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Labor & Employment Law Newsletter

Terminating Employees in Japan – An Overview, Common Pitfalls and How to Avoid Costly Mistakes (Part II of III)

Editor's Note: Part I of this article covered ordinary dismissals and was published in the previous issue of the newsletter. Part III will address punitive dismissals and will appear in the next issue.

Dismissals for Purposes of Downsizing

As the term suggests, dismissals for purposes of downsizing are conducted with the aim of reducing the size of a company's workforce to deal with financial difficulties or for other business-related reasons. Because dismissals for purposes of downsizing are conducted without a cause attributable to an employee (e.g., an employee's work performance or a violation of the company's rules), courts tend to apply a stricter standard in determining the validity of these dismissals compared to ordinary dismissals that were discussed in the previous issue. Employers should note that even the layoff of a single employee can be regarded as a dismissal for purposes of downsizing as long as the dismissal is done for this reason.

Relevant Factors

Japanese labor statutes do not spell out what a company must do to validly dismiss an employee for purposes of downsizing. Under the relevant case law, however, a company generally must establish that:

(1) It is critical for the company's business that it reduce the size of its workforce;
(2) it has done everything it can reasonably do to avoid dismissals;
(3) the choice of employee(s) to be dismissed is reasonable; and
(4) it provided the employee(s) with a full and complete explanation of the contemplated dismissal, as well as ample opportunity for discussion.

Courts have historically treated each of the four factors as requirements. Therefore, a finding that even a single factor was lacking would invalidate the dismissal. However, recent court decisions have employed a kind of "totality of the circumstances" test. This trend suggests that even if one of the four factors may not be fully satisfied, the court may nevertheless find the dismissal valid if the other three factors were sufficiently met.

Despite this apparent relaxation of the standard, however, a prudent HR manager would be well advised to treat each factor as an ironclad requirement. Even today, some courts still find dismissals invalid because the employer failed to meet one of the four factors, in particular the duty to avoid the dismissal in the first place and the reasonableness of the choice of employee to be let go.

The four factors in detail are as follows.

(1) The Necessity for Downsizing

Any downsizing-related dismissals are required to be based on a real business need. Some examples include the need to address sharp financial losses, to deal with a severe economic downturn, or to adjust to a prolonged decline in the industry that the company operates in.

While some courts have held that this factor is met only when bankruptcy appears unavoidable, most courts have been more flexible and defer to the employer's business judgment. For example, in some cases the requisite necessity is found where a company finds itself in excessive debt or is consistently suffering losses. In other recent cases, courts found that this factor was met when an employer dismisses employees in order to streamline management or to enhance their competitiveness, even when

Koinobori (carp streamers) at Tokyo Tower

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Message from the Labor and Employment Practice Group

Kojima Law Offices have provided legal services in the area of labor and employment law since its founding in 1984. Our Labor and Employment Practice Group represents clients in labor disputes and assists them in structuring and implementing HR policies. We work with both foreign headquarters and local management to timely and appropriately resolve employment issues that overseas companies face operating in Japan. As part of our continuing effort to reach out and share our expertise with others, the Labor and Employment Practice Group publishes this newsletter to provide a better understanding of this complex area of law, thereby enabling the reader to make more appropriate employment and labor decisions. We hope you find the newsletter both interesting and informative and welcome any feedback you wish to share with us.

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the company's overall financial condition is not in dire jeopardy.

On the other hand, courts often find that a company is not justified in dismissing employees if the employer acts in a way that contradicts its claim of needing to reduce its head count (such as giving out significant pay raises or hiring a large number of new employees shortly after deciding to implement the dismissals).

(2) Efforts to Avoid Dismissals

Under the relevant case law, dismissals must essentially be considered only as a last resort since the impact on the targeted employee will be immense. Prior to dismissing an employee, a company must do its utmost to avoid the dismissal. For instance, a company could initiate cost cutting measures (including across-the-board pay cuts, reducing overtime pay by cutting back on or eliminating overtime work), less reliance on temporary workers, a moratorium on new hiring, the secondment of targeted employees (so-called *shukkou*, which refers to the temporary transfer of an employee to another company while that individual remains an employee of his/her original company), shifting target employees to other positions or departments (companies should consider offering transfer or secondment opportunities to employees whose workplaces are fixed under their employment agreements before deciding to dismiss them), job-sharing (a flexible work option in which two or possibly more employees share a single job), temporary lay-offs, and calling for and encouraging voluntary resignations.

Generally, courts have identified this last measure as crucial. Employers should therefore make a good-faith effort to promote voluntary resignations. This objective can often be achieved by having the company offer employees various financial incentives prior to dismissing them (even if the target employee declines to resign voluntarily).

Overall, courts will determine whether a company has taken adequate steps to avoid dismissals by looking at a variety of factors. These factors include the size of the company, the company's financial condition, the composition of the company's workforce (e.g., the ratio of regular *seishain* employees to non-regular employees, employees' ages, etc.), the degree of the necessity and how urgently the company needs to downsize. The complexity of this determination means employers should consult with a specialist as early as possible about the steps it should take to validly dismiss employees.

(3) Reasonableness of Selection of Employee(s) to be Dismissed

Employers are required to apply specific, objective and reasonable criteria in determining which employees are to be dismissed. Companies using criteria that are not specific, objective and reasonable face an increased risk that the dismissal will be invalidated.

Acceptable criteria can include the following: (i) quantifiable factors such as length of service, workplace attendance and disciplinary violations; (ii) contributions made to the company in terms of business results; (iii) the status of employment (e.g., regular *seishain* employees are afforded greater protection than non-regular workers); and (iv) how difficult it will be for the dismissed employee to be reemployