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Some Thoughts on Director Liability and Workout Situations

I. Obligations and Liabilities of Directors

1. Obligations of Directors

(1) A director bears to the company the duties of the due care of a good faith caretaker and of loyalty (to comply with laws and regulations, articles of incorporation, and resolutions of meetings of shareholders, and to faithfully undertake his/her duties for the company). In general, the courts have found the contents of the duties of due care and loyalty to be the same.

(2) Duty to Observe/Superintend: The duty of a director to observe the matters of the company is not limited to those matters addressed at a board of directors meeting, but includes the duty to observe the overall performance of the representative director and others in undertaking their work, and to ensure the appropriate performance of such work through the board of directors. Note that the representative director has the duty to report to the board of directors, at least once every three months, the status of performance of company matters.

2. Liabilities of Directors

(1) Liability to the Company (Civil Liability)

Under the Corporate Law, a director is liable to compensate the company for any damages incurred by the company as a result of a breach of duty by the director. "Breach of duty" includes the case of a violation of laws and regulations, and the articles of incorporation, in addition to violations of the duties of due care and loyalty.

In general, breach of duty is liability for negligence (mistakes), but as an exception, in the case of a conflict of interest transaction, a director is held liable without negligence, or with negligence being inferred.

Also, in regard to an illegal distribution or provision of benefits, a director bears a particularly heavy liability, for which a director is held liable without negligence, or with negligence being inferred.

(2) Liability to Third Persons (Civil Liability)

In the case of (a) malice (acting with knowledge) or gross negligence (material lack of care) for a breach of duty, (b) a negligently made false recordation or public notice, or (c) a negligently made false entry or other similar indication in regard to material matters in financial documents and operating reports, a director will be liable to compensate for damages incurred by a third person as a result of such act.

II. General Background to Workouts in Japan----Some Aspects

1. “Main Bank”

In Japan, a peculiar banking practice has been established for decades. Since the capital market did not develop sufficiently to fill the needs for capital caused by the rapid growth of industrialization, each company tried to develop and strengthen a relationship with some particular bank, so that the bank can provide capital when the borrower is in need of cash. For such purpose, the borrowers ordinarily provided financial and all the other important information about themselves to the bank. Such bank has been called the “main bank” of the borrower. As a part of the main bank practice, the main bank and the borrowers often engaged in cross-shareholdings. Main banks have helped the borrowers not only in meeting their financial needs but also by introducing business opportunities and sometimes by loaning their personnel to the borrowers. As a result of such close relationship, it has been generally believed that the main bank should rescue the borrower from its financial crisis, and, in the case of restructuring, should play a main role in formulating a restructuring plan and securing agreements from all the other lenders and creditors to the plan. The main bank is almost always required to assume more losses than the other financing institutions and creditors.

Following the collapse of the bubble economy the financial condition of Japanese banks deteriorated. Also, since then (and perhaps as a result of the collapse) shareholders of banks have started to watch managements’ decisions much more closely than they did in the past. As a result, Japanese banks are limiting the scope of their responsibilities as main banks, which, in any event, have been less a legal and more a moral obligation in almost all cases.

As the financing function of a main bank diminished, somebody had to assume the function in workout settings. The government of Japan thus established the Industrial Revitalization Corporation of Japan in 2003 to facilitate out-of-court workouts. Although IRCJ developed various models, the basic investment/business model of IRCJ was to purchase the outstanding loans against a target company from non-main banks and, together with the main bank, formulate a restructuring plan. IRCJ often extended a DIP loan during the process, or subscribed for the stock of the target company. IRCJ conducted thorough due diligence, and formulated a realistic restructuring plan that avoided conflicts of interest, something which the structures of main bank-led workouts almost always involved.

At the expiration of the 2-year buyout period in 2005, the government’s attempt to activate the private workout market through its intervention turned out to be a great success. It has ceased purchasing loans and is now in the stage of having the debtors fixed and exited from the restructuring process. It should complete the process by the end of the fiscal year ending in 2008.

2. Trade Creditors

As a result of the less developed capital market, trade creditors have provided finance to purchasers, i.e., the payments are often made 4 to 6 months after the goods have been delivered¹. If, under such circumstances, the purchaser fails, the sellers claim for the sale of

¹ Payments have often been made by promissory notes with long maturities, which are endorsable. An endorser is liable to honor the note, and any issuer who fails to honor its promissory note twice or more within any half a year will be excluded from banking transactions. Those rules are the source of trust by the business circles in promissory notes. Note holders often obtained finance by discounting the notes at the banks. Failure of the issuer, thus, easily affects the note holder’s sustainability as a business enterprise.

goods for 5 to 7 months remains unpaid. Such practice jeopardizes the enterprise value of the purchaser once it fails to honor the invoices.

