6. Commercial Law

A case concerning the purchase of parent corporation's shares by its wholly-owned subsidiary and the liability of the parent corporation's directors to their corporation.

Decision by the First Petty Bench of the Supreme Court on September 9, 1993. Case No. (*o*) 1400 of 1989. A claim for damages against directors. 47 *Minsyū* 4814; 1474 *Hanrei Taimuzu* 17; 831 *Hanrei Jihō* 78.

[Reference: Commercial Code before the 1981 Amendment, Article 210; Civil Code, Articles 415 and 644; Commercial Code, Articles 254(3) and 266(1)(v).]

[Facts]

P Mining Corporation (not a party to this action; hereinafter referred to as "P Corporation") planned to merge Q Cement Corporation (not a party to this action; hereinafter referred to as "Q Corporation") for the purpose of promoting the diversification of business and increasing the number of strong shareholders. A shareholder R (not a party to this action) holding about 26% of the total number of issued shares in P Corporation, however, expressed his view against this merger plan, so that there was a fear of not passing a resolution to approve of this plan at the general meeting of P Corporation.

Thus, on December 3, 1975, the committee of executive directors of P Corporation decided to make S Corporation (not a party to this action; hereinafter referred to as "S Corporation"), a wholly-owned subsidiary of P Corporation purchase all the shares in P Corporation held by R and then to make S Corporation resell them to other member corporations of the same corporate group to which P Corporation has belonged. Following this decision, S Corporation purchased P Corporation's shares held by R at 530 yen per share, at a total amount of 8 billion 200 million yen, in December 1975, and resold them to those member corporations at 300 yen per share, at a total amount of 4 billion 660 million yen, between January 1976 and March 1976. The market price of a P Corporation share fluctuated between 380 yen and 400 yen at the time when S Corporation made the purchase and then fluctuated between 310 yen and 350 yen at the time when S Corporation resold. As the result of these stock tradings, S Corporation suffered a loss on sale to the amount of about 3 billion 550 million yen, while P Corporation succeeded in merging Q Corporation on May 1, 1976 as planned.

Afterwards, X (plaintiff, *kōso* respondent, *jōkoku* respondent) who acquired 1,000 shares in P Corporation in March 1978, however, filed a representative action against director Y_1 and other four directors of P Corporation (defendants, *kōso* appellants, *jōkoku* appellants), arguing that the acquisition of P Corporation's shares by S Corporation was the acquisition of parent corporation's shares by its wholly-owned subsidiary and so violated Article 210 of the Commecial Code, from which P Corporation suffered the same amount of damages as S Corporation's loss on sale, and then X required Y_1 and the other defendants to pay 100 million yen of the said damages to P Corporation. Against X's claim Y_1 and the other defendants argued as follows:

(1) Since it was with an intention of self-advertisement that X filed the representative action in this case, X's claim should be dismissed as an abuse of the shareholder's right.

(2) The acquisition of P Corporation's shares by S Corporation did not correspond to the acquisition by a stock corporation of its own shares prohibited under Article 210 of the Commercial Code.

(3) Even if the share-acquisition concerned had been regarded as the acquisition by a stock corporation of its own shares, the acquisition of P Corporation's shares by S Corporation would not have gone against the aim of Article 210 of the Commercial Code because S Corporation purchased and held P Corporation's shares temporarily in order to resell them, for the proper purposes of realizing the planned merger of Q Corporation and increasing the number of strong shareholders etc., and actually resold them immediately after the purchase.

(4) It was because P Corporation made S Corporation resell shares of the former at a price less than the purchasing price, not

because P Corporation made S Corporation acquire them that the alleged damages arose.

But the court of first instance (Decision by the Tokyo District Court on May 29, 1986) dismissed the above arguments by Y_1 and the other defendants and allowed X's claim. Y_1 and the other defendants filed a *kōso* appeal against that decision, repeating the above-mentioned arguments in the first instance and also making further arguments in relation to the estimation of the amount of damages, that since the acquistion of P Corporation's shares by S Corporation brought the former such positive profits as a resumption of dividend-payment, an increase in credit of P Corporation, an enrichment of management, an increase in the number of strong shareholders, etc., these profits should be deducted from an alleged amount of damages.

