Corporate Directors' Liabilities Towards Shareholders

Etsuro Kuronuma

I. INTRODUCTION

Corporate directors' liabilities are major tools to secure the performance of directors' duties. Corporate directors' duties are major tools to keep directors' interests aligned with corporate interests or shareholders' interests in order to reduce agency costs and to secure efficient management of business. Directors' liabilities have been a major subject in corporate law, and the subject is broad and profound.

This essay examines two basic issues related to corporate directors' duties and liabilities towards shareholders. First it analyses views on the party to which corporate directors' fiduciary duties are directed by assessing situations where shareholders depart from the corporate relationship voluntarily or involuntarily. Second, it analyses how each view on directors' duties makes use of statutory provisions of the Company Act to pursue directors' liabilities, including a look at some technical problems on direct pursuit of directors' liability by each shareholder.

In this essay, *corporate directors* refers to both managing directors (regardless of whether they are executive officers or directors) and directors who supervise the performance of managing directors of publicly held stock companies.

II. To Whom Should Corporate Directors Owe Fiduciary Duties?

1. Departure from Dogmatic Thoughts

It has been a tradition to think that corporate directors owe fiduciary duties not to their shareholders but to their company. The underlying dogma is that there is a contractual relationship between the company and its directors, whereas there is no direct legal relationship between corporate directors and shareholders. However, corporate law scholars began to notice many situations where corporate interests diverged from shareholders' interests, spawning some debate among scholars and practitioners on this subject.[1]

2. Purpose of Corporate Law

The issue of the party to which the duties of directors are directed relates to the issue of the purpose of corporate law. On the latter issue, we can find two theories of maximization of corporate value and maximization of shareholder value. Because shareholders' interests are residual, shareholders' interests increase as corporate interests increase. Corporate value thus coincides with shareholder value in most cases. However, when existing shareholders are squeezed out in the process of corporate reorganizations,[2] shareholder value often differs from corporate value. While shareholder value under a reorganization process is measured by the value that shareholders get for their stock, the corporate value of the transaction is measured by the value of corporate assets as a going concern. Nonetheless, case law and literature have been commingling the two terms of shareholder value and corporate value on purpose (or without purpose).

3. Ambiguous Meaning of 'Corporate Value' in Corporate Value Report and Case Law

The first literature to use the term 'corporate value' was the Corporate Value Report of the Corporate Value Study Group in 2005.[3] The concept of the report is quite simple. If a takeover proposal increases corporate value, directors of the target company should not take defensive measures against the takeover attempt. If a takeover proposal decreases corporate value, directors of the target company should take defensive measures against the takeover attempt. But 'corporate value' was not defined in the report. The Ministry of Economy, Trade, and Industry (METI) and the Ministry of Justice jointly

---

1 Y. Ohta / M. Yano, *Taikô-teki baishû teian e no taiyô ni saishite no torishimari-yaku no kôdo junsoku (1)-(3)* [On the rule of conducts in the case where directors react to competitive bids for corporate control (1)-(3)], Shôji Hômu No. 1884, p. 15, No. 1885, p. 38, No. 1889, p. 50 (2009-2010).

2 Corporate reorganizations mean mergers and stock-for-stock exchanges, which are often preceded by tender offers in this context.

3 Corporate Value Study Group, Corporate Value Report (2005), available at *http://www.meti.go.jp/policy/economy/keiei_innovation/keizaihousei/pdf/houkokusyo_hontai_eng.pdf.*

published 'Guideline Regarding Takeover Defense' (hereafter, the Guideline) based on the Corporate Value Report.[4] In the Guideline, the term 'corporate value' is replaced by the terms 'corporate value and shareholders' common interests'. But the two terms were not defined in the Guideline and the difference between the two terms is still unclear.

The first Supreme Court decision to employ the term 'corporate value' was the Bull-Dog Sauce Decision of August 7, 2007.[5] When required to decide whether a defensive measure by a target company violated the principle of equality of shareholders, the Supreme Court decided as follows:

> [I]n cases where, by the taking of control of the company by a specific shareholder, the corporate value and the interest of the company, and ultimately the common interest of shareholders would be harmed, treating the above shareholder in a discriminatory manner in order to prevent this from happening is not immediately against the underlying idea of the principle of the equality of shareholders, unless it is against the idea of fairness and lacks reasonableness.

Whether corporate value is different from the common interest of shareholders is still ambiguous in the Supreme Court decision.

III. Different Views on Corporate Directors' Duties

1. Corporate Value as a Total Value of the Company for Shareholders and Other Constituencies

If one thinks that corporate directors should perform their duties to maximize total value of shareholders, creditors, employees, consumers and other constituencies of the company and uses the term 'corporate value' to indicate this value, then 'corporate value' is clearly different from 'shareholder value'. I call this notion 'Constituency Theory'. The Guideline says, 'A joint-stock corporation aims to enhance its corporate value and ultimately shareholder interests by respecting its relationship with various stakeholders, such as its employees, suppliers, and customers.' One might derive the Constituency Theory from the Guideline.

2. Corporate Value as a Market Capitalization of the Company

Corporate takeovers sometimes have destructive effects on the target company. Suppose that market capitalization of A Company was 5 billion yen. Bidder X subjectively thought

4 Ministry of Economy, Trade, and Industry / Ministry of Justice, Guideline Regarding Takeover Defense for the Purpose of Protection and Enhancement of Corporate Value and Shareholders' Common Interests (2005), available at *http://www.meti.go.jp/policy/economy/keiei_innovation/keizaihousei/pdf/shishin_hontai.pdf.*

5 Minshû Vol. 61 no. 5, p. 2215, engl. translation available at *http://www.courts.go.jp/english/judgments/text/7007.08.07-2007.-Kyo-.No.30.html.*

she could raise the value of A Company up to 7 billion yen by replacing incumbent management, and she paid 6 billion yen to all the shareholders of A. Yet the value of A Company under X's management is objectively expected to be 3 billion yen. While the Corporate Value of A Company decreases by X's takeover, former shareholders of A Company are happy with the payment of 6 billion yen. Proponents of corporate value as market capitalization would require corporate directors to defend against value-decreasing takeovers. I call this notion 'Market Capitalization Theory'.

Under Market Capitalization Theory, when a takeover increases corporate capitalization by replacing employees, such a takeover attempt is welcomed, even if the decrease in existing employees' interest is larger than the increase in corporate value. In such a case, indeed, the increase of corporate value might be achieved only by abusive deprivation of employees' interests. I understand there are some arguments against Market Capitalization Theory from the standpoint of Constituency Theory.

The Tokyo High Court decision on Nippon Broadcasting System seems to employ Market Capitalization Theory.[6] In this case, a target management planned a share option issue to frustrate a hostile takeover attempt without shareholders' approval. The Tokyo High Court held that under special circumstances which would justify a share option issue from the viewpoint of protecting the interests of the company's shareholders as a whole, such a share option issue would not constitute an unfair issue, even if made principally for the purpose of maintaining or securing control of the company by a particular shareholder. Among examples of special circumstances, the court provides four examples:

(1) where the buyer has no true intention of managing the company, and has the sole purpose of forcing the company and its supporters to take the shares back at an intended price (known as a 'greenmail' case);
(2) where the buyer aims to conduct a 'scorched earth' policy of management towards the company, whereby it has the intellectual property, know-how and trade secrets transferred to itself or to its group companies;
(3) where the buyer aims to divert the company's assets as a source of funds to repay the debts of the buyer or its group companies; and
(4) where the buyer aims to sell off the company's high-value assets that are not pertinent to the company's business for the time being.

In the Nippon Broadcasting System case, the acquirer did not try to get all the outstanding shares of the target company. The court would like to protect minority shareholders who remain in the target company. However, it seems possible to read this decision to mean that directors have rights and duties to protect a company from an acquirer who decreases corporate value after the acquisition.

