

A Model For Olympus Shareholder Litigation

Law360, New York (January 05, 2012, 7:08 PM ET) -- The admission by Olympus Corporation of a JPY 135 billion (\$1.8 billion)[1] accounting scandal[2] and the dramatic drop in the company's share price since news of the irregularities became public leave little doubt that litigation will result.[3]

The U.S. Supreme Court's 2010 ruling in *Morrison v. National Australia Bank Ltd.* (561 U.S. 08-1191 (2010)) closed the door to international investors seeking recovery through the U.S. courts for fraud-related losses unless the transactions were executed in the U.S. *Morrison* precludes all but Olympus' American Depository Receipts buyers[4], from U.S. litigation but international investors may take advantage of Japan's 2006 Financial Instruments and Exchange Act (FIEA) and recent case law to bring civil suits in Japan. Investors that made large share purchases over the last year[5] may well find it economical to bring individual FIEA claims.

Olympus' largest potential claimants in shareholder litigation include U.S.-based Harris Associates LP and Southeastern Asset Management Inc.[6], which together hold nearly 10 percent of shares outstanding.[7] As these entities remain invested (indeed, they are pushing to replace the company's current management)[8], their significant stake in a recovery may make them unlikely to sue. But investors' interests vary and may change as the company's response to the scandal plays out. Furthermore, the company itself may file suit on behalf of its investors against directors, managers and advisers.[9]

The shareholder suits against Livedoor Co. Ltd., whose accounting fraud remains the largest yet to be litigated under FIEA, provide some basis for assessing the prospects for shareholder litigation against Olympus in Japan. Similarities in the nature of the alleged frauds perpetrated by the two companies (described below) make the Livedoor experience particularly instructive. In light of the findings of fraud by Olympus' Third Party Committee[10] and Olympus' JPY 57 billion (\$740 million)[11] restatement of retained earnings as of March 31, 2011, the Livedoor experience suggests that at least some Olympus shareholders could recover much of their losses through litigation.



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Japanese Legal Developments

Private securities litigation in Japan does not have a long history, but legal developments since the passage of FIEA in 2006 make the prospects for Japanese civil suits in misstatement cases stronger than some U.S. commentators appreciate.[12] Although there is currently no class action procedure in Japan[13], this has not prevented groups of individual investors from successfully litigating their securities claims with common legal representation, as happened in the Livedoor and Seibu Railway Company Ltd. (Seibu Railway) cases.[14] One suit against Livedoor was brought on behalf of more than 3,000 individual plaintiffs with common representation.

FIEA Article 21-2 imposes strict liability for material written misstatements in certain corporate documents, including prospectuses and annual financial reports. Strict liability allows investors to prevail without having to prove scienter, reliance, or loss causation. Whereas under U.S. law (Sections 11 and 12 of the Securities Act of 1933) this doctrine applies only to purchases pursuant to an offering, in Japan (under Article 21-2) it extends to investors who “purchased securities [in the secondary market] within a year prior to the corrective disclosure date and who still held the shares on the corrective disclosure date.”[15]

Article 21-2 also imposes a statutory measure of damages, equal to the change in average share price over a defined period (described further below). Together, these provisions make it less burdensome for plaintiffs to prove damages for many secondary market purchases under Article 21-2 in Japan than to prove such damages under U.S. Securities and Exchange Commission Rule 10b-5 in the U.S.

The FIEA litigation against Livedoor provides some insight into the course that Japanese litigation could take against Olympus. Investors in Livedoor, an internet portal and services company, claimed damages from a 2006 share price collapse that was triggered by news of fictitious profits, fraudulent acquisitions and the CEO’s arrest.[16] The private plaintiffs did not have to make a separate showing of materiality because the ensuing regulatory investigation established that there were material misstatements and omissions.[17] Courts in the four major Livedoor cases[18] awarded a total of JPY 19 billion in damages (about \$250 million). Per-share awards in the individual cases ranged from 28 percent to 73 percent of the stock’s one-month average pre-disclosure price.[19]

