WHITE COLLAR CRIME - JAPAN

Underwriters' liability for false statements made in IPO

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Introduction

In December 2020 the Supreme Court handed down a decision in relation to certain obligations of lead underwriters and bookrunners in an initial public offering (IPO).(1) Although the underlying facts related to an IPO, the judgment also applies to underwriters involved in the submission of a securities registration statement and there are useful takeaways for any company faced with investigating allegations of impropriety made by a whistleblower.

The case related to a now bankrupt semiconductor manufacturer, FOI, which was listed on the Market of the High-Growth and Emerging Stocks (Mothers) Index of the Tokyo Stock Exchange (TSE) in 2009.(2) Mizuho Securities Company Limited acted as lead underwriter for FOI in its IPO.

In 2010, shortly after FOI's listing, the Securities and Exchange Surveillance Commission of the Financial Services Agency commenced an investigation into FOI for a suspected breach of the Financial Instruments and Exchange Act. FOI admitted accounting fraud, filed for bankruptcy and was delisted from the Mothers index in June 2010.

The Supreme Court found that Mizuho had not taken certain steps when allegations of fraud were first brought to its attention. As a result, it was liable to compensate investors which had subscribed to the IPO. This article revisits the facts of the case and offers tips for companies looking to deploy best practice when dealing with similar allegations from a whistleblower.

Facts

FOI was based in Kanagawa Prefecture and, in the early 2000s, held itself out as a rapidly growing semiconductor manufacturer. However, the company's apparent financial success was a sham. Certain FOI directors had been engaging in accounting fraud from approximately 2004 onwards. FOI used fake invoices to inflate its total sales; the company's financial statements stated that its annual turnover was Y5 billion to Y7 billion (roughly $46 million to $65 million), when in reality it was only Y100 million to Y200 million (roughly $1 million to $2 million).

In May 2007 Mizuho entered into a contract with FOI to act as lead underwriter in its planned IPO. Mizuho started due diligence shortly thereafter. Several months later, Mizuho recommended that FOI move forward with its listing application. FOI then filed a listing application with the Mothers Index and Mizuho submitted the required supporting documentation to the TSE. The TSE set Monday 18 February 2008 as the target date for approval of the IPO.

On Thursday 14 February 2008 Mizuho received an anonymous letter alleging that FOI had engaged in accounting fraud (first letter).

The first letter named three FOI board members, including the CEO, who were allegedly aware of the fraud, and stated that FOI had been falsely reporting each year that it had Y5 billion to Y7 billion of sales in total, when in reality its annual sales were only Y100 million to Y200 million.

The first letter also discussed how FOI was creating false records to justify its stated sales figures (eg, forgery of invoices and fake deliveries) and pointed to an employee of Fujitsu Limited who was allegedly collaborating with FOI by issuing false purchase orders to help cover up the fraud(3)

Mizuho did two things after receiving the first letter:

- The lead banker at Mizuho contacted FOI's board members against whom the allegations of accounting fraud had been made and shared the letter's contents. In response, the board members said that they suspected that the first letter had been sent by a disgruntled current or former employee wishing to harm and obstruct FOI's business. The Mizuho banker then requested that the board members seek to identify this individual and take "necessary actions" against them if they were still employed. FOI told Mizuho that they believed the person who sent the first letter was the head of internal audit.
- After carrying out additional due diligence in April 2008 by reviewing further documentation submitted by FOI, Mizuho decided that the first letter was not credible.

In May 2008 FOI decided to recommence the IPO process and Mizuho began further due diligence. Mizuho concluded that there were no issues preventing FOI from moving forward with its listing application. However, in reaching this decision, the lead banker at Mizuho decided that it was unnecessary to speak to FOI's head of internal audit (ie, the suspected whistleblower). Whether this was because the board members had already removed this individual from his position after receipt of the first letter or because the lead banker believed that FOI would not permit Mizuho to speak to the individual is unclear. In any event, Mizuho was told that he had been transferred to a different department and was planning to resign shortly.

FOI submitted its second IPO application to the Mothers Index in December 2008 but withdrew it in May 2009.