---

6 Tokyo High Court, Judgment of March 23, 2005, Hanrei Jihô No. 1899, p. 56. An English summary is available at 2 University of Tokyo Soft Law Review, 112 (2010) (also available at *http://www.gcoe.j.u-tokyo.ac.jp/publications/UTsoftlaw2.pdf*).

3. Common Interests of Shareholders

In the case described in (2), one might think that directors of A Company should not take defensive measures against X because X's plan maximizes the common interests of existing shareholders of A Company. I call this view 'Shareholder Value Theory'. Commentators might be divided over what directors of A Company should do to perform their duty to maximize shareholder value. Nonetheless, Shareholder Value Theory clearly differs from Market Capitalization Theory in that the former does not take into account the value of the company after acquisition. Even if A's directors invite a competing offer from Y, which proposes to pay 5.5 billion yen to shareholders, and the corporate value of A Company is reasonably expected to be 6 billion yen under Y's management, the directors still should not obstruct X's attempt under Shareholder Value Theory.

The argument against Shareholder Value Theory would be that the social costs of persuading corporate directors to look after existing shareholders only are so large that the efficient economy of a country would be lost. A counter argument to this would be that no rule could prevent wealthy people from wasting their money in our free economy.

One thing that must be made clear is that the notion that corporate directors should prefer shareholder value to corporate value does not solve the question of allocation of interests among classes of shareholders. For example, Company A issues class B stock and class C stock, where the value of each share issue is 2.5 billion yen respectively before a merger proposal is made. Two proposals are made to the management of A Company from X and Y. Proposal X is to give X stock worth 2 billion yen to class B shareholders and to squeeze out class C shareholders by paying 4 billion yen in total, whereas Proposal Y is to give X stock worth 3 billion yen to class B shareholders and to squeeze out class C shareholders by paying 2 billion yen in total. Shareholder Value Theory does not necessarily require directors of A Company to accept proposal X, which increases shareholder value by 1 billion yen.

4. Recent Case Involving an MBO

One judgment discussed the duties of directors who were faced with a management buyout (MBO).[7] In a case where directors of a target company were brought action by shareholders and required to pay damages to them (known as the Rex Holdings Case), the Tokyo District Court held as follows: (1) directors have a duty of due care (Company Act Art. 330, Civil Code Art. 644) as well as a duty of loyalty towards the company; (2) as a for-profit corporation, each company purports to pursue the common interests of shareholders through the increase of corporate value in general; (3) therefore, directors of a stock company have a duty to care about the common interests of shareholders. This judgment is the first to decide on the duty of directors in the face of MBO, although the

7 Tokyo District Court, Judgment of April 1, 2011, Kin'yû Shôji Hanrei No. 1363, p. 48.

judgment itself rejected the plaintiff's claim that the directors breached their duty of due care and loyalty. Though the court still connected the common interests of shareholders to corporate value, the substance of the shareholder's claim was that the price of the tender offer was too low. In addition, the tender offer price has nothing to do with the value of the company after an MBO. Therefore, directors' duty to care about the common interest of shareholders in this judgment means that the duty of directors towards shareholders is to increase shareholder value.

IV. Other Considerations

1. When Minority Shareholders Are Involved

In most takeover cases, an acquirer purchases as much stock as possible by a tender offer at the first stage. Then the acquirer merges with the company by stock-for-stock exchange or merger at the second stage. In such situations, there are no *common* interests of shareholders at the second stage, because the major shareholder (acquirer) and minor shareholders have different interests to each other. The major shareholder at the second stage has special interests as an acquirer that other shareholders do not have. Directors of a company should have a duty to care about the interests of shareholders who do not have a special relationship with the company other than as shareholders. Therefore, shareholder value should mean the amount of consideration that shareholders other than an acquirer get through a tender offer and subsequent mergers.