The statutory measure of damage per share for violations of Article 21-2 is the difference in average closing price from the month preceding the disclosure of the “truth regarding the false statements” to the month following.[20] It is the defendants’ burden to quantify and deduct from this statutory measure the effect on price of factors other than disclosure of the misstatements.[21] In all four major Livedoor cases, the court ruled that price drops in response to news of the stock’s delisting and the CEO’s arrest were not attributable to the misstatements. In three of the cases, the Tokyo District Court found that the delisting and the arrest accounted for two-thirds of the statutory damage; in the fourth, the Tokyo High Court reduced statutory damages for these factors by only 10 percent.[22]

Although complexities in the Livedoor fact-pattern made it difficult to separate out the price effect of misstatements from that of other factors, economic analysis in such situations can be influential. For example, in September 2011, the Supreme Court remanded the Seibu Railway case back to the Tokyo High Court, requiring that damages under FIEA be adjusted for the effect of general market movements and other factors unrelated to any misstatement.[23]

The Olympus Case

The Olympus scandal broke on Oct. 14, 2011, when the company’s recently ousted President and CEO Michael Woodford went public with his concerns about unusually high payments the company had made to an adviser in connection with the 2008 acquisition of U.K. medical equipment company Gyrus Group PLC.[24]

On Nov. 8, 2011, the company admitted to having hidden losses on securities investments dating back two decades[25] and that nearly \$1.5 billion in payments were made in connection with the Gyrus transaction and three other domestic acquisitions in an effort to “resolve unrealized losses.”[26]

The New York Times later reported that it had received a copy of a memo stating that Japanese officials were investigating whether billions of dollars more in illicit payments may have been paid and whether organized crime was involved.[27] A third-party committee of experts set up by the company to investigate the allegations announced its findings on Dec. 6. The committee confirmed that Olympus had engaged in illegal activities — by improperly deferring investment losses for more than 20 years, and engaging in a cover-up at significant expense — but it reported that organized crime syndicates were not involved.[28]

In its investigation report, the committee explained that the investment losses originated with a “speculative investment strategy” (or *zaiteku*) that Olympus launched in response to the rise in the value of the Japanese yen after 1985.[29] These losses increased substantially in the early 1990s as higher risk investments were made in an effort to recover initial losses. By the late 1990s the unrealized losses approached JPY 100 billion (\$1.3 billion)[30] and the looming introduction of fair value accounting, which would have revealed them, led executives in the accounting department to implement an elaborate cover-up. They developed a “loss separation scheme” to move unrealized losses off of Olympus’s balance sheet via transfers known as *tobashi*. [32]

Under the scheme, impaired assets were sold at book value (i.e., at cost) to off-balance sheet “receiver funds” set up and controlled by the company, thereby eliminating these assets from Olympus’ balance sheet. The receiver funds were financed by third-party banks to which Olympus pledged collateral.[33] The receiver funds then acquired growth companies (three domestic ones between 2003 and 2005[34] and the British company Gyrus Group PLC in 2008)[35], which Olympus later bought from the receiver funds at inflated prices and with payment of excessive advisory fees.

These expenditures channeled money back to the funds beginning in 2007[36], allowing them to pay their operating expenses[37], repay the banks and release the collateral provided by Olympus at the outset. Olympus booked its excess payments for the growth companies as goodwill and then began to write this down, effectively amortizing the original investment losses.

As of April 1, 2008, Olympus overstated its goodwill by JPY 72 billion (\$940 million) and, after consolidation of the remaining receiver funds, overstated its investment securities due to unrealized investment losses of JPY 100 (\$1.3 billion).[38] Following the excess payments made by Olympus between September 2007 and March 2011[39], the receiver funds were successively liquidated. As of April 1, 2011, all investment losses had been realized and all but JPY 42.4 billion (\$550 million) of the associated goodwill had been written down[40], making the asset overstatement in the 2011 financials much smaller than it had been in each of the prior restated financial years.