In addition, shopping mall companies have developed a practice under which daily sales revenue of the tenant shops is deposited with the mall companies and, at the end of each month, the deposited sales revenues are refunded back to the tenants after deduction of monthly rents, which are computed upon monthly sales results.

Thus, trade creditors are financially dependent on the purchasers or the mall companies, and their failure immediately severely hits the trade creditors' business. In Japan there is a particularly strong necessity for protection of the trade creditors' claims.

III. Treatment of Claims under Bankruptcy

1. DIP Financing

DIP financing provided post-petition (with the court approval in the case of those extended during the gap period²) are treated as administrative claims.

However, pre-petition DIP financing, which is provided during the workout period, cannot be automatically granted administrative claim status. The debtor (or its trustee) can of course make a settlement post-petition with the pre-DIP lender, with court approval, to treat the pre-DIP financing as an administrative claim. Since, however, such outcome is not predictable for sure, most lenders are naturally reluctant to extend a pre-DIP loan to an ailing company at the time when it is really in need of cash.

2. Trade Creditors

Pre-petition trade claims are unsecured claims subject to pro rata distribution. In practice, however, the debtors often pay them fully, with the court approval. The law permits the debtor to settle small amount pre-petition claims where (i) it causes the proceeding to proceed smoothly, or (ii) the debtor's business would face material difficulties unless such small amount pre-petition claim is paid. Accordingly, experienced bankruptcy attorneys informally discuss application of the small amount provision with bankruptcy judges, to help the out-of-court workouts proceed smoothly. "Small amount" is often conveniently interpreted.

There are, however, uncertainties about the treatment of such trade claims once the workout fails and an insolvency proceeding starts, and, as long as such uncertainties remain, vendors will often not fully cooperate with the purchaser debtor company and refuse to trade with it unless the company provides a deposit or favorably changes the payment terms.

3. Enforcing Plan Approved by a Majority But Not All of the Creditors

It is not easy to secure unanimous approval from all the creditors, especially under the long lasting main bank practice. Non-main banks complain about any plan and demand that the main bank should bear more loss, in view of the information that the main bank received from the borrower, the amount of revenue and other benefits which the main bank had received from the past transactions with the borrower, etc. If any one of those lenders or a creditor refuses to accept the plan, the workout will fail, no matter how fair and equitable it might be.

In order to cope with such problem, it is now advocated that a new law to facilitate out-of-court workouts be enacted. Presently, the outline of the law is as follows:

² Period from the petition filing/injunction order until the commencement order.

- (1) Initiate workout discussion;
- (2) Formulate a plan;
- (3) Secure approval from vast majority of the creditors;
- (4) If the workout plan cannot be enforced due to opposition by a limited number of creditors, the debtor can file a petition with the court for confirmation of the plan;
- (5) The court can confirm the plan, unless the process of the workout or the plan was clearly unfair or inequitable, upon hearing from opposing creditors, independent advisors involved in the workout process, and others;
- (6) Any opposing creditor may raise an objection to the confirmation order within a prescribed period;
- (7) Upon such objection, the confirmation order loses its effect, but if no objection has been filed, the confirmation order shall become final and non-appealable.

The goal of such law is to utilize the judiciary function (i) to give a path for a fair and equitable workout plan to become enforceable, and (ii), even in the event that the plan may not become enforceable, to give some meaningful extent of predictability that the claims of DIP lenders and trade creditors which have accrued during the workout process will be granted administrative claim status in the insolvency proceeding to follow.

IV. Obligation and Liability of Non-Debtor Directors----In Workout Context

1. Directors of DIP Lenders/Vendors

As outlined in III above, pre-petition claims of a DIP lender or a vendor are not necessarily protected post-petition simply because they entered into those transactions with the intention to support the debtor's business. There are two types of reorganization proceedings in Japan: Corporate Reorganization and Civil Rehabilitation. Under Corporate Reorganization, a court-appointed trustee leads the proceeding, whereas under Civil Rehabilitation, DIP leads it, with a supervisor monitoring in general. In the case of Civil Rehabilitation, a plan may be formulated and treatment of pre-petition claims may be determined more liberally with less stringent court control, but still the results are unpredictable. If the contemplated workout eventually fails and the pre-petition claim of a DIP lender/vendor is treated just as a pre-petition unsecured claim, each of the directors who made the decision faces the risk of personal liability for a breach of the duty of due care as a director.

