

Criminal Liability of Directors and Officers in Japan

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Introduction

Japan has a comprehensive statutory scheme prohibiting, and sternly punishing, a variety of bad acts committed by a company's directors and officers before, during and after an insolvency proceeding. Notwithstanding this broad and seemingly intimidating set of laws, as a practical matter, prosecution and conviction of an individual requires knowing and intentional misconduct.

Trading While Insolvent

Out-of-court restructurings remain most popular in Japan and a focus on maintaining the business as a going concern continues to be a better cultural fit than liquidation. Accordingly, Japanese law does not prohibit trading while insolvent (in some ways the system encourages insolvent companies to resist an insolvency filing) and mere insolvency of a company, the timing of an insolvency filing, or lack of a filing does not alone give rise to criminal penalties. Instead, criminal liability may arise as a result of an individual's engaging in activities that are harmful to the corporation or its creditors. While the absolute risk may be greater for transactions occurring prior to a filing and subject to avoidance, this is due to the increased scrutiny placed upon transactions that are voided. Japanese courts have always required that the harm to a corporation be coupled with intentional misconduct by an accused officer or director.

It is reasonable to maintain that this requirement of intent has generally worked well for troubled companies in Japan. Directors and officers are free to take actions that they believe, in good faith, are in the best interest of reorganization. Creditors, in turn, may be confident that fear of criminal sanctions by corporate decision makers is not an incentive for liquidation. At the same time, all stakeholders can take comfort that intentional bad acts that harm the business can be punished.

Crime and Punishment in Japan

By any measure, Japan (despite being a densely populated nation) has one of the lowest crime rates in the world. Low overall crime coupled with a staggering ninety-nine percent conviction rate, give the appearance that Japan's criminal justice system has considerable excess capacity. In fact, Japan's court system is as over-burdened as those of other countries. Some legal commentators argue that it is the very dearth of prosecutorial resources that results in only a select few cases being prosecuted, with a near guarantee of conviction. In any event, the one percent acquittal rate led to recent pressure to reform the professional-judge system in favor of a lay-judge (*saiban-in*) system. Currently, criminal cases in Japan are decided by either a single judge or a three-judge panel. Under the reforms, adopted by the Diet on May 21, 2004 and to become effective by May 1, 2009, the most serious cases¹ will be decided by a panel of three professional judges and six lay judges. However, cases concerning criminal acts of officers and directors will, for the foreseeable future, continue to be tried under the old system.

The Statutory Scheme

Director and officer criminal liability under Japanese law involves an interplay among several laws:

- The Corporation Law of Japan (Law No. 86, July 26, 2005) (*Kaisha Ho*)² is distinct from The Commercial Code of Japan (Law No. 48, March 9, 1899) (*Sho Ho*). Until its amendment in 2005 (Law No. 87, July 26, 2005), the Commercial Code contained many of the penal provisions relating to corporate activity (Ch.7, Art. 486-499). The provisions of the Corporation Law superseded many former Commercial Code provisions; specifically, Articles 33 through 500 of the Commercial Code were deleted and incorporated with amendments into the Corporation Law. This is significant because cases prior to July 2005 necessarily refer to the prior Commercial Code provisions.

¹ The Act Concerning Participation of Lay Assessors in Criminal Trials, Article 2(1), provides that the District Court will handle only the cases involving crimes punishable by death or imprisonment for an indefinite period or by imprisonment with work or involving crimes in which the victim has died due to an intentional criminal act and those cases noted in Courts Act Article 26(2)(ii) (involving crimes punishable by death, imprisonment of not less than one year with or without work.)

² Throughout this paper, where statutes are quoted, they are unofficial English translations of the original Japanese text.

- The Penal Code of Japan (Law No. 45 of 1907) (*Kei Ho*) includes many standard elements one would expect to find in a penal code.
- Japanese insolvency proceedings can be implemented through any one of four distinct insolvency law regimes (collectively, the “*Insolvency Laws*”) selected based upon the attributes of the debtor and whether the outcome will be a reorganization or liquidation:
 - Bankruptcy Law of Japan (Law No. 75, June 2, 2004) (*Hasan Ho*);
 - Special Liquidation Law (Art. 510-574 of Corporation Law) (*Tokubetsu Seisan in Kaisha Ho*);
 - Civil Rehabilitation Law (Law No. 225, December 22, 1999) (*Minji Saisei Ho*);
 - and
 - Corporate Reorganization Law (Law No. 154, December 13, 2002) (*Kaisha Kosei Ho*).

Each of the Bankruptcy Law, Civil Rehabilitation Law and Corporate Reorganization Law contains, in its last section, substantially similar penal provisions.