Upholding the decision made by the court of first instance, the *kōso* appellate court (Decision by the Tokyo High Court on June 3, 1989) dismissed the *kōso* appeal. Y_1 and the other defendants filed a *jōkoku* appeal against that decision on the basis of the following reasons:

(1) X did not acquire 1,000 shaes in P Corporation until two years had passed since the acquisition of P Corporation's shares by S Corporation. In this sense, even if X were to win the case, he could not gain any profit. Nonetheless, he filed this action, which amounted to an abuse of the shareholder's right with the intention of self-advertisement. Thus X's claim should be dismissed.

(2) S Corporation, which has been a wholly-owned subsidiary of P Corporation, has had its own legal personality separate from that of its parent corporation P. Therefore, the acquisition of P Corporation's shares by S Corporation did not violate Article 210 of the Commercial Code prior to the 1981 law-amendment which prohibited the acquisition by a stock corporation of its own shares only.

(3) P Corporation neither entered a difference between the purchasing price of the relevant shares and the reselling price thereof under its losses, nor made an entry of the difference into its balance sheet as a claim against S Corporation. The decision by the *kōso* appellate court nonetheless found easily that the relevant shares were

purchased and resold for the account of P Corporation and that it suffered the alleged damage from this trading, without making it clear which corporation did sustain the damage, P or S. Therefore, the finding of this decision was wrong.

(4) The damages alleged by X were caused by S Corporation reselling the relevant shares in P Corporation at a lower price than the purchasing one. In this sense, reasonable causation could not be found between the acquisition of P Corporation's shares by S Corporation and the damages.

(5) Though the said share-acquisition brought about the merger with R Corporation as planned, the decision by the *kōso* appellate court did not set off the amount of damages from that share-acquisition against that of the profit of realizing the planned merger through it, and so was wrong.

[Opinions of the Court]

Jōkoku appeal dismissed.

(1) As to reason (1) of the *jōkoku* appeal.

The decision by the *kōso* appellate court, which stated that X's filing of this action was not an abuse of right, can be approved of as a proper one.

(2) As to reason (2) of the *jōkoku* appeal.

Article 210 of the Commercial Code ought to be construed to allow the acquisition of a parent corporation's shares by its wholly-owned subsidiary also exceptionally only if there is one of the permissible causes to such a share-acquisition regulated by Article 210, or there is one of other particular permissible causes, such as a gratuitous acquisition. The reason for construing so is that the acquisition of a parent corporation's shares by its wholly-owned subsidiary is likely to have the same harmful effects as the acquisition by a stock corporation of its own shares, and that giving legal permission to the share-acquisition of the former type may result in overlooking the evasion of the regulation against the share-acquisition of the latter type provided by Article 210 through a wholly-owned subsidiary.

(3) As to reasons (3) and (4) of the *jōkoku* appeal.

S Corporation has decreased in its asset value to the amount of

3 billion 551 million and 600 thousand yen equal to the difference between the purchasing price of 8 billion 215 million yen and the reselling price of 4 billion 663 million 400 thousand yen. Therefore, it ought to be said that P Corporation holding all the issued shares in S Corporation also has decreased in its asset value to the same amount as S Corporation's loss, and thereby has suffered the same amount of damages, since any contrary argument and showing were not made in this case. It is also obvious that there is a reasonable causation between the acquisition of P Corporation's shares by S Corporation and the damage suffered by P Corporation.

(4) As to reason (5) of the *jōkoku* appeal.

Since there is not any reasonable causation between the share-acquisition in this case and the profits alleged by Y_1 and the other defendants, the decision by the appellate court, which stated that the alleged profits should not be deducted from the amount of damages to P Corporation, may be approved of as a proper one.

