International Law Office

CAPITAL MARKETS - JAPAN

Are lead managers liable for material misstatements in IPO disclosure documents?

July 17 2018 | Contributed by Nagashima Ohno & Tsunematsu

Introduction

In a recent case, the plaintiffs – which were investors that had purchased shares in a company offered through an initial public offering (IPO) or, subsequently, through secondary market trading – sued various defendants, including investment banks which had served as underwriters in the IPO, for damages after they discovered that certain financial information disclosed prior to the IPO had been falsified. At trial, the Tokyo District Court ruled that the lead manager was liable for damages incurred by the plaintiffs that had acquired shares through the IPO (the IPO plaintiffs). However, in a 23 March 2018 judgment, the Tokyo High Court overturned the district court's judgment and ruled that the lead manager was not liable for the IPO plaintiffs' damages. This update summarises the facts and procedural history of this case and analyses the implications that may arise from the Tokyo High Court judgment.

Facts

The company was a Japanese manufacturer of semiconductor production equipment. In November 2009 it conducted an IPO and its shares were listed on the Mothers (Market of the high-growth and emerging stocks) section of the Tokyo Stock Exchange (ie, the section designated for companies with high growth potential). However, after the IPO, it was discovered that:

- the company had committed accounting fraud; and
- certain documents disclosed in relation to the IPO, including the company's financial statements, had contained falsified information.

Surprisingly, as much as 97.3% of the sales reported in the company's financial statements for the fiscal year ending March 2009 did not actually occur. The company filed for bankruptcy in May 2010 and its shares were delisted from the Mothers section of the stock exchange in June 2010.

In the course of the due diligence for the IPO, various facts signalling the potential existence of accounting fraud had become known, such as a dramatic increase in sales despite the ongoing global economic downturn triggered by the collapse of Lehman Brothers and an excessive concentration of sales at the fiscal year end. The lead manager for the IPO investigated these facts, mainly by:

- making inquiries into the company, analysts and the accounting firm hired by the company to perform an accounting audit of its financial records;
- inspecting the company's factory; and
- interviewing some of the company's customers.

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Following this investigation, the lead manager concluded that these anomalies had been reasonably explainable.

In addition, the Tokyo Stock Exchange and the lead manager received anonymous letters on two occasions, each providing details of the alleged accounting fraud (eg, allegations addressing how such fraud had been implemented, its scope and the details of the individuals involved). In response, the lead manager conducted an additional due diligence investigation (which mainly involved examinations of copies of relevant company books and records, many of which contained falsified information and documents, and interviews of representatives of the accounting firm) and ultimately concluded that the accounting fraud allegations stated in these letters were unsupported.

The plaintiffs sued the company and various other parties – including the company's directors, the accounting firm and underwriters involved in the IPO – seeking an award of damages.

Applicable securities regulations

Consistent with practices in most other jurisdictions, under Japanese securities regulations, underwriters (including lead managers) are liable for damages incurred by investors that acquire securities through a public offering if the statutorily required disclosure documents contain any material misstatement. In order to avoid such liability where a material misstatement exists, an underwriter must, in essence, establish that it did not know of the misstatement despite acting in accordance with the requisite duty of care. In this case, one of the main issues was whether the lead manager had acted in accordance with the requisite duty of care when conducting due diligence for the IPO.

Tokyo District Court decision

In its 20 December 2016 judgment, the Tokyo District Court (the first-instance court for this litigation) determined that the lead manager was liable for the IPO plaintiffs' losses arising from their purchase of shares through the IPO. According to the court, although the correctness of the disclosed financial information should have been strictly confirmed by the underwriters' due diligence, an accounting firm conducting an accounting audit has primary responsibility for fulfilling that obligation. Underwriters may rely on findings and conclusions from the accounting audit unless, during the course of their due diligence investigation, they discover a fact that casts doubt on the reliability of such findings or the correctness of the company's financial information.

