

A Case in Which Directors Were Not Held Liable for Loss Attributed to Issuers' Default on Redemption of Bonds They Approved to Assume: Judgment of the Tokyo High Court on Sep. 20th, 2018, 2018WLJPCA09206008¹

Yoshiko Wang

1. Facts Material to This Case

In this case, a company (hereinafter referred to as "A K.K.") whose stock is listed with the First Section of Tokyo Stock Exchange assumed three types of bonds. A K.K. assumed the first type of bond on Sep. 14th, 2006. This bond was issued by Aruji Group K.K. (hereinafter referred to as "Aruji"), was offered in private, and was guaranteed jointly and severally by Solid-Kama Company Ltd. (hereinafter referred to as "Solid-Kama"), a Russian company, until Jan. 25th, 2008 and by Areheld Ltd. (hereinafter referred to as "Areheld"), another Russian Company, after Areheld assumed the whole obligation of Solid-Kama. The issue price of this bond was 12,000,000,000 yen in total, the maturity date was set on Sep. 14th, 2013, and the coupon yield was expected to be around 9.3% annually. This bond was issued to finance Aruji for building a business center in Moscow, Russia.

The second type of bond A K.K. assumed on May 11th, 2007 was also issued by Aruji and offered in private. The issue price of this bond was 6,000,000,000 yen in total, the maturity date was set on May 23rd, 2010, and the coupon yield was expected to be around 15% annually. This bond was issued to finance Aruji for its investment in Russian real estate market.

A K.K. assumed the third type of bond on Sep. 8th, 2008. This bond was issued by B and Kislania Enterprises Company Ltd. (hereinafter referred to as "Kislania"), a Cypriot company, was offered in private, was secured with 1000 shares of stock of Anothia Enterprises Company

¹ This paper was presented at 2019 NCYU-OCU Conference on Economics, Management and Information Science on Aug. 22nd, 2019.

Ltd. (hereinafter referred to as “Anothia”), another Cypriot company, that were owned by B, and was granted with a right to convert into stocks of Kislania. The issue price of this bond was 3,000,000,000 yen in total, the maturity date was set on Sep. 12th, 2013, and the coupon yield was expected to be around 3% annually. This bond was issued to finance Kislania for setting up a plan to develop fundamental tourism facilities in Greece and for obtaining land for construction of resort facilities under such plan.

On Jun. 10th, 2011, A K.K. released that the principal and unpaid interest on the second type of bond, amount to 7,953,000,000 yen in total, would be added as loss from valuation on available-for-sale securities on its balance sheet. A K.K. also filed on Feb. 14th, 2012 its quarterly report for period ended Dec. 31st, 2011 with the principal and unpaid interest on the third type of bond, amount to 3,071,000,000 yen in total, as extraordinary loss. Furthermore, on Nov. 19th, 2012, A K.K. released that it was to declare the principal and unpaid interest on the first type of bond, amount to 13,267,000,000 yen in total, as loss from valuation on available-for-sale securities back on its quarterly statement for period same as above due to Areheld’s insolvency and incapability of bond redemption.

Following these releases, one stockholder of A K.K. brought a derivative action before Tokyo District Court against former and current directors of A K.K., twelve people in total, alleging that A K.K. suffered the loss of the principal on all three types of bonds because directors did not fulfill their obligation by failing to discuss the condition of the bond’s issuers and the credibility of guarantees who guaranteed the redemption of the bonds jointly and severally with the issuers at the board meetings where decisions that A K.K. should assume the bonds were made.

Tokyo District Court dismissed plaintiff’s motion, stating that directors of A K.K. did not violate their duty to administer the mandated business with the care of a good manager. Plaintiff appealed.

2. Judgment of the Tokyo High Court

Whether there is a doubt on reasonableness in acquisition and analysis of information in the process of recognizing facts which becomes the basis of the decision of A K.K. board that the company should assume the bonds at issue, shall be determined in accordance with

understanding and experience held by ordinary directors in light of economic situation and management practice at the point of time when such decision is made. In this case, appellant did not present any specific or objective evidence and exhibit to prove that appellees violated their duty except the bonds at issue became irredeemable in part and appellees did not go through a comprehensive process of gathering and analyzing information as the appellant expected.