[Comment]

1. Points in the Case.

The current Commercial Code prohibits a stock corporation from acquiring its own shares in principle (Article 210). In addition, it treats a corporation which holds more than half of all the issued shares in another corporation as a parent corporation of the latter and the latter as a subsidiary corporation of the former, and then prohibits also a subsidiary corporation from acquiring shares in its parent one in principle (Article 211-2). This regulation against the acquisition of a parent corporation's shares by its subsidiary was introduced when the Commercial Code was partly amended in 1981, and there had not been such a provision in the Commercial Code prior to the 1981 amendment (hereinafter referred to as "the preceeding Code"). But even then, it was widely interpreted that Article 210 of the preceeding Code against the acquisition by a stock corporation of its own shares should prohibit not only a parent corporation from making its subsidiary acquire its own shares for its account, but also prohibit a subsidiary corporation from acquiring shares in its parent corporation for its account. Although there were disputes among scholars as to which corporations could be included in the category of "subsidiary corporations" which was subject to the regulation, and which criteria should be used in judging whether a corporation be a subsidiary of another one or not, almost all scholars agreed that Article 210 of the preceeding Code could be applied analogically to the acquisition of a parent corporation's shares by its wholly-owned subsidiary. In this sense, not only under the current Commercial Code but also under the preceeding Code the acquisition of P Corporation's shares by S Corporation in this case is to be judged illegal. This decision of the Supreme Court has confirmed it (opinion (2) of the judgment).

The point is the directors' liabilities to their corporation (i.e., P Corporation) and to its subsidiary (i.e., S Corporation) in this case. Since the share-acquisition by S Corporation in this case is judged illegal as stated above, from which S Corporation has suffered a damage of more than 3 billion 500 million yen, it is no doubt that the directors of S Corporation ought to be liable to it for the said damages. On the other hand, it has been at issue in this case whether the directors of P Corporation, who made S Corporation acquire P Corporation's shares, are liable to their corporation for damages therefrom. Though until now it has been disputed from the viewpoint of the law of corporate group whether the directors of a parent corporation, who made its subsidiary commit some wrongful act, are liable to the subsidiary corporation concerned for damages, their liabilities to their corporation in such a case have been seldom dealt with. Therefore, the first decision by the Supreme Court entering into the latter problem is remarkable both theoretically and in practice.

In addition, the Supreme Court's decision has referred to other problems including the following.

(a) In what circumstances is the filing of a representative action regarded as an abuse of shareholder's right?

(b) May a stock corporation acquire its own shares or its parent corporation's shares, if doing so is found necessary in order to carry out the business purposes of realizing a planned merger etc., or to avoid suffering substantial damage?

2. Filing the Representative Action and Abuse of Shareholder's Right.

In this case, X became a shareholder in P Corporation, acquiring 1,000 shares for the first time after the acquisition of P Corporation's shares by S Corporation in question, and then filed the representative action. Referring to this point, Y_1 and the other defendants argued that the filing of the representative action by X was to correspond to an abuse of shareholder's right because it was motivated by X's self-advertisement, and that X's claim should be dismissed. In this respect, the *kōso* appellate court (Decision by the Tokyo High Court) rejected the defence of Y_1 and the other defendants, stating that "a shareholders' representative action itself does not bring the plaintiff shareholder any direct proprietary profits. Therefore, even if the plaintiff shareholder aims at the enforcement of a corporate claim for damages, but on the other hand he is scheming his self-advertisement thereby, the filing of the representative action can not be naturally regarded as an abuse of shareholder's right only because of such a motive in filing the action by the plaintiff." The Supreme Court decision also dismissed the claim of Y_1 and the other defendants, stating that the decision by the *kōso* appellate court could be approved of as a proper one considering the facts found in this case.

Considering this point, it is certain that an abusive filing of the representative action should not be allowed, since no doubt the shareholder's right to file the representative action is subject to the rule prohibiting an abuse of any right. But, if the filing of the representative action were to be regarded as an abuse of a shareholder's right only because of the motive in filing the action of the plaintiff's self-advertisement, even in the case when the sufficient reasons to make the directors liable to their corporation are really found, the representative action system cannot carry out its essential functions of preparation of corporate damage and correcting directors' wrongful acts. In this sesnse, the filing of the representative action ought to be able to be regarded as an abuse of a shareholder's right, only if the plaintiff shareholder files this action with the intention of pursuing his unfair personal profit, such as an intention of levying blackmail on his corporation, though there is no reason to make the defendant directors liable to their corporation. And it seems that the judgment thereof itself must be made as carefully as possible. In this respect, since it was found that Y_1 and the other defendant directors acted in breach of Article 210 of the Commercial Code, and this is a sufficient reason to make Y_1 and the other defendant directors liable to P Corporation, this Supreme Court decision, which did not find the filing of the representative action as an abuse of shareholder's right in this case, is thought to be proper.