Olympus shares fell by more than 80 percent from a close of JPY 2,482 on Oct. 13, just before the scandal broke, to a low of JPY 460 on Nov. 11, just after the company first admitted to the fraud but before any details had been disclosed.[41] Since then, the price has recovered somewhat but as of Dec. 30 stood at JPY 1,012, less than half its Oct. 13 level.[42]

A similar fact pattern arose in the Livedoor scandal, with news of the alleged fraud and the CEO’s departure precipitating a share price crash before any details were disclosed.[43] The Livedoor matter is also similar in that it involved overpriced corporate acquisitions.[44] That the date of the initial revelations was treated by the Livedoor courts as the corrective disclosure date under FIEA even though the “truth” concerning the misstatements was not revealed until later may be indicative of what Olympus litigants can expect.[45] If the Olympus courts follow the Livedoor precedent, the Oct. 14 revelations and Nov. 8 admissions could be treated as corrective disclosures.[46]

Olympus' share price decline since Oct. 14 reflects market participants' expectations regarding the depth of financial problems at the company and the implications for future performance. Detailed economic analysis will be needed to determine how much of the price decline is attributable to misstatements and omissions rather than factors that the court may decide to exclude from damages, including a possible initial over-reaction consistent with the recent partial share price recovery.

The share price effect of delisting was deemed excludable from damages in the Livedoor cases. Olympus averted the risk of delisting on Dec. 14 by meeting the Tokyo Stock Exchange's deadline for filing restatements for the previous five financial years. However, the risk of delisting remains because the Exchange is conducting its own investigation and could decide to sanction the company based on its findings.[47] This delisting risk may continue to depress the share price.

Another complication specific to Olympus is that the restatement improved recent results. Annual operating income was adjusted upward on restatement by an average of JPY 4 billion (\$52 million) over the last three fiscal years, equivalent to a rise of 11 percent in the most recent year.[48] The increase in income was the result of reversing the amortization of phony goodwill. That Olympus was actually performing better in recent years than originally reported may have boosted the company's share price on disclosure. Economic analysis could be used to quantify this effect.

It is hard to predict what adjustments to statutory damages the Japanese courts might decide should be made to account for the effect on price of factors other than disclosure of the misstatements. What we do know is that if Oct. 14 is determined to be the relevant disclosure date, statutory damages under Article 21-2 would exceed JPY 1,200 per share before adjustment, or about half the pre-disclosure price.

Though the door is closed to litigation for most Olympus shareholders in the U.S., the statutory protections provided by FIEA and the rulings in Livedoor and other recent cases have opened the door to such litigation in Japan.

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[1] Values reported in Japanese yen are converted to US dollars at the rate of 76.9 JPY/\$ reported in the Financial Times for Jan. 2, 2012.

[2] The JPY 135 billion consists of JPY 118 in investment losses and JPY 17 billion in "scheme management expenses." See "Notice Concerning the Receipt of Third Party Committee Report," Olympus Corporation News Release, Dec. 6, 2011 ("Olympus Dec. 6, 2011 News Release"), and "Notice Concerning Filing of the Amendments to the Past Securities Reports and Partial Corrections to Past Financial Results (Kessan Tanshin) and That for the First Quarter of the Fiscal Year Ending March 2012," Olympus Corporation News Release, December 15, 2011 ("Olympus Dec.15, 2011 News Release").

[3] A class action complaint has already been filed in federal court in Pennsylvania on behalf of investors who bought Olympus American Depository Receipts between Nov. 7, 2006 and Nov. 7, 2011 (Graham v. Olympus Corporation, et al., case number 5:11-cv-07103, U.S. District Court for the Eastern District of Pennsylvania).

[4] Olympus common stock is listed in Tokyo. Only about 1 million of the 271 million Olympus shares outstanding back American Depository Receipts traded by investors in the U.S. (shares outstanding are from Bloomberg LLP and American Depository Receipts outstanding are from "Notice Regarding Litigation in the United States of America Brought against Olympus Corporation," Olympus Corporation News Release, Nov. 25, 2011).

[5] FIEA Article 21-2 applies to purchases of securities within a year prior to the corrective disclosure.

[6] Another major institutional investor is UK-based Baillie Gifford & Co., which owns about four percent. Tomoko Yamazaki, "Olympus Shareholder Calls for Woodford Return," Bloomberg, Nov. 10, 2011.

[7] Kana Ingaki, "Olympus Warned by Big Investors," The Wall Street Journal, Dec. 19, 2011.

[8] Ibid.

