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Calculation of Damages Arising from False Securities Reporting in Japan

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Background

In 2011 and 2012, two Supreme Court cases[1] discussed how the court should calculate damages arising from stock purchase and sale made on the basis of false securities disclosures. In 2021 and 2022, two district courts further addressed the issue[2]. We seem to know enough at this point to understand the basic approach of the courts and the problems associated with it. This issue goes to the foundation of damage theories in the Japanese jurisprudence.

General damage calculation theory under Japanese law

Similar to Common Law, a tortfeasor must compensate the victim for damages proximately caused by the relevant wrong committed under Japanese tort theory. This principle derives from a similar principle developed under contract law.[34] Traditionally, the prevailing theory has argued that the victim's financial statuses before and after the wrong are compared and the difference observed is deemed to be the damages suffered (the "difference theory"). This theory was mostly developed under traffic accident cases. For example, if an employee earned 10 million yen annually before a traffic accident that resulted in injury reducing his salary to 3 million yen, the difference of 7 million is the damage to be awarded. Curiously, Japanese courts don't look at non-monetary adversities caused as a whole as damages. They see them in terms of monetary amounts as derived from the cause by calculating the difference between before and after the cause and each damage is itemized and aggregated. Thus, absent usual circumstances under Civil Procedure Code Article 248 discussed below, valuation of damages is not performed by courts as such because damage already is a yen amount as proven by the plaintiff.

Japanese law does not recognize punitive damages. Damages are confirmed and awarded (on the basis of proof offered by the plaintiff) by the court since there is no jury in civil cases.

Hypothetical

To illustrate points of contention in a fact pattern, we assume the following facts:

1. False disclosures were made by the issuer during April 1, 2010 and March 1, 2015.

2. Purchase and sale transactions proximately caused by false information occurred between April 1, 2015 (the "start date," being the date on which the special investigation committee of the issuer announced that they suspected false disclosures) and October 1, 2015 (the "end date," being the date on which amendment security filings were made).

3. Stock price on April 1, 2015 was 350 yen per share and stock price on October 1, 2015 was 200 yen. The same price was 150 yen at the conclusion of the oral hearing of the litigation (the "conclusion date").

4. See the chart at the end for the price movements.

Uncertainty of "difference" amount

In the context of false disclosures in securities filings, the concept of "difference" is not clear in the following sense:

1. First, it is uncertain whether the difference is to be observed for the whole purchase and sale process (the "transaction flow theory") or independently at each of the times at purchase and sale (the "independent transaction theory"). Both theories are currently in use by courts.

   a. If the court is to go by the independent transaction theory, what damages existed must be ascertained relative to the purchase of stock made on the basis of false information. Query whether the damages are (a) the purchase price itself because if the false information was known, the purchase wouldn't have been made, or (b) the difference between (i) the stock price that reflects the correct information and (ii) the stock price formed under false disclosure. Or does that depend on circumstances including the circumstances and purpose of purchase? Is the former amount (i) (price based on correct information) objectively ascertainable?

2. Second, under the independent transaction theory, it is also uncertain what damages should be recognized relative to the disposition of stock based on the new disclosure of truthful information on the end date.

   a. It seems sensible to rely on the difference between (a) the price that would have been formed under accurate information and (b) the price at which sale was made in an irrational state of mind affected by false accounting. The former amount isn't necessarily the actual stock price prevailing at the time of correction disclosure, because it takes time to analyze the information and shareholders would be selling in panic without clarity of the objective price.

3. Third, practitioners tend to argue that it is easier and more appropriate to see the transaction flow in total from the time of purchase through sale.

   a. If this approach is pursued, the difference will be simply that between the purchase price and the sale price, subject to the proximity test.

Japanese damages calculation is often criticized for excessive requirement of itemization and specificity. Whatever damages that cannot be accurately and objectively established are usually impossible to be awarded. This point was condemned by legal practitioners for a long time, and the legislators in response created a provision in the Civil Procedure Code that allows the court (if only sparingly) to use discretion in recognizing an appropriate damage amount if the proof is extremely difficult, provided that damages have in fact been suffered. Civ. Proc. Code, Article 248.

Court decisions

Tokyo District Court

1. The price differential between the start date and the end date is the amount of damages caused proximately by the false disclosures.

2. Such proximate damages include (a) the difference at the time of purchase between the stock acquisition price and the stock price that would have prevailed if based on accurate information (the "inflated difference"), and (b) the difference at the time of sale between the stock price that would have been formed based on the revised information and the price of actual sale that was made in panic (the "anxiety difference").

3. Any pricing fluctuation after the end date through the conclusion date will not be considered if the sale price was higher than that of the conclusion date price (the "post-end date decline amount").

Fukuoka District Court

1. The proximately caused damages are the aggregated amount of (a) the inflated difference and (b) the anxiety difference.

2. The post-end date decline amount will be disregarded from the amount of damages as a rule.

3. If the shareholder still keeps the shares on the conclusion date, the sale price shall be deemed to be the conclusion date price.

