

# Determining recoverable damages following material misstatements in securities registration statements

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## Introduction

In general, any company that conducts a public offering of its securities must file a securities registration statement, which is a statutorily required disclosure document. If the securities registration statement contains a material misstatement, investors that acquire securities through the relevant offering can hold the issuing company liable for damages relating to losses arising from such misstatement. However, it is unclear what level of damages is recoverable if:

- the defendant (ie, the issuing company) successfully proves that the loss incurred by the investor is at least partly attributable to another factor or circumstance unrelated to the material misstatement; but
- the nature of the loss makes it extremely difficult for the defendant to prove how much of the loss is attributable to such unrelated factors or circumstances (the subject scenario).

In its 11 October 2018 judgment, the Supreme Court ruled that when determining the amount of damages to be awarded in the above scenario, the courts may determine the amount of the plaintiff's loss attributable to factors or circumstances unrelated to the material misstatement that should be deducted. This article summarises the facts of the case and the Supreme Court rulings applicable to the subject scenario.

## Facts

The issuing company (ie, the defendant) was a large Japanese manufacturer whose stock was listed on the first section of the Tokyo Stock Exchange. In December 2006 the defendant filed a semi-annual report in which it reported a consolidated net loss of Y2.8 million for the first half of the fiscal year ending in September 2006. In January 2007 the defendant conducted a public offering of its shares, for which it filed a securities registration statement which incorporated the semi-annual report by reference. In addition, in June 2007 the defendant filed its annual securities report in which it reported a Y15.8 million consolidated net profit for the fiscal year ending in March 2007. Both the semi-annual report and the annual securities report were statutorily required disclosure documents.

However, in September 2007 the defendant publicly announced that it:

- might correct the results disclosed in its 2006 semi-annual report and 2007 annual securities report; and
- had reduced its forecasted consolidated operating income for the 2008 fiscal year by Y57 billion.

Thereafter, the defendant filed amendments to its semi-annual report and annual securities report; the originally reported Y2.8 million loss and Y15.8 million profit were revised to be a Y10 million loss and Y4.5 million loss, respectively.

The plaintiffs were investors that had acquired the defendant's shares through both the public offering in January 2007 and secondary market transactions during the relevant period. They

AUTHOR

[Takashi Tsukioka](#)



sought a judgment against the defendant for damages based on the alleged losses that they had incurred based on the material misstatements in the semi-annual report (which was incorporated by reference into the securities registration statement) and the annual securities report.

### **Applicable securities regulations and legal issues**

Under the Financial Instruments and Exchange Act (FIEA), if a statutorily required disclosure document such as a securities registration statement, annual securities report or semi-annual report contains a material misstatement, the company that filed such disclosure document will be held liable for damages incurred by investors that acquire its securities without knowledge of such misstatement.

The loss sustained by a defrauded investor that acquires securities through a public offering is basically the difference in:

- the market value of the subject securities as of when the investor seeks damages (or the sales price if the securities were sold before the investor sought damages); and
- the purchase price paid by the investor for the securities.

However, a decline in the value of the securities may be attributed to various factors. Even if there is a material misstatement in a disclosure document that, upon disclosure, negatively affects the value of the securities, other entirely unrelated factors or circumstances (eg, the occurrence of a natural disaster or general stock market trends) may also contribute to the decline of the value of the securities. For this reason, in the subject scenario, the FIEA allows the issuing company to mitigate its liability by establishing that the loss is attributable, in whole or in part, to circumstances unrelated to the misstatement in question. The issuing company must prove not only that the decline in the securities' value is attributable to a circumstance unrelated to the misstatement, but also the specific amount of loss attributable to such circumstance. If the issuing company succeeds in establishing that the decline in the securities' value was entirely attributable to circumstances unrelated to the misstatement, it will avoid all liability for the loss incurred by investors.

The foregoing notwithstanding, it can be difficult for an issuing company to prove the specific amount of loss attributable to such unrelated circumstances. Therefore, in cases involving investors that acquire securities through secondary market transactions, there is a provision in the FIEA which authorises the courts to determine the appropriate amount of loss incurred by investors for which the issuing company is not to be held liable if the court finds that:

- the whole or part of the loss arose from circumstances unrelated to the misstatement in question; and
- it would be extremely difficult to prove the amount of such loss due to its nature.

Article 248 of the Code of Civil Procedure includes a general provision that allows the courts to decide the appropriate amount of a loss when they determine that:

- a loss has been incurred; and
- it would be extremely difficult to prove the amount of such loss due to its nature.