In Summer 2009 FOI decided to submit a third application for an IPO. Mizuho conducted additional due diligence, including interviewing FOI's external accountant. Based on this interview, Mizuho determined once again that there were no issues preventing the IPO from going ahead. In August 2009 FOI submitted its third application to the Mothers Index and Mizuho provided the required supporting documentation to the TSE. In October 2009 the TSE approved FOI's listing application.

On 27 October 2009 Mizuho received another anonymous letter (second letter) which contained allegations similar to the first letter. The second letter was also sent to the TSE and FOI's accountant.

Mizuho interviewed FOI's accountant. The accountant explained that he had reviewed the relevant bank statements and had spoken to a Fujitsu employee to assist with corroborating the financial figures.(4) Mizuho concluded that the second letter was also not credible; once again, they did not speak to the suspected whistleblower.

On 11 November 2009 Mizuho entered into a principal underwriting agreement with FOI and on 20 November 2009 FOI was listed on the Mothers Index.

By May 2010, FOI had announced that its registration statement contained false statements and that it had filed for bankruptcy. It was delisted in June 2010.

Issue

From 2010 to 2011, more than 200 parties who had subscribed to FOI's IPO brought claims against numerous defendants, seeking damages for losses incurred due to the fraud.(5)

The named defendants included:

- FOI's former directors;
- FOI's former auditors;
- Mizuho Securities as the lead underwriter and bookrunner;
- nine other securities companies which had acted as underwriters;
- several companies that had sold FOI's shares; and
- the TSE and an independent entity which reviews IPO applications on behalf of the TSE.

The claim was based on Section 1(21) of the Financial Instruments and Exchange Act, which states as follows:

> *When a Securities Registration Statement contains any false statement in relation to a material fact/matter, or omits making a statement in relation to: (a) a material fact/matter that should be stated; or (b) a material fact that is necessary for avoiding misunderstanding, the following persons*

shall be liable to compensate persons who acquire the Securities through a Public Offering or Secondary Distribution for losses arising from the false statement or the omission of the material fact, except in cases where the person who acquired the Securities was aware of the relevant omission or that the statement was false at the time the Securities were acquired.(6)

Section 2(iii)(21) provides that the persons or entities specified will be exempt from civil liability if they:

- did not know of the existence of the false statement (in all cases); and
- were unable to have known, despite having made reasonable enquiries (in cases not related to financial or accounting statements).

Tokyo District Court decision

The Tokyo District Court found FOI's former directors, auditors and Mizuho partially liable for the losses incurred by the claimants but rejected the claims against the other defendants. The court held that Mizuho had not taken the steps necessary to dispel the concerns raised in the first and second letters that the accounting statements may be false. The Tokyo District Court also held that Section 2(iii)(21) of the Financial Instruments and Exchange Act does not mean that an underwriter is exempt from liability arising from falsified financial statements if they simply demonstrate that they were unaware. Underwriters are still responsible for making reasonable enquiries to assess the credibility of the conclusions reached by accountants.

The former auditors and Mizuho appealed.

Tokyo High Court decision

The Tokyo High Court held that if a false statement relates to financial statements, Section 2(iii)(21) of the Financial Instruments and Exchange Act only requires the person or entity to prove that they unaware of the existence of the false statement and does not require them to also make reasonable enquiries.

Based on this interpretation, the Tokyo High Court found that Mizuho had not known about the existence of the false statement and was therefore exempt from liability in accordance with Section 2(iii)(21) of the act. The court dismissed the auditors' appeal.

The claimants appealed.

Supreme Court decision

The Supreme Court held that the Financial Instruments and Exchange Act requires the accuracy of financial statements to be confirmed by accountants or auditing firms that have no conflict of interest. The underwriters are then entitled to rely on the audit conducted by the accountants provided that the underwriters are not aware of any fact which would call into question the accuracy of the financial statements. If, on the other hand, a false statement is made in a document other than the financial statements, the underwriters must demonstrate not only that they were unaware of any false statements, but also that they took reasonable care and made reasonable enquiries when reviewing the documents.