It is true that provisions of Asset Management Rule (hereinafter referred to as "AMR") in A K.K. were not followed in purchasing the second type of bond. However, the decision that A K.K. should assume such bond was made not by one manager who acted in excess of his/her authority granted under AMR, but by a resolution made by the same board of directors who stipulated AMR. Therefore, deviation from AMR does not necessarily mean that appellees violate their duty.

Also, it is not proper to substitute a question of appellees' observation of duty for a question of appellees' ability to trust experts' opinions. Critiques of the objective expertise of appellees' expert witness and reasonableness of such witness' opinions will not become a reason for appellees' violation of their duty and the witness' opinions were not determinant to appellees' decision of A K.K.'s purchase of bonds. The board of directors considered opinions from the witness because he/she had been a financial advisor for A K.K. for ten years and a firm which the witness represented used to be a advisor for A K.K. and suggested A K.K. to make some investment in Vietnam.

In sum, judgment of the Tokyo District Court is to be upheld that appellees did not violate their duty to administer the mandated business with the care of a good manager.

3. Analysis

3.1 Significance of This Case

Nowadays, almost all companies in Japan are Kabushiki Kaisha, or Stock Companies. Under Japanese Companies Act, operation of such companies is to be executed by directors.

In executing operation of a stock company, making a profit always comes first. There are several methods to increase profit and making an investment in financial instruments such as

bonds is one of them. Compared to other financial instruments, investment in bonds is more stable in a sense that bondholders will receive redemption of coupon once or twice a year and redemption of principal at maturity.

By the way, directors are in a relationship with a stock company and such relationship is to be governed by provisions on Mandate. Thus, directors are charged with a duty to administer the mandated business with the care of a good manager. Meanwhile, directors are to face personal liability for loss suffered by a stock company when they fail to exercise such duty. Therefore, the question is, will directors take any responsibility if the bonds they decide that the company they serve should assume become irredeemable?

This case is the latest one to discuss this issue and will help develop standards of directors' conduct in approval of companies' bond purchase and standards to review their civil liability when redemption of bonds companies assumed is in default.

3.2 Business Judgment Rule as a Long Existing Rule for Courts to Examine Directors' Observation of Duty

In general, courts have been reluctant to determine whether directors fail to exercise their duty after their decision goes awry. There is a concern that liability that is too strict may decrease directors' motivation to make challenging decision which may turn out so prosperous as to generate great profit for a stock company; On the other hand, it is considered that there will be no incentive to force directors fulfill their obligation if sanctions are too weak. Thus, courts have discovered a principle of law called "Business Judgment Rule" which describes that courts will determine whether directors violate their duty only in light of the facts that occurred until the point of time when they make the challenged business judgment and will not hold directors liable with hindsight.

3.3 Prerequisite for Business Judgment Rule to Apply and Applicability of the Rule in This Case

Business Judgement Rule applies to a situation where there is a business judgment. Ordinarily, there is a business judgment insofar as a decision is made by a resolution of a board of directors. This is not always true, however. Even a decision is made by a resolution of a board of directors, it cannot be recognized as a business judgment when the calling procedures

provided by Japanese Companies Act are not followed or when directors who have a special interest in the resolution participate in the vote.

Meanwhile, a business judgment does not have to be made by a resolution of a board of directors all the time; When a board delegates its power of decision-making to a committee or a person, the decision made by the committee or person can be a business judgment. In that case, delegation has to be legitimate². Also, the decision has to be ratified by the board if the person who makes the decision has conflict of interest.

There is no dispute over the calling procedures of the board meeting of A K.K. in which directors decided that the company should assume bonds or the special interest of directors of A K.K. Therefore, each decision made by the board of A K.K. to assume bond should be considered as a business judgment.