[9] The company itself is considering bringing litigation against its directors, non-directors and advisors, auditors included. Olympus has announced that it will make a decision on this in the first half of January, based on the results of the investigations by of its Director Liability Investigation Committee, Non-Director Management Liability Investigation Committee, and lawyers. See "Measures to be Implemented," Presentation of Shuichi Takayama, Olympus Corporation, Dec. 15, 2011.

[10] Olympus Dec. 6, 2011 News Release.

[11] Olympus Dec. 15, 2011 News Release.

[12] See e.g. Jonathan Stempel, "Analysis: Olympus investors may find courthouse door closed," Reuters, Nov. 9, 2011.

[13] A special committee under the Cabinet Office recently published a report proposing several options for introducing class actions in Japan. "Consumer Commission Expert Examination Committee on the Relief System for Collective Consumer Damage," Cabinet Office of the Government of Japan, August 2011, <http://www.cao.go.jp/consumer/history/01/kabusoshiki/shudan/index.html>.

[14] Makoto Ikeya and Stouru Kishitani, "Trends in Securities Litigation in Japan: 1998-2008," NERA Economic Consulting study, 2009, www.nera.com.

[15] FIEA, Article 21-2-2 (translated by NERA).

[16] See e.g. "Horie's Lawyer Denies His Client Knew of Wrongdoing at Livedoor," The Wall Street Journal, May 30, 2006.

[17] In the past, private plaintiffs have waited for the release of findings of investigations by the Securities and Exchange Surveillance Committee (the Japanese equivalent of the SEC) before proceeding with their own civil litigation because an administrative sanction may effectively establish a material misstatement or omission.

[18] The Tokyo District Court ruled on May 21, 2009, June 18, 2009, and July 9, 2009; the Tokyo High Court did so on Dec. 16, 2009. See case numbers: 2006 (Wa) No.11635, 2006 (Wa) No.14512, 2006 (Wa) No.19657, 2006 (Wa) No.28790, 2006 (Wa) No.12156, 2006 (Wa) No.15763, 2006 (Wa) No.8743, 2006 (Wa) No.11131, 2006 (Wa) No.13653, 2006 (Wa) No.16445, 2006 (Wa) No.19161, 2006 (Wa) No.21742, 2006 (Wa) No.27720, 2007 (Wa) No.2901, 2007 (Wa) No.8084, 2007 (Wa) No.12626, 2007 (Wa) No.18058, 2007 (Wa) No.24421, 2008 (Wa) No.32, 2008 (Wa) No.691, 2008 (Ne) No.3757.

[19] These courts awarded an amount of per share damages in each case which ranged across the cases between JPY 200 and JPY 527, as compared to the statutory damage of JPY 585. The variation in these awards is explained by different adjustments to statutory damages for factors other than disclosure of the misstatements (described further below). The average share price for the one month prior to the disclosure was 720 JPY.

[20] While the closing prices are not explicitly called for in Article 21-2, they were used in calculations admitted in evidence in the Livedoor and Seibu Railway cases and were accepted by the court.

[21] Article 21-2 also grants judges wide discretion to further reduce damages below the formulaic amount: “[I]f, [...] a part or all of the loss suffered by the party making the claim is determined to have been caused by factors other than the drop in value of the securities resulting from the false statements in the documents in question, but due to the nature of the losses suffered by the other factors, it is extremely difficult to prove the amount, the Court may approve an amount of losses not applicable to damages based on oral arguments and results of examination of all evidence.” FIEA Article 21-2(5).

[22] See cases listed in footnote 18.

[23] The Supreme Court decision, Sept. 13, 2011, 2009 (Ju) No.1177, 2010 (Ju) No.1485. Similarly, in a Companies Act case decided by the Tokyo High Court and reviewed by the Supreme Court in April 2011, the use of a market model to adjust market prices for the effect of general market movements was accepted. In that case, Mr. Ikeya introduced the market model as the basis of his economic analysis, which was accepted over that of the opposing expert. See “NERA's Role in Intelligence Ltd. Case before Tokyo High Court,” http://www.nera.com/66_7302.htm.

[24] “Ousted Olympus President Cites Clash Over Deals,” Wall Street Journal, Oct. 15, 2011.

[25] “Notice Concerning Past Activities Regarding Deferral in Posting of Losses,” Olympus Corporation News Release, Nov. 8, 2011 (“Olympus November 8, 2011 News Release”).

