted the proposal to the board, Article 21-18 of the Law for Special Provisions for the Commercial Code Concerning Audits, etc., of Joint Stock Company (the Special Provisions) provides the fault-based liability with a burden of proof on the officer. Liability of the directors is imposed pursuant to the general duty of care and loyalty (21-17 of the Special Provisions).

53 Article 21-21 of the Special Provisions.

54 It was proposed by the Japan Business Federation (Nippon Keidanren), Proposal for Revision of the Corporations Law: Securing International Competitiveness for Corporations, Respecting the Choices of Corporations, Shareholders, and Other Stakeholders (October 16, 2003).

because they are inefficient, and that the 1993 Revision had nothing to do with it. This is only partially true. The question is why they are being changed *at this time*. Although it is true that the rules were criticized even before the 1993 Revision, they had remained intact for more than 50 years. There is no doubt that the 1993 Revision motivated the change.

### C. The Rise of Business Judgment Rules

The concept of business judgment rules in the United States[55] has been well recognized for many years among Japanese academics. However, there had been few cases that explicitly declared the rule. Since the 1993 Revision, there has been a significant increase in the number of cases that explicitly refer to management's broad discretion in making a business decision.[56] For instance, one of the recent cases[57] states as follows: "A director's business decisions in relation to a certain business activity is not beyond the permitted scope of his discretion and therefore does not constitute a breach of duties of care or of duty of loyalty unless there is an important and careless misunderstanding of factual basis for the decision and the process and the substance of the decision making is markedly unreasonable and improper for an corporate manager."[58]

Probably, it was not the substance of the courts' decision that was changed. Even earlier cases did not review the merit of managements' business decision. Rather, it was change in the form of the sentence that many courts explicitly refer to business

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55 A recent formulation is found in American Law Institute (ALI), Principles of Corporate Governance: Analysis and Recommendations (1994), Article 4.01(c).

56 As recent cases, see, Keihoku Yakult v. unidentified defendant, Hanrei Jiho v. 1888, p. 3 (Tokyo District Court December 16, 2004), Unidentified plaintiff v. Sogo, Hanrei Jiho v. 1886, p.112 (Tokyo District Court September 28, 2004), Unidentified plaintiff v. unidentified defendant, Hanei Times v.1167, p.208 (Osaka District Court July 28, 2004), Unidentified plaintiff v. unidentified defendant, Kinyu Shoji Hanrei v. 1172 p.39(Tokyo District Court May 12, 2003).

57 Hongo v. Matsushita, Hanrei Jiho v. 1710, p 153 (Osaka District Court May 16, 1999).

58 Although those cases are no doubt influenced, they are different from the business judgment rule in the United States, in that the court does check that the substance of the management's decision is markedly inappropriate or not based on detailed fact-findings, even where the court does not find any problem in the decision-making or information-gathering processes. Compare the decision with the ALI's formulation cited in footnote 55.

judgment rule and announce the limited scope of their review on the managements' decision before they examine the particular cases. Those cases might be best understood as the courts' message to the business community who are not satisfied with the case-by-case decisions but seek for more explicit guarantees of non-interference to business decisions.

### D. Summary

Substantive rules on management liability have been changed considerably in the last decade. Strict liability is disappearing and the courts repeatedly declare business judgment rule. These changes would mitigate potential risk to which management members are exposed. Although the changes in substantive rules regarding management liability are not direct responses to the 1993 Revision, they should no be regarded as independent movements. Those rules might be reasonable by themselves but it should be noted that they were never introduced in the many revisions before that of 1993.

## VI. Conclusions

This article reviewed the transformation of the management liability regime in Japan during the last decade. In retrospect, the 1993 Revision marked the beginning of a series of subsequent changes in statutory and in case law. As indicated in the introduction, this may be understood as an example of significant subsequent changes in legal rules following from an unexpected reform taking place where strong complementarities exist.

The 1993 Revision, in itself, results in an increase in the probability of litigation. It has already had ambiguous effects. The revision may have enhanced the disciplinary effect on management and, at the same time, incurred more expected deadweight loss caused by possible wasteful litigation. In addition, the 1993 Revision, directly or indirectly, caused subsequent reforms on the management liability regime. One cannot even be sure to what extent the potential liability of directors and officers has been significantly enhanced. Although I do not assert that the effect of the 1993 Revision was totally canceled out by the subsequent changes, the magnitude of the reform has been considerably mitigated. Therefore, it does not make much sense to ask such simplistic questions as whether the 1993 Revision improved firms' performance by enhancing the monitoring function, or caused harm by increasing incidents of wasteful litigation.

The evaluation of the 1993 Revision is made even more complicated by the fact that some revisions subsequent to the 1993 Revision also have ambivalent effects. For instance, the changes in procedural rules on derivative actions may alleviate the cost of waste litigation. At the same time, such a reform as unlimited authorization for company's intervention for the benefit of the defendant managements could simply aggravate other agency costs.

Finally, there may be further changes to rules, although they will be even more indirectly related to the 1993 Revision. The emphasis on the role of outside directors in recent corporate law reform is an example. Although Japanese corporate law has not had any legal effect on "outside directors" for many years, recent revisions incorporate deregulation coupled with the adoption of outside directors[59]. A board decision approved by a body of outside directors may be upheld more easily by the court in connection with potential management liability. Although current Japanese corporate law does not contain judicial doctrine to provide such an effect,[60] it may be possible that future case law will incorporate such elements found in the United States courts.[61] In fact, several companies voluntarily set up a non-statutory committee that consists of more "independent" professionals in the context of take-over defense apparently expecting that its decision would in effect exclude the court's review on the merit.

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59 For example, when an outside director is appointed, simplified procedure becomes available for several corporate actions that otherwise need board meeting approval. See, Corporate Code Article 373(1)(ii). Companies with "Committee Systems" can delegate substantial corporate decisions to officers while it is a requirement to have three statutory committees, the majority of members of which should be outside directors (Corporate Code 400(3)).

60 See Gilson and Milhaupt (2004).

61 Unfortunately, the definition of the term "outside director," under current law, is too loose to give their approval a function of justifying the management decision. See, Gilson and Milhaupt (2004).

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