3.4 Factors Needed to Be Considered in Reviewing Directors' Exercise of Duty When Business Judgment Rule Applies and Appropriateness of the Judgment in This Case

When Business Judgment Rule applies, how will a court determine whether directors have done fulfilled their duty to administer the mandated business with the care of a good manager? Several courts have represented opinions on this matter. In 1993, Tokyo District Court stated that whether directors violated their duty depended on whether there was careless mistake in their recognition of the facts which became the basis of their business judgment and whether the decision-making process was extremely unreasonable from an ordinary entrepreneur's point of view³. In 1996, Tokyo District Court determined that directors did not violate their duty on the ground that there was no material careless mistake in their recognition of the facts which became the basis of their decision and both the decision-making process and the decision itself were neither extremely unreasonable nor improper from an entrepreneur's point of view⁴. In 2002, Tokyo District Court concluded that directors

² It is said that board of directors may not delegate the power of making decisions on the execution of important operation which includes the disposal of and acceptance of assignment of important assets. Japanese Companies Act § 362 (4)(1). One judicial opinion suggests that purchase of bonds may be considered as the disposal of important assets, depending on the principal on purchased bonds, the proportion of the principal on such bonds in the total value of a company's assets, the purpose to keep such bonds, how purchase of such bonds is conducted, and how purchase of bonds has been handled previously. Judgment of the Supreme Court on Jan. 20th, 1994.

³ Judgment of the Tokyo District Court on Sep. 16th, 1993.

⁴ Judgment of the Tokyo District Court on Feb. 8th, 1996.

made a decision deviating from the permissible scope of discretion and violated their duty after examined whether there was careless mistake in recognition of the facts which became the basis of their business judgment and whether both the decision-making process and the decision itself were extremely unreasonable from a director's point of view. According to the Court, careless mistake in recognition of the facts was to be caused by unreasonableness in gathering and analyzing information and examining such information in light of the situation at the point of time when their decision was made. The Court also mentioned that extreme unreasonableness in the decision-making process and the decision itself was to be formed by extreme unreasonableness in the reasoning process for reaching a business judgment and the judgment itself⁵. In 2004, Tokyo District Court stated whether directors violated their duty by deviating from the permissible scope of discretion was to be determined by whether, under the situation at the point of time when the decision was made and in light of the extent to which a director was ordinarily expected in a large bank same as the one in that action, it was reasonable as to acquisition and analysis of information and examination of such information to reach a decision, and whether there was extreme unreasonableness in the reasoning process for reaching such a decision and the decision itself⁶. In the same year, Tokyo District Court also rephrased its opinion in 1993. It mentioned that unless there was an emergency, directors who made a decision outside the permissible scope of discretion and abused their power, violated their duty when there was careless mistakes in recognition of the facts which became the basis of directors' decision or there was no reasonable acquisition and examination of information that were required in light of the situation at the point of time when their decision was made, and when there was unreasonableness in the decision-making process from an ordinary entrepreneur's point of view⁷. In 2005, Tokyo District Court showed that whether directors violated their duty by deviating from permissible scope of discretion, is dependent on whether, under the situation at the point of time when their decision was made, there was careless mistake and lack of reasonableness in the process of recognizing facts (acquisition of information and analysis and examination of such information) which became the basis of directors' decision and whether there was extreme unreasonableness in the reasoning process for reaching their decision and the decision itself⁸.

⁵ Judgment of the Tokyo District Court on Apr. 25th, 2002.

⁶ Judgment of the Tokyo District Court on Mar. 25th, 2004.

⁷ Judgment of the Tokyo District Court on Sep. 28th, 2004.

⁸ Judgment of the Tokyo District Court on Mar. 3rd, 2005.

These judicial opinions reflect that three factors have been recognized to determine whether directors have fulfilled their duty under Business Judgment Rule: the first is the accuracy or reasonableness of directors' recognition of the facts which are the basis of their judgment; the second is the reasonableness of the decision-making process; and the third is the reasonableness of the decision itself.