Director and Officer Liability Under the Corporation Law

Directors, Officers and Others

Traditionally, in Japan, a company’s directors have the statutory authority to manage a corporation. Increasingly, the use of executive officers in management has become more common in Japan. The penal provisions of the Corporation Law apply to guilty promoters, directors, auditors, accounting partners, managers, employees and inspectors and, for corporations in liquidation, liquidators and their proxies, supervisory commissioners and investigation commissioners (“*Directors, Officers and Others*”) (C.L., Art. 960). The primary director and officer liability provisions of the Corporation Law apply only to a stock companies (*Kabushiki-Kaisha*).

*Aggravated Breach of Trust*³

Aggravated Breach of Trust occurs when any of the Directors, Officers and Others:

for the purpose of promoting his/her own interest or the interest of a third party, or inflicting damage on *Kabushiki-Kaisha*, commits an act in breach of his/her legal duty and causes financial loss to the company ... (C.L., Art. 960).

It carries a penalty of “imprisonment with work for not more than 10 years or a fine of not more than ¥10,000,000 or both” (C.L., Art. 960). Aggravated Breach of Trust has most often been applied within the context of nonperforming bank loans. The element of promoting self or third party interest is satisfied if the self-interest outweighs the benefit to the bank. For example, in the case of Hokkaido-Takushoku Bank (Sapporo High Court, August 31, 2006), the Court found that the president and former president of the bank concealed their lending practices in order to avoid claims against themselves and were thereby promoting their own financial and reputational interests where disclosure would have benefited the bank. These executives approved numerous loans to borrowers on the verge of insolvency without taking adequate measures to increase the likelihood of collection or other recovery. The bank’s failure in 1997 and subsequent liquidation attracted significant media attention. In addition, a director of one of the bank’s borrowers himself became a central character in the case and was convicted of the crime of conspiracy to commit Aggravated Breach of Trust (P.C., Art. 60 and 65). He was found to have fully understood the damage the bank would suffer by making a loan to his company and that the bank directors were promoting their own interests, but had nevertheless, threatened and coerced the directors into continuing to make improper loans to the borrower.

In the bank example, when a borrower’s financial condition suggests little possibility of collection, it becomes a bank director’s duty to adopt measures to maximize the bank’s recovery.

³ The general (not “aggravated”) Breach of Trust provision is found in Article 247 of the Penal Code and applies to “any person who is in charge of the affairs of another” and carries a lesser penalty of “imprisonment with work for not more than 5 years or a fine of not more than ¥500,000”.

The Supreme Court (May 24, 1983) has ruled that whether a “financial loss” occurred must be adjudged from an economic and not a legal point of view. Therefore, a bank suffers its financial loss at the time it loans money if it has little prospect of recovering, even though a default has not yet occurred under the loan documents.

Crimes Endangering Property of the Corporation

Article 963 of the Corporation Law imposes criminal penalties of up to five years’ imprisonment with work and up to a ¥5 Million fine on Directors, Officers and Others who commit such acts as (i) declaring a dividend or distributing surplus when none exists, (ii) causing a *Kabushiki-Kaisha* to unlawfully acquire its own shares,⁴ and (iii) disposing of a *Kabushiki-Kaisha*’s assets in a speculative transaction outside the scope of the corporation’s business.

Director and Officer Liability Under the Penal Code

Fraud

The Penal Code provides that “a person who defrauds another of property” or “a person who obtains or causes another to obtain” a profit by fraud, shall be punished by up to ten years’ imprisonment with work (P.C., Art. 246).

In a landmark insolvency case, the Supreme Court of Japan (No. 1939, June 6, 1967) ruled that where the responsible directors ordered products from vendors even though the corporation had no ability to pay (and the directors had no intention of paying) the order constituted fraud. The Court explained that intent is a vital element of fraud. Likewise, the Penal Code provides that (i) except where expressly provided by law, an act performed without the intent to commit a crime is not punishable, and (ii) when a person who commits a crime is not, at the time of its commission, aware of the facts constituting a greater crime, the person shall not be punished for the greater crime (P.C., Art. 38). However, knowledge of a law is *not* treated as a prerequisite to intending to commit a crime (P.C., Art. 38). We are unaware of any existing cases that support an argument imputing knowledge. Theoretically, however, by analogy to violent crimes, if a

⁴ The Corporation Law now provides for expanded circumstances whereby a corporation is permitted to acquire its own shares. Scholars have called for a re-examination of criminal penalties in this area.

person should have or ought to have known that the actions would result in the commission of a crime, a conviction for fraud could possibly be attained.