[26] Nathan Layne and Isabel Reynolds, “Olympus admits hid losses for decades,” Reuters, Nov. 8, 2011.

[27] The memo was reportedly prepared by investigators and circulated at a meeting of officials from Japan's Securities and Exchange Surveillance Commission, the Tokyo prosecutor's office and the Tokyo Metropolitan Police Department. Hiroko Tabuchi, “Billions Lost By Olympus May Be Tied To Criminals,” New York Times, Nov. 18, 2011.

[28] Olympus Dec. 6, 2011 News Release.

[29] “Investigation Report, Summary,” Olympus Corporation, The Third-Party Committee, Dec. 6, 2011, (“Investigation Report”) p. 6.

[30] Ibid.

[31] Investigation Report, pp. 7-8.

[32] The first receiver funds, Central Forest Corp. and Quick Progress Co., were set up between 1997 and 1998 as part of the European Route. Investigation Report, p. 10.

[33] Investigation Report, pp. 8-11.

[34] Investigation Report, pp. 12.

[35] Olympus Nov. 8, 2011 News Release, and Olympus Dec. 6, 2011 News Release.

[36] According to the investigation report, Olympus purchased shares of the three domestic companies from a receiver fund called G.C. New Vision Ventures LP in September 2007. Investigation Report, pp. 12-13.

[37] Additional losses resulted from the operating expenses of the receiver funds; between April 1, 2001, and April 1 2006, these reportedly amounted to JPY 28 billion. "Amendments to the Past Securities Reports and Outline of Financial Results for the First Six Months of the Fiscal Year Ending March 31, 2012," Presentation by Hironobu Kawamata, Olympus Corporation, Dec. 15, 2011 ("Olympus Dec. 15, 2011 Presentation").

[38] This overstatement of net assets included an overstatement of goodwill and an overstatement of investment securities including those consolidated from off-balance sheet receiver funds at above-market values. Olympus Dec. 15, 2011 Presentation, p.6, and Olympus Dec. 15, 2011 News Release.

[39] The "loss separation scheme" involved the transfer of losses via three separate collections of receiver funds: the "domestic route," the "European route," and the "Singapore route." These receiver funds were reportedly closed down (or "settled") in September 2007, October 2008, and March 2011, respectively. Investigation Report, pp. 12-13 and 17.

[40] Olympus Dec. 15, 2011 Presentation.

[41] Nathan Layne and Isabel Reynolds, "Olympus admits hid losses for decades," Reuters, Nov. 8, 2011.

[42] On the day of Michael Woodford's initial disclosure and the following trading day, the share price dropped 37 percent. The company's Nov. 8, 2011 admission that it had hidden investment losses of an unspecified amount in its annual reports was followed by a 53 percent drop in share price over three days. On the day the third-party committee released its investigation report the share price rose 9 percent. But the company's Dec. 14, 2011 announcement and Dec. 15, 2011 restatement of financial statements was accompanied by a 24 percent fall in the share price over the two days.

[43] Yukari Iwatani Kane, "Investors flee after raid on Japan's Livedoor," Reuters, Jan. 16, 2006.

[44] "Horie's Lawyer Denies His Client Knew of Wrongdoing at Livedoor," The Wall Street Journal, May 30, 2006.

[45] The Tokyo High Court Livedoor judgment, Dec. 16, 2009, 2008 (Ne) No.3757.

[46] FIEA does not explicitly address the possibility of multiple corrective disclosure dates, nor is there a clear precedent. Consequently, opinion will likely differ regarding the appropriate corrective disclosure date for calculating statutory damages under Article 21-2. Scandal-related events that occurred on different days include the disclosure by former President and CEO Michael Woodford of his concerns about the Gyrus transaction, the company's initial admission, the release of the third-party investigation report, and the company's restatement. The largest share price drops followed the breaking of the story and the company's initial admission, but only later would the market learn how the fraud operated or

the magnitude of the written misstatements.

[47] Yuri Kageyama, "Olympus meets deadline for revised earnings report, Japanese regulators say Olympus met deadline for revised earnings report," Associated Press, Dec. 14, 2011.

[48] Olympus Dec. 15, 2011 Presentation, p.5.

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