It is noteworthy, however, that courts do not have to examine three factors all at once because what matters is what the three factors stand for. This issue was brought up by one judicial opinion of the Supreme Court and discussed extensively among scholars. In 2010, the Supreme Court expressed that directors did not violate their duty unless it was extremely unreasonable as to the decision-making process and the decision itself⁹. Since it was so established that whether directors fulfilled their duty were to be determined in light of three factors, some scholars viewed that the first factor was removed by the Supreme Court due to its lack of appearance in the Court's opinion¹⁰. On the contrary, several scholars protested that the Supreme Court did not change the way to review directors' exercise of their duty even though the phrasing was slightly different from other cases¹¹. According to those scholars, what the word "process" meant had changed from time to time: "Process" appeared in the phrase "decision-making process" in 1993 and 1996 Tokyo District Court's opinions; In 2002 and 2004 Tokyo District Court's opinions, "process" was considered as one of reasoning; And, in 2005 Tokyo District Court's opinion, "process" was used to indicate both one of recognition of facts which embodied acquisition and analysis of information and examination of such information and one of reasoning. Thus, scholars commented that the "process" as in "decision-making process" or "reasoning process" referred to a process of considering whether doing one thing rather than not doing such thing would be more desirable for a company and such process should not be separated from the business judgment itself. On the other hand, the "process" as in "process of recognition of facts" constituted another factor because acquisition and analysis of information and examination of such information were more likely to be a precondition for decision-making, reasoning, or decision itself¹². Upon consideration stated above, scholars who supported the 2010 Supreme Court's opinion noted that the conventional three factors could

⁹ Judgment of the Supreme Court on Jul. 15th, 2010.

¹⁰ Otsuka Kazunari, Takatani Yusuke, and Ito Nanako, *Business Law*, Vol. 10, No. 11, at 16 (2010). Yamada Yasuhiro, *Journal for Audit & Supervisory Board Members*, No. 578, at 119 (2011).

¹¹ Ochiai Seiichi, *Commercial Law Review*, No. 1913, at 7 (2010). Kitamura Masashi, *Jurist*, No. 1420, at 139 (2011).

¹² Tanaka Wataru, *Jurist*, No. 1442, 2012, at 103. Ito Yasushi, *Commercial Law Review*, No. 2009, at 53 (2013).

be shortened to two¹³.

Tokyo High Court, in the case at issue, followed such theory for the most parts. However, the Court did not mention whether the decision itself made by the board of directors of A K.K. was extremely unreasonable. Theoretically, such phrasing may imply further changes of factors to determine whether directors have fulfilled their duty under Business Judgment Rule, but it does not seem to make a big difference in the real world because courts have not found the business judgment itself made by a board of directors extremely unreasonable insofar as acquisition and analysis of information and examination of such information are not extremely unreasonable.

Should whether it is extremely unreasonable as to acquisition and analysis of information and examination of such information is so important as to influence the whole judgment on whether directors have fulfilled their duty to administer the mandated business with the care of a good manager, when do directors gather and analyze information and examine such information sufficiently in deciding that the company they serve should assume bonds?

Even though there are not many cases discussing the extent to which directors are to gather and analyze information and examine such information in deciding that the company they serve should assume bonds, directors should make all information available to them to enable them aware of whether there are risks of default on redemption and how likely such risks will occur.

In a case where K.K. Medeka Japan (hereinafter referred to as “Medeka”) assumed bonds issued by one company eleven times in eight months¹⁴, Tokyo District Court concluded that the representative director did not gather and analyze information and examine such information sufficiently. The court pointed out that the bonds issuer was not a listing company, it had only 10,000 yen of capital, it was not rated by any rating agency, and there was an agreement limiting the assets for redemption of bonds to the payment from certain transactions between the issuer and a third party company. Under such circumstances, the court expressed that the

¹³ Morimoto Shigeru, Business Judgment and “Business Judgment Rule”, Gendai Minjihou No Jitsumu To Riron, at 654 (2013).