Therefore, if an underwriter identifies information that casts serious doubt on the reliability of the information on which the financial statements are based, the underwriters must conduct an investigation. If they enter into an underwriting agreement without carrying out such an investigation and it emerges that material misstatements were made, the underwriter will not be exempt from liability.

Based on the facts of the case – including that Mizuho had received the first and second letters, that the letters had contained a significant amount of detail and that figures pointed out in the letters matched the actual numbers from the company's accounts – the Supreme Court found that Mizuho should have concluded that the letters cast serious doubt as to the reliability of the underlying documentation reviewed by the accountants. Therefore, Mizuho should have investigated further.

The following factors led the Supreme Court to conclude that the steps Mizuho had taken were either insufficient or inappropriate:

- Despite the first letter alleging that the fraud was being committed by certain FOI board members, Mizuho had shared the contents of the first letter with the named board members and essentially requested that the board take retaliatory action against the person suspected of raising the concerns.
- Mizuho had not interviewed FOI's head of internal audit despite learning that he may have sent the first letter. Therefore, the Supreme Court found that Mizuho had not taken appropriate steps to assess the letters' reliability.
- Although Mizuho had reviewed certain financial documentation and interviewed employees at Fujitsu, as

well as the accountant who had been responsible for preparing the financial statements, the Supreme Court found that these steps were insufficient to remove the doubt about the financial statements' accuracy that had been raised in the letters. For instance, it turned out that one of the Fujitsu employees who had been interviewed had cooperated with FOI in perpetrating the fraud. In addition, the information provided by the accountant suggested that he had done nothing more than review the bank statements provided by companies which may have been part of the fraud.

Comment

This case offers useful guidance to not only banks involved in rights issues but also any company investigating a report made by a whistleblower. When a whistleblowing report has been made, companies should not:

- inform the individuals against whom the allegations were made of the allegations;
- request that an anonymous whistleblower be identified and that retaliatory steps be taken against them; or
- conclude that none of the allegations are true just because some of the allegations seem inaccurate.

As part of sound risk management, companies, particularly financial institutions, must implement systems and controls that minimise legal risk. It is critical that a proposed transaction is put on hold until allegations, which if true could create significant liability, are credibly investigated.

The first step in setting up a credible investigation is to ensure that the legal or compliance function – not the deal team – has responsibility for conducting the investigation, ideally with the assistance of outside counsel.

It is of the utmost importance that the legal or compliance team is given the authority to prevent the transaction from progressing further if they spot any red flags. The transaction must be put on hold until any concerns are satisfactorily resolved. Companies can help to achieve this by having a corporate structure in which independent reporting lines exist and final institutional approval for the transaction rests outside the deal team.

Banks may also consider implementing a process shortly before the transaction closes whereby senior members of the deal team give written confirmations or attestations that they are unaware of any potential legal reason why the transaction should not proceed or, if they are aware of any such reasons, that the risk in question has been referred to the legal or compliance team for an independent review and that said team are content for the transaction to proceed. The legal or compliance team should, of course, corroborate accordingly. This kind of process can help to focus minds because if it later turns out that any of the confirmations or attestations were untrue when made, appropriate human resources actions (eg, disciplinary procedures) can be taken against the relevant individuals.

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Endnotes

(1) *Saikō Saibansho* (Supreme Court) 22 December 2021, Hei30 (jyu) 1961 (Japan).

(2) The Mothers Index is for emerging companies with high growth potential and is seen as a stepping stone for listing on the main market.

(3) Claims were brought against Fujitsu and its employee by the same claimants in a different litigation. The Tokyo District Court found the Fujitsu employee liable but not Fujitsu itself. The decision was appealed to the Tokyo High Court, which allowed the appeal on the basis that there was insufficient causation between the misconduct and the damages incurred by the claimants. The claimants appealed to the Supreme Court.

(4) It was later discovered that the Fujitsu employee had been introduced to the accountant by FOI board members involved in the fraud.

(5) Japan does not have a statutory class action or group litigation system.

(6) This is an unofficial translation.