2. When a Partial Bid Is Made

When an acquirer makes a partial tender offer, it will be difficult to calculate the value that existing shareholders expect to get. But it will still not be impossible to calculate it, and Shareholder Value Theory can be applied to the case of a partial bid. The Financial Instruments and Exchange Act permits partial bids when the acquirer's holding rate of equity securities after the tender offer does not exceed two-thirds.[8] On the other hand, courts tend to require the amount of consideration that target shareholders get in the second-stage merger transaction to be as much as the tender offer price in order to reduce the coercive effect of a two-tier tender offer.[9]

---

8 Art. 27-13(4) of Financial Instruments and Exchange Act [*Kin'yû shôhin torihiki-hô*], Law No. 65/2006 as amended by Law No. 32/2010; Art. 14-2-2 of Financial Instruments and Exchange Order [*Kin'yû shôhin torihiki-hô shikô-rei*], Order No. 321/1965 as amended by Order No. 137/2010.

9 Tokyo District Court, Judgment of March 31, 2009, Hanrei Jihô No. 2040, p. 135.

V. To Whom Should Corporate Directors Be Liable?

1. Statutory Provisions on Directors' Liabilities Towards a Third Party

Proponents of Corporate Value Theory would explain that if a corporate director breaches her duty to a company, she is liable to the company for damages caused by the breach of her duty. This is what Article 423 para. 1 of the Company Act provides. It is also possible for a director's breach of duty to cause an individual shareholder's loss directly while not causing a company's loss. For such a case, Article 429 para. 1 provides that if directors are with knowledge or grossly negligent in performing their duties, such directors shall be liable to a third party for damages arising as a result thereof. For example, when a company issues new stock to a third party on a condition advantageous to the third party, existing shareholders suffer a loss in their share value; however, the company gains capital by the misconduct, so the company suffers no loss. In such a situation, the Supreme Court recognized that 'the third party' of Article 429 para. 1 includes shareholders, so damaged shareholders can pursue directors' liability towards them.[10] Because Article 429 para. 1 attributes directors' liabilities towards a third party to their breach of duties towards the company, directors' direct liabilities towards individual shareholders would not be inconsistent with Corporate Value Theory.

Shareholder Value Theory also uses Article 429 para. 1 of the Company Act as a means of implementing directors' duties towards shareholders. For that purpose, 'their duty' should be read to include both duty to a company and duty to shareholders as a whole.

2. Direct Pursuit for Damages of Indirect Loss

Apart from situations where corporate value and shareholder value diverge, suppose that a company suffered a loss by a director's mismanagement, and shareholders as a whole also suffered a loss in the form of a decrease in the value of their shares. Is it permissible for each shareholder to pursue directors' liability directly based on Article 429 para. 1 of the Company Act?

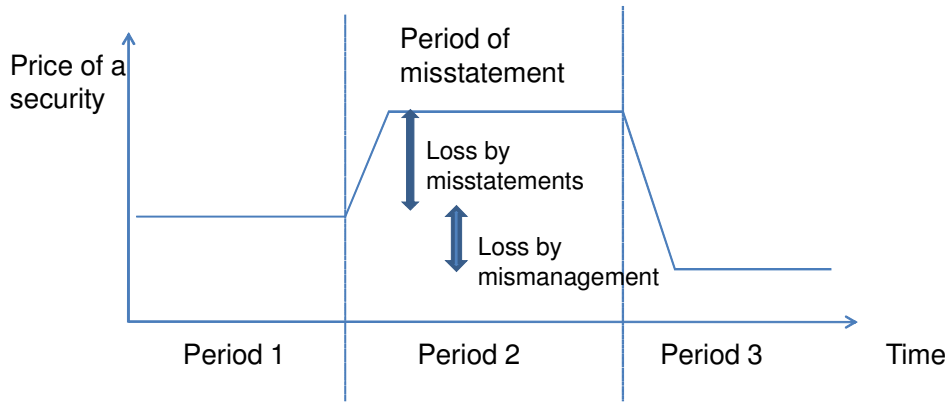
The Tokyo High Court, which dealt with this issue, held as follows.[11] When shareholders of a publicly held company suffer a loss caused equally by a declining stock price reflecting bad business performance of the company and by negligent misconduct of directors, shareholders who pursue directors' liability must use derivative suits unless special circumstances exist. The reason each shareholder's direct claims are rejected is that if a company recovers the loss by a derivative suit, each shareholder's loss also disappears.