Discussion

Tokyo District Court uses the transaction flow theory from the time of purchase to that of sale. Fukuoka District Court suggests that damages are assessed under the independent transaction theory, i.e., both at purchase and at sale, and aggregate them. It seems easier and more natural if the entire transaction is seen as a whole because the plaintiff's damages relate to the entire flow of purchase and sale and not those isolated at the two points in time. Also the damage amount can differ between the two approaches, because the aggregate amount of the inflated difference and the anxiety difference at the times of purchase and sale is not equal to the overall difference between the prices at the two points in time. In addition, ascertaining the "price that would have been" both at purchase and sale is extremely difficult in practice, where the actual prices prevailing at two points in time are objectively ascertainable. This transaction flow approach is also consistent with the 2012 Supreme Court holding under Livedoor.

Assuming that the independent transactions theory is still valid (indeed some courts continue to rely on it), however, we still need to analyze the issue of whether the entire purchase amount is damages or only the inflated difference at the time of purchase. Japanese courts are flexible to go by either approach because different damage amounts can be justified depending on actual facts and the positions argued by the parties. It seems to me however that such approach is inconsistent with the general theory of damage calculation (as held by the Supreme Court in Livedoor), and it tends to render damage calculations to be *ad hoc* and uncertain.

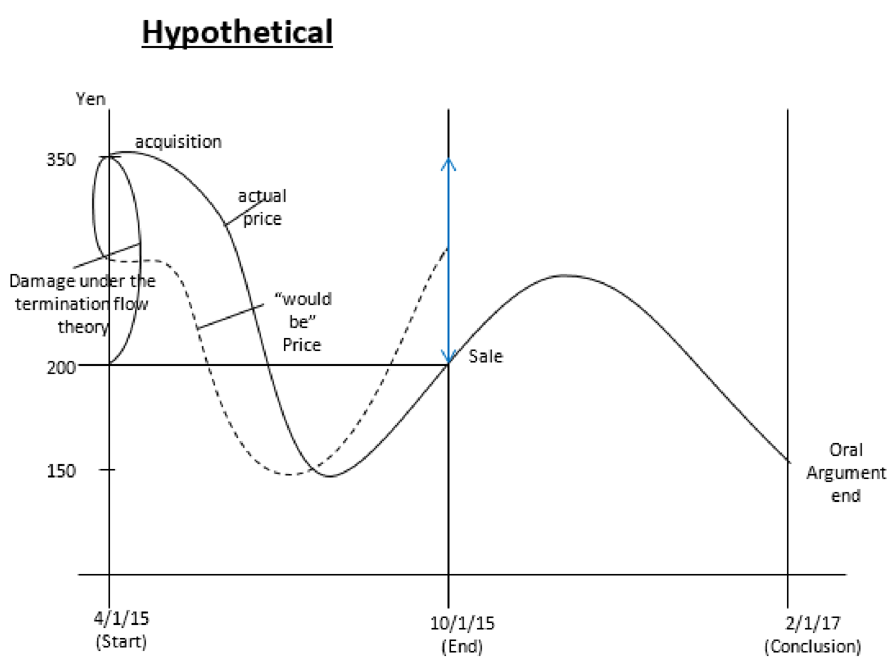
How the post-end date decline amount should be treated is a sensitive question. Both district court decisions suggest that post-end date decline is irrelevant in damages calculation because it is no longer associated with the false disclosure after the end date. Generally speaking, this observation seems justified. For shareholders that haven't disposed shares until the conclusion date, however, such approach may not be appropriate (see bullet 3 of Fukuoka District Court summary above). This is because they aren't obligated to dispose of the shares at the end date and the decline may be regarded as continued result of the false reporting. The plaintiff bears the burden of the amount of damages but in this circumstance it may not be fair to require the plaintiff to prove that the decline is associated with false reporting. It is probably assumed that the shareholder held them longer because of his desire to recover part of the loss. There are similar issues of (a) how to treat post-end date price increase and (b) how to deal with general inflation during the review period.

Takeaways

1. False securities disclosures present a unique issue of how the relevant damages should be ascertained under damage calculation theories. Overall, courts are relying on the traditional proximate damage theory as applied for the entire duration from purchase through sale (Supreme Court and Tokyo District Court), with some exceptions.

2. Given the practical difficulty involved in ascertaining a damage amount, the court's discretionary power is more likely to be invoked to overcome Japan's tendency to be too specific in requiring itemization of damages. This is particularly true for prices that would have been.

3. An important practical issue is how to deal with the post-end date decline in stock price. Generally, it would be acceptable to disregard it because such decline is no longer deemed related to false disclosure. However, it also has to do with when the shareholder actually sells the shares.



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If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings Tokyo lawyer:

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[1] Supreme Court, September 13, 2011, Minshu 65-6-2511 (in re Seibu Railway) and Supreme Court, March 1, 2012, Minshu 66-5-1957 (in re Livedoor).

[2] Tokyo District Court, May 13, 2021, Kinyu Homujijo 2175-54 and Fukuoka District Court, March 10, 2022, Kinyu Homujijo 1642-23.

[3] Civil Code, Article 416.

[4] Influential commentators have argued that damages under torts and those under breach of contract are fundamentally different, particularly when the tortfeasor was not in a position to foresee special damages. Be that as it may, the traditional court theory has been that torts and breach of contract calculate damages similarly.