In assessing the obligation of a director of a DIP lender/vendor in extending DIP finance or trade finance to a company undergoing an out-of-court workout, the business judgment rule will apply.

2. Business Judgment Rule

Japanese courts recognize the business judgment rule, under which a director has a certain scope of discretion, and only where the director's act has exceeded the boundary of such discretion will the director be deemed to have violated the duty of due care and be held personally liable for the damages caused to the company. This is the business judgment rule in Japan. Under the rule, there are two tests: (i) whether there was any negligent and material error in recognition of the facts upon which the business judgment has been made, and (ii) whether any materially unreasonable or inappropriate element for management of an enterprise was involved in the process or the substance of the decision made by the director. For a director to be exempted from personal liability for a breach of the duty of due care,

he/she has to clear the above two tests. In regard to a director's obligation and the liability of a director in relation to a workout, since the issue is, in addition to the probability of successful reorganization, the reasonableness of the management's judgment on post-petition treatment of a pre-petition, consultation with bankruptcy specialists and various measures of precaution are essential to meet the requirements under the business judgment rule. Generally, unless there are apparent benefits to justify the risk to be borne by entering into the transaction, the risk of personal liability is not so remote for the directors involved in the decision and the matter should be closely considered. Since, the business judgment rule itself has been created to protect a director from personal liability resulting from any kind of acts as a director, it appears difficult, and probably inappropriate, to separately categorize the workout situation and set forth any specific new rule loosening the degree of due care for such situations.

3. Directors of Pre-petition Lenders

A director of a pre-petition lender faces a greater variety of alternatives in rescue measures in the workout situation, and in the event where he/she has made a decision to step forward but the debtor none-the-less fails, some other elements may be taken into consideration to determine whether he/she may be exempted from personal liability under the business judgment rule. Those rescue measures could include: (i) that he/she bilaterally agrees to reschedule his/her company's claim without involving other creditors, (ii) that he/she refrains from foreclosing a lien, or (iii) that he/she extends a new loan to the debtor. Those measures are taken with the intention to help the debtor from the crisis of bankruptcy. If the director and the debtor are fortunate, the debtor will successfully return from the crisis and the lender may enjoy repayment of the existing loan rather than the originally limited possibility of collection, but if not, the director's personal liability will be in question.

In any event, the business judgment rule will be applied to determine the director's personal liability in relation to the judgment that he/she had made, and, of course, the existence of already jeopardized claims is taken into consideration. The result is, however, still unpredictable, and moreover there seems to be no way to make it more predictable.

V. Obligation and Liability of Non-Debtor Directors----In Workout of Cross-border Corporate Group Setting

Assuming that a Japanese corporation is a wholly owned subsidiary of a foreign parent, the director of the Japanese subsidiary is, on the one hand, a director of the subsidiary subject to obligations owed to the shareholder and creditors, but, on the other hand, an agent of the parent. If the parent requests that the Japanese subsidiary extend a loan to the parent, the question arises whether the director's duties owed to the shareholders and the creditors are discharged simply because of the instruction given by the parent as the sole shareholder. Since, however, the directors are under a duty not only to the shareholders but also to the creditors, especially when the company is in the twilight zone of questionable financial health, the director's duty of due care still remains in place, and thus a director's personal liability will be closely examined if the parent fails and the Japanese subsidiary suffers a loss.

Of course, due consideration will be made to the benefit that the subsidiary would have gotten in exchange for the loan it was going to make. The benefit might be the parent's financial recovery that will result in expanded business of the Japanese subsidiary. Avoidance of bankruptcy of the parent itself could also be a benefit for the subsidiary. All of those elements will be taken into consideration when the business judgment rule is applied, and

essentially, there do not appear to be any particular elements in a cross-border corporate group workout situation that may lead to a different conclusion for Japanese law purposes.

VI. Conclusion

Under case law, it is established that there is a realm of broad discretion for directors in making judgments on business administration, and a director is deemed to have breached the duty of due care only in the event that he/she oversteps such realm of discretion. The question is determined by applying the business judgment rule. The rule takes into consideration all the relevant elements, and even though there seem to be greater ambiguities and more contingent considerations for a director in a workout situation, the business judgement rule can still be applied. Accordingly, establishing a particular rule applicable only to the workout process, whether completely domestic or cross-border, appears unlikely and impractical under Japanese law.