In the matter of Toyota-shoji (Osaka District Court, May 2, 1989) directors of a gold bullion company were found to have solicited transactions with counterparties knowing that there was little chance that the company would honor its obligations to the counterparties. The Court found that the directors committed fraud by (i) concealing the truth about the company's financial condition, (ii) expressly representing to counterparties that the company was financially stable, and (iii) assuring the return of the counterparties' gold at the end of the respective contractual terms.

Recently, the Osaka High Court (January 19, 2005) found fraud where a manager and responsible director caused a corporation to sell and promise to repurchase mortgage deeds. The corporation was highly leveraged, and the manager and director were found to have known it could not satisfy its buy-back obligations.

Other Corporate Crimes

An exhaustive discussion of the provisions of the Penal Code is beyond the scope of this paper, however, it is noteworthy to mention that the Penal Code prescribes various criminal penalties for obstructing compulsory execution on or seizure of an asset (Art. 96-2), obstructing the fairness of a public auction or bidding process (Art. 96-3), forging private documents (Art. 159), counterfeiting a private seal (Art. 167), perjury (Art.169-170) and making false expert testimony or interpretation under oath (which is treated as perjury) (Art. 171).

Director and Officer Liability Under the Insolvency Laws

Japanese Insolvency Regimes

In Japan, both Bankruptcy and Special Liquidation are liquidating procedures. Bankruptcy is by far the more common procedure for liquidating a business and applies to individuals as well as corporate entities.

Corporate Reorganization is used most frequently in high profile, large scale corporate restructuring cases. However, Civil Rehabilitation, applicable to both corporate entities and individuals, is the more common restructuring procedure. In Civil Rehabilitation, unlike the other regimes whereby a court-appointed trustee leads the case, the proceeding is ordinarily led by the debtor supervised by a court-appointed supervisor. This is significant because more debtor misconduct is possible when debtor management plays the most active role.

Dual Objective

The penal provisions of the Insolvency Laws are intended to promote fairness to creditors and the integrity of the insolvency procedure.

Fairness of Consequences

It is not surprising that fraudulent activity that unfairly disadvantages creditors is subject to severe penalties including imprisonment with labor not exceeding ten years and fines up to ¥10 Million (B.C., Art. 265; Corp. R.L., Art. 266; Civ. R.L., Art. 255). Fraudulent activity includes actions to (i) conceal or destroy the debtor's property, (ii) falsely report the transfer of the debtor's property, (iii) falsely report the debtor's obligations, (iv) modify the status of the debtor's property and decrease the price thereof, and (v) disposal of debtor's assets to the disadvantage of creditors⁵.

Integrity of Procedure

Actions that compromise the integrity of the insolvency procedure give rise to criminal penalties in Japan. These include (i) refusing to or making false explanations (B.C., Art. 268; Civ. R.L., Art. 258; Corp.R.L., Art. 269), (ii) refusing to disclose material assets and property (B.C, Art. 269)⁶, (iii) concealing or destroying books and records concerning the status of the business or properties (B.C., Art. 270; Corp.R.L., Art. 270; Civ. R.L., Art. 259), (iv) refusing explanation at questioning by the Court (B.C., Art.271), (v) interfering with the of duty of the trustee (B.C., Art. 272; Civ. R.L., Art. 271; Corp.R.L., Art. 260) and (vi) bribery (B.C. Art. 273-274; Corp.R.L., Art. 272-273; Civ. R.L., Art. 261-262).

⁵ Disposition of property at distressed prices may occur if such prices have a rational basis.

⁶ A bankrupt has the duty to disclose important assets in writing to the court daily.

Conclusion

In Japan, in order for criminal liability to attach to Directors, Officers and Others, there must almost always be an intentional act of misconduct, and the particular criminal statutes applicable to such persons should be viewed as variations on the Penal Code crime of fraud.

While Japanese law provides an extensive framework for imposing criminal liability upon Directors, Officers and Others, in practice, prosecutions are pursued and convictions are obtained mostly in the largest, highly publicized matters. Very little case law exists regarding criminal liability of corporate actors.

The year 2004 provides an extreme example where, according to Japan's Annual Statistics of Prosecution, the twenty-four bankruptcy-related criminal cases accepted by prosecutors resulted in only two indictments and only one conviction. On average, for the five-year period ending in 2005, the thirty cases accepted annually by prosecutors led to only eight indictments and four convictions.⁷

Statistics such as these, and the very small number of prosecutions, raise questions as to the impact Japan's imposing array of criminal statutes actually has on the day to day conduct of officers and directors of financially troubled companies.

⁷ The conviction rates for this category are nearly half the rate for all crimes, however, because the number of cases is so small each individual case has an overly significant impact on a percentage basis.