3. Acquisition of Parent Corporation's Shares by its Subsidiary and Room for Legally Doing So.

Since in interpreting Article 210 of the Commercial Code at the time of the share-acquisition concerned, almost all scholars agreed that the acquisition of a parent corporation's shares by its wholly-owned subsidiary could be identified with the acquisition by the parent corporation of its own shares, no doubt the acquisition of P Corporation's shares by its wholly-owned subsidiary, i.e., S Corporation was illegal even under the then Commercial Code. Yet it is for the political purpose of preventing any harmful effects from being caused that the Japanese Commercial Code has prohibited the acquisition by a stock corporation of its own shares and the acquisition of a parent corporation's shares by its subsidiary in principle. Thus, these prohibitive regulations can be exceptionally lifted only if there are not such harmful effects, and also it is found necessary to allow the acquisition of a corporation's own shares or a parent corporation's shares. The current Commercial Code does provide explicitly for some causes to permit such share-acquisitions exceptionally (hereinafter referred to as "permissible causes"), and also these share-acquisitions are construed to be permitted if it is obvious that any harmful effects are not caused thereby because of, e.g., gratuitous or factorial acquisitions by a stock corporation of its own shares or shares in its parent corporation, though not provided for explicitly by the Commercial Code.

In this respect, it is certain that there were not those permissible causes in this case, but Y_1 and the other defendants argued, "Since for the business purpose of P Corporation carrying out the planned merger smoothly it is necessary for S Corporation to acquire P Corporation's shares, and also thereby the harmful effects, on which the regulation against the acquisition by a stock corporation of its own shares is based, do not really exist, the share-acquisition made by S Corporation is not contrary to the aims of Article 210." Thus, the point in this case is whether such a corporate business purpose to carry out some corporate plans can be included in the explicit permissible causes or the implicit ones. Considering this point, first, as long as a particular act is a malfeasance, it can not be justified, even if it is necessary for corporate business purposes. Secondly, the Japanese Commercial Code prohibits the acquisition by a stock corporation of its own shares or those in its parent corporation in principle, from the viewpoint of generally preventing harmful effects from being caused thereby, and so does not adopt an approach to judge on a case-by-case basis whether it is illegal or not for a given stock corporation to acquire its own shares or shares in its parent corporation, taking into account whether any harmful effect is caused thereby in each case. Thus, the argument of Y_1 and the other defendants, which was to justify the share-acquisition made by S Corporation in this case for the reason that harmful effects were not caused concretely thereby, can not be allowed, and so the Supreme Court decision thereon may be appreciated as a proper one.

Incidentally, the court of first instance (Decision by the Tokyo District Court) has decided as obiter dictum, "The acquisition by a stock corporation of its own shares, as long as it does not cause any harmful effects, may naturally be permitted, even if it is not justified exceptionally by the permissible causes explicitly provided by the Commercial Code. But, moreover, if a certain shareholder is cornering a considerable number of shares in a stock corporation for the purpose of pursuing some antisocial profits, and then has a controlling influence over its management, with the result that there is danger of causing substantial damage to all concerned in the corporation and the danger is pressing, it is not possible to say that there is no room for permitting such an acquisition by a stock corporation of its own shares as aims at both frustrating that perverse ambition of the shareholder concerned and preventing the corporation from suffering substantial damage, even if this share-acquisition is neither justified by the explicit or implicit permissible causes, nor unlikely to cause harmful effects."

On the other hand, taking a strict interpretation, the Tokyo High Court decision did not include such a necessity for avoidance of corporate substantial damage among the permissible causes, and also the Supreme Court decision in this case approved of the decision. Although the Tokyo District Court decision, taking surrounding circumstances into account, did not allow the acquisition of P Corporation's shares by S Corporation after all, the construction to include the necessity for avoiding corporate substantial damage among the permissible causes referred to by the Tokyo District Court is doubtful in itself. For, if such a factor is to be approved of as a permissible cause, it means instead that the more influential and vicious the greenmailer is as a corporate racketeer, the more likely the acquisition by a stock corporation of its own shares is to be permitted as necessary corporate action, so that this can aggravate the evil of greenmail created by the share-cornering. Also, in order to give the directors a ground for rejecting greenmail, the necessity for corporate damage avoidance should not be included among permissible causes. In that sense, the Tokyo High Court decision to this effect and the Supreme Court decision supporting it seem to be proper.