¹⁴ Judgment of the Saitama District Court on Sep. 2nd, 2011.

representative director of Medeka, in determining the company should assume the bonds, ought to verify whether obligatory rights the bonds issuer held against the third party company were legitimate, and discuss sincerely whether to put a lien on such obligatory rights. Contrary to the expectation, the representative director, relying blindly on the person who suggested him to assume the bonds because the company the person owned once assumed bad debts held by Medeka, did not make himself/herself knowledgeable of the indenture itself and realize that the assets for redemption of bond was limited to certain payment when he decided that Medeka should assume the bond first time. Nor did the representative director conduct research and examination sufficiently on the terms of the indentures and the conditions of the transaction in advance of other purchases following the first purchase. Also, the representative director failed to figure out the risk Medeka were to assume by not verifying the ratio of the amount of money to assume the bond to Medeka's surplus and the assets and financial circumstances of the issuer all the time¹⁵.

Compared to the representative director of Medeka, directors of A K.K., in examining whether A K.K. should assume the first type of bond, obtained Aruji's general information, its financial statement for the fiscal year before the bond was issued, its tax return statement for the same period, and personal resume of the representative of Aruji, and gained an understanding that Aruji was capitalized at 52,000,000 yen, it had good reputation among companies who desired to make an investment in securities issued by Russian companies, and there were no material liabilities that would obstruct Aruji from bond redemption. Directors of A K.K. also acquired documents regarding Aruji's estimated cash flow following the issuance of bond and examined how Aruji would manage the fund and redeem the bond. In order to verify whether the plan to raise assets for redemption represented by Aruji was feasible, directors of A K.K. looked into a summary of construction project and reports regarding economic circumstances in Moscow, sent a team to Russia who met with the senior vice president of Moscow Ministry of Government Asset Management and senior vice minister of Federal Agency for State Property Management of Russia, and acquired knowledge of the circumstances of real estate market in Moscow and risk of investment in Russia. Since the redemption was to be guaranteed by Solid-Kama, directors of A K.K. checked reports on general information of Solid-Kama and

¹⁵ It seems that the representative director of Medeka once decided that the company should spend 2,200,000,000 yen firstly and 1,800,000,000 yen secondly to assume issuer's bond when Medeka's surplus was only 4,304,921,000 yen.

properties owned by Solid-Kama, learned Solid-Kama was specialized in construction and operation of real estate, the properties Solid-Kama owned were worth of 201,827,800 dollars, and the value of such properties had risen in 15 percent each year for five years in a row and would keep rising in the following five to seven years, and concluded that Solid-Kama had enough resources as a joint and several guarantee. In order to keep Solid-Kama's financial circumstances good, directors of A K.K. asked another company which belonged to the same group with Solid-Kama to monitor financial circumstances of Solid-Kama and instruct Solid-Kama to exercise its duty as a joint and several guarantee until Aruji fulfilled its obligation of redemption. In addition, directors of A K.K. went to A K.K.'s financial advisor and was recommended strongly to assume the bond. Moreover, a board meeting was held and directors of A K.K. who were present at the meeting approved the purchase of the bond unanimously after discussing the probability of the earnings growth of A K.K. to cover the large amount of money to purchase the bond and coupon payment that was to be received continuously until the maturity of bond¹⁶. When Aruji suggested A K.K. switch the joint and several guarantee from Solid-Kama to Areheld, directors of A K.K. obtained personal resume of Areheld's representative, general information of the company whose stocks constituted main asset in Areheld, and documents regarding the structure of Areheld's assets, and concluded that Areheld had enough valuable assets as a joint and several guarantee.

In purchasing the second type of bond issued by Aruji, directors of A K.K. acquired reports on Russian real estate investment schemes and Russian closed-end real estate investment schemes and learned that Aruji was going to build a closed-end investment scheme, invest in development of real estate in Russia via such investment scheme, and raise money for redemption with dividends of the shares of such investment scheme. In order to keep the increase of value in such shares, directors of A K.K. examined that management system and control system were implemented in the investment scheme. They also obtained general information of real estate investment projects and checked construction cost and construction period of the properties in which Aruji was going to invest. Meanwhile, they was informed from Aruji's financial statement that there were no material liabilities that would obstruct Aruji from bond redemption. Some directors of A K.K. met with important people in Russian