However, this conclusion is not always justified. Suppose that a company made public its bad performance after a long period of hiding that bad performance. Shareholders

10 Supreme Court, Judgment of September 9, 1997, Hanrei Jihô No. 1618, p. 138.
11 Tokyo High Court, Judgment of January 18, 2005, Kin'yû Shôji Hanrei No. 1209, p. 10.

who purchased the company's stock during the periods when the performance was misstated can pursue directors' liability based either on Article 24-4 of the Financial Instruments and Exchange Act or on Article 429 para. 1 of the Company Act; they can even pursue company liability based either on Article 21-2 of the Financial Instruments and Exchange Act or on Article 350 of the Company Act. Shareholders who purchased the stocks before misstatements were made and still hold the stocks can bring derivative suits against corporate directors and recover their loss if they succeed. In contrast, those shareholders who bought their stock before misstatements were made and sold them after the misstatements became public cannot bring derivative suits because they are no longer shareholders of the company. Nor can they get a remedy by derivative suits brought by existing shareholders (see *Figure 1*).

Figure 1



Type of shareholders	Methods of recovery
Purchased stocks in period 2 and held them until period 3 began	Can pursue liabilities of directors and the company
Purchased stocks in period 1 and hold them until the present	Can bring a derivative suit for directors' liability against the company
Purchased stocks in period 1 and sold them in period 3	Can bring a direct suit against directors, or nothing?

The arguments above lead us to conclude that shareholders who suffered indirect loss but cannot get a remedy by derivative suits should be entitled to pursue direct liability of directors.[12]

Counter arguments can be made against the above theory. Directors who breached a duty to their company and who paid all the damages to the company are still obliged to pay former shareholders' damages (double liabilities). The reason double liabilities arise is that shareholders who purchased stocks after the company's bad performance was made public receive profits by the directors compensating the company's damages. Theoretically, the double liability problem should be addressed by permitting directors who performed their duty of paying damages to receive back the profits of enriched shareholders. Practically, because directors' liability to their company is joint and several, it is unthinkable for a director to perform her duty of paying damages both to her company and to the former shareholders.

VI. TEMPORARY CONCLUSIONS

This question – to which party corporate directors owe fiduciary duty – is rooted in the purpose of corporate law and difficult to answer. I do not have a clear answer to it, but my impression is that making directors perform their duty to maximize shareholder value would provide an appropriate mechanism to the law of corporations in adjusting the various interests of parties surrounding a company. Because no one performs a fiduciary duty to two or more parties, the interests of creditors, employees and other constituencies should be protected through legislation addressed to a company itself or through express or implied contracts between a company and each party above. The same is true as a duty of directors of a company that issues plural classes of equity securities.

As far as liability provisions are concerned, two provisions on directors' liability towards a company and towards a third party inherited characteristics of civil law tradition. In addition to those provisions, Japan introduced shareholder derivative suits from US law in 1950, which has deepened the discussion on directors' liability as well as complicated it. It seems important to recognize that the directors' liability provision (Art. 429 para. 1 of the Company Act) is broad enough to provide remedial means to various different parties, such as shareholders and creditors. Therefore, we should construct effects and requirements of the provision through analysing the function it should perform in relation to each situation where it is applied.

12 E. KURONUMA, *Torishimari-yaku no tôshi-ka ni taisuru sekinin* [Directors' Liability towards Investors], Shôji Hômu No. 1740, p. 17 (2005).