4. Acquisition of Parent Corporation's Shares by its Subsidiary and Damage of the Parent Corporation.

No doubt, in this case S Corporation suffered the damage of more than 3 billion 500 million yen from purchasing shares in its parent corporation, i.e., P Corporation and reselling them at a lower price. While the court of first instance, the appellate court and the Supreme Court all estimated the amount of damages suffered by S Corporation at more than 3 billion 500 million yen, by calculating the difference between the purchasing price and the reselling one, a few scholars regard the sum total of both the difference between the purchasing price and the market price at the time of share-purchase and the difference between the reselling price and the market price at the time of resale as the amount of damages. But, the acquisition of P Corporation's shares by S Corporation and resale thereof ought to be looked upon as a continuous act which was designed from the first as *one* scheme with the intention of both purchasing them at a higher price than the market price and reselling them at a lower price than the purchasing one to the member corporations of the corporate group to which both P and S Corporations belonged. Thus, at least as far as this case is concerned, the judicial way for estimating the amount of damages is thought to be reasonable.

On the other hand, since the shareholder in P Corporation, X, sued its directors, Y_1 and the other defendants, for their liabilities to it in this case, the point is whether P Corporation suffered any damage from the illegal acquisition of its shares by S Corporation as its subsidiary, and what the damage of P Corporation was, if any.

In this respect, the Supreme Court decision identified the damages suffered by S Corporation from its acquiring of P Corporation's shares with the damages of its parent corporation, i.e., P Corporation, and then imposed the liabilities to pay damages to P Corporation upon its directors, Y_1 and the other defendants. A handful of scholars, however, have criticised the decision and argued that since S Corporation, even if it was a wholly-owned subsidiary of P Corporation, had a legal personality of its own separate from that of P Corporation, and to make the directors of P Corporation liable to it did not lead to the reparation of S Corporation's damages, it was doubtful to identify the damages of even a wholly-owned subsidiary corporation with that of its parent corporation. Following this argument, it is the liabilities to S Corporation of both S Corporation's directors and some of P Corporation's directors commanding them that should be sued for in this case.

But, S Corporation suffered damage from its acquisition of P Corporation's shares, so that P Corporation can be thought to have also sustained damage in the form of a valuation loss of S Corporation's shares held by it. Therefore, since it can be said that P Corporation did suffered damage in the form of a valuation loss of shares in its subsidiary even indirectly, it seems possible to find the damage of P Corporation's own in this case. In this sense, the Supreme Court decision to the same effect can be appreciated as a proper one. Yet, it is an incidental question how to estimate the amount of damages suffered by a parent corporation from the acquisition of its shares by its subsidiary corporation, if the latter is not a wholly-owned subsidiary but a partly-owned one. Though it was not the matter at issue in this case, where S Corporation was a wholly-owned subsidiary of P Corporation, the question should be a future problem to be considered.

5. Room for the Set-off of Loss against Profit.

Lastly, since the second instance in this case, it has been a matter at issue whether to set off the amount of P Corporation's damages against that of profit obtained by it through the acquisition of its shares by its wholly-owned subsidiary, i.e., S Corporation, in estimating the amount of damages. Though Y_1 and the other defendants made an argument for such a set-off as a defence, the *kōso* appellate court dismissed their argument, and also the Supreme Court decision supported the dismissal.

Considering this problem, since the profit alleged by Y_1 and the other defendants was caused by the malfeasance of corporate illegal acquisition of its own shares, it is very doubtful whether the set-off of the identical amount of damages caused by the malfeasance involved against that of such profit is to be permitted in the world. Moreover, taking into account that the representative action has not only the function of preparation of corporate damage but also the preventive role against wrongful acts by corporate directors, to permit the set-off of loss against profit even in cases of acts done in breach of legal prohibitions is to result in weakening the latter role of the representative action. Therefore, it ought to be judged very carefully whether to permit the set-off of loss against profit, in which senses the decisions of the appellate court and the Supreme Court that both rejected the defence of the set-off of loss against profit could be supported in their results.

Prof. YASUHIRO OSAKI
NOBUO NAKAMURA