¹⁶ In considering whether A K.K. should assume the first type of bond, directors of A K.K. struggled with the fact that the surplus of A K.K. was 32,000,000,000 yen while it would take 12,000,000,000 yen to assume the bond. However, the expectation that the coupon payment was going to be accumulated to 7,812,000,000 yen by the bond maturity encourages those directors.

economic industry, confirmed Aruji's reputation in the industry, and walked around properties mentioned in the investment projects. As the first type of bond, the financial advisor of A K.K. was very positive about the directors' bond purchase decision. Additionally, a board meeting was held and directors of A K.K. who attended the meeting approved the purchase of the bond unanimously, after considering the amount of money to assume the bond, A K.K.'s surplus, the amount of coupon payment that was to be received continuously until maturity of the bond¹⁷, and the Aruji's agreement to submit the financial statement of its own every three months and the financial statement of the investment scheme every six months.

Same as the first and second types of bonds, directors of A K.K., in examining whether the company should assume the third type of bond, obtained a document regarding requirement for issuance of the bond, drafts of the bond indenture, memorandum attached to the indenture, and mortgage agreement. Directors of A K.K. also learned how Kislania were to raise money for bond redemption. Since stocks of Anothia were provided as collaterals for the bond, directors of A K.K. studied the value of Anothia stocks based on the value of an investment scheme that were owned by Anothia and the rent the investment scheme would charge for its management service of the real estate. In order to verify construction would begin after the issuance of bond, directors of A K.K. discussed general information of a project in Greece and identified the location and construction period of the project and the circumstances of real estate market in Greece. In addition, directors of A K.K. asked Kislania to add a clause to report in writing the progress of the project every six months and thereby set aside a system to monitor the progress of the project as a bondholder. The financial advisor of A K. K. recommended the investment this time as well. Further, a board meeting was held and directors who were present at the meeting voted for the purchase of bond unanimously, after confirming Aruji's success of coupon payment for the first and second types of bonds, the amount of money to assume the third type of bond, and A K.K.'s surplus¹⁸.

In sum, directors of A K.K. gathered and analyzed information about the bond issuer, its plan to raise the money for redemption, its guarantees or the issuer who provided its stocks as

¹⁷ In determining whether A K.K. should assume the second type of bond, directors of A K.K. recognized that A K.K. had a surplus of 24,600,000,000 yen and it would take 6,000,000,000 yen to assume the bond. They also took into consideration that the coupon payment was expected to be accumulated to 2,700,000,000 yen by the bond maturity.

¹⁸ In examining whether A K.K. should assume the third type of bond, directors of A K.K. discussed that A K.K. had a surplus of 24,900,000,000 yen and it would take 3,000,000,000 yen to assume the bond.

collaterals for the bond, and expert's opinions, identified whether there were risks of default on redemption and how likely such risks would occur, and tried to manage or even reduce such risks. Thus, their recognition of facts was not found to be unreasonable.

3.5 Issues Left for Further Study

Based on the discussion above, when Business Judgment Rule applies, the most important factor to determine whether directors have fulfilled their duty is gathering and analyzing information and examining such information available to them. Precedents suggest that directors need to understand how the money their company paid for bond purchase are to be managed by bond issuers and how bond issuers are to obtain assets for bond redemption. In addition, directors are called to examine whether the plan presented by bond issuers to obtain assets for redemption is feasible. It is also recommended that directors verify whether parties and contracts presented by bond issuers are true. Having the debt guaranteed and obtaining opinions from financial experts are considered desirable at the same time.

Despite of these perception, it is still somewhat difficult to reveal all standards under which directors' acquisition and analysis of information and examination of such information will be seemed adequate. Many issues are left unresolved, such as how much information would be enough for directors' knowledge on bond issuers' plan to obtain assets for redemption and how much examination on the feasibility of such plan directors of a bond purchasing company need to run. Answers to these issues may vary with bond issuers' status, the ratio of the amount of money to assume bonds to the surplus of bond purchasing companies, experience and capability of directors, and the scale of bond purchasing companies. Therefore, further study based on more cases is required to settle these issues and to provide a whole picture of the function and effect of Business Judgment Rule when directors' decision that the company they serve should assume bonds is questioned.