In this case, the lead manager's behaviour after receiving the anonymous letters was at issue. According to the Tokyo District Court, once details of the accounting fraud had been revealed to the lead manager through the letters, they should have taken appropriate steps to investigate such allegations by employing supplementary measures (ie, measures that are not ordinarily taken in typical due diligence investigations, such as examining original books and records and carrying out additional investigations) to confirm the accuracy of the information concerning the company's sales to customers which had been disputed in the letters. The lead manager's conduct in this regard, which included examining copies of the relevant company books and records instead of originals, was deemed insufficient. Thus, the district court concluded that the lead manager had failed to conduct due diligence with the requisite due care and was therefore liable to the IPO plaintiffs.

Tokyo High Court decision

The lead manager appealed the Tokyo District Court's judgment to the Tokyo High Court, which:

- ruled that the lead manager had acted with the requisite due care in conducting its due diligence; and
- overturned the Tokyo District Court's judgment holding the lead manager liable for the IPO plaintiffs' damages.

In its judgment, the Tokyo High Court agreed with the Tokyo District Court's ruling that the correctness of the disclosed financial information should have been strictly confirmed through the underwriters' due diligence. However, the Tokyo High Court held that it is inefficient for underwriters to conduct the same examination as that conducted by accounting firms, which are experts in accounting retained to audit a company's financial records. As for the financial information reviewed by such accounting firms in connection with their audits, underwriters should be able to rely on the findings and conclusions from such an audit (in this regard, the due care requirement will be met) as long as they confirm through their due diligence that no facts exist which would cast doubt on the reliability of such results. On the other hand, if underwriters become aware of any such facts through their due diligence, they should conduct further due diligence and reasonably determine whether the facts are a valid basis for concern. In conducting this additional due diligence, the required standard of care is the level of care that a reasonable underwriter (as opposed to an accounting expert) would have exercised in the same or similar circumstances. Where the underwriters, after having performed the requisite due diligence, reasonably declare that the doubt in question is invalid, the underwriters can rely on such audit results (again, assuming that the due care requirement has been met).

In the present case, the two anonymous letters cast doubt on the reliability of the audit results prepared by the accounting firm. Thus, the lead manager had been required to conduct additional due diligence with the requisite due care. The lead manager's determination that the allegations made in the letters were unsubstantiated based on the additional due diligence, including interviews with representatives of the accounting firm which had prepared the audit report, was reasonable. Thus the lead manager should have been allowed to rely on the audit report.

Analysis and practical implications

The Tokyo District Court's decision was reported to be the first to hold an underwriter liable to investors that purchased shares in a company based on material misstatements in the financial information contained in the statutory disclosure document for a public offering in Japan. However, the Tokyo High Court overturned the first-instance court decision in this regard and concluded that the lead manager was not liable to investors.

One main factor leading to the different conclusions of the courts is the divergence in their views on the actions to be taken by underwriters when faced with facts that cast doubt on the reliability of an issuing company's financial information. In the Tokyo District Court's view, underwriters must re-examine and confirm facts (ie, by examining original documents and records and interviewing customers) that have been previously examined by accountants for the purpose of preparing an audit report. This investigation would substantially duplicate the examination conducted by accounting firms. In this regard, the Tokyo High Court concluded that underwriters are not required to perform an investigation that is substantially identical to the examination performed by the accounting firm for the preparation of an audit report. Rather, underwriters will be deemed to have acted with the requisite due care as long as they reasonably determine, after having performed the requisite due diligence (eg, by interviewing representatives of the accounting firm which prepared the audit report), that any doubts as to the reliability of the audit are invalid.

Although there may be further developments if the Supreme Court accepts this case for review, in contrast to the Tokyo District Court judgment, the Tokyo High Court judgment limits the scope of underwriters' responsibilities and liability in the context of securities offerings. From an investor's perspective, the chances of recovering damages in cases involving falsified financial information in statutorily required disclosure documents may now be more limited, especially if the issuer becomes insolvent.

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