This provision of the code generally aids plaintiffs seeking an award of damages, whereas the above FIEA provision benefits defendants seeking to mitigate or avoid liability for losses incurred by investors through secondary market transactions.

Contrastingly, the FIEA does not include a similar provision for situations in which investors acquire securities through a public offering in a primary market transaction. While there were numerous factual and legal issues in the subject case resolved by the Tokyo District Court and the Tokyo High Court, the heart of the Supreme Court decision addressed whether, in the subject scenario, the court could determine the appropriate amount of loss incurred by investors for which the issuing company would not be liable if the court found that:

- such loss was partly attributable to circumstances unrelated to the misstatement in the company's securities registration statement; and
- it was extremely difficult to prove the amount of such loss due to its nature.

### **Supreme Court decision**

The Supreme Court held that, in the subject scenario, the courts can determine the appropriate amount of loss incurred by investors that acquire securities through a public offering for which the issuing company is not liable if they find that:

- the loss is partly attributable to circumstances unrelated to the misstatement in the securities registration statement; and

- it would be extremely difficult to prove the amount of such loss due to its nature.

In reaching this conclusion, the Supreme Court referenced neither the FIEA provision for secondary market transactions nor Article 248 of the Code of Civil Procedure. Instead, it indicated that Article 248 of the code applied *mutatis mutandis* in determining the liability exposure of the company in question.

The Supreme Court decision explains that investors that acquire securities through a public offering can generally seek to hold the issuing company liable for damages up to the amount which is the difference (ie, decline in value) between the purchase price paid for the relevant securities and the market value of the securities as of when the investor seeks damages (or the sales price if the securities were sold) without having to prove the actual loss amount, which may be difficult to prove. Further, the decision provides that the issuing company will be held liable for such damages, even if it is not negligent, in cases where there is any material misstatement in its securities registration statement. On the other hand, the decision acknowledges that the issuing company's liability may be mitigated or eliminated if it proves that the loss is attributable, partly or entirely, to circumstances unrelated to the misstatement in question. This is how, according to the Supreme Court, the FIEA:

- compensates investors who sustain losses in the subject scenario; and
- ensures the fairness of the securities market when determining a loss amount appropriate for the specific case.

With this background, the Supreme Court decision states that it is unfair and incompatible with the FIEA's balanced structure not to reduce damages in cases involving the subject scenario where it is extremely difficult to prove the amount of the loss attributable to unrelated circumstances due to the nature of such loss. Further, the Supreme Court understands that Article 248 of the Code of Civil Procedure allows the court to determine an appropriate amount of loss to achieve fairness between the parties if the court determines that:

- there is a loss; and
- it would be extremely difficult to prove the amount of such loss due to its nature.

### **Analysis and practical implications**

Previously, some people supported the view that the courts can apply (or apply *mutatis mutandis*) Article 248 of the Code of Civil Procedure when determining the loss suffered by investors that acquire securities in a public offering in reliance on a securities registration statement that contains a material misstatement. However, others opposed this view. This Supreme Court decision put an end to this argument by ruling that, in the subject scenario, the courts can determine the appropriate amount of loss suffered by investors if they find that:

- all or part of the loss arose from circumstances unrelated to the misstatement in the relevant securities registration statement; and
- it would be extremely difficult to prove the amount of such loss due to its nature.

Although this conclusion seems fair and helpful for companies issuing securities through public offerings, it goes without saying that, notwithstanding other considerations, material misstatements in statutorily required disclosure documents will result in severe consequences for such companies. On the other hand, this Supreme Court decision may serve to reduce the amount of possible damages awarded to investors that acquire securities through public offering transactions in the subject scenario. By applying *mutatis mutandis* Article 248 of the Code of Civil Procedure (and determining that the re-evaluation lowering the forecast of the company's consolidated operating income was a significant reason to reduce the amount of the damage award in the case at hand), as much as 60% of the share price decline was deducted (ie, deemed attributable to unrelated circumstances) when calculating the loss attributable to the misstatements in the statutorily required disclosure documents. The impact of this decision may be significant depending on the case.

*For further information on this topic please contact [Takashi Tsukioka](#) at Nagashima Ohno & Tsunematsu by telephone (+81 3 6889 7000) or email ([t\\_tsukioka@noandt.com](mailto:t_tsukioka@noandt.com)). The Nagashima Ohno & Tsunematsu website can be accessed at [www.noandt.com](http://www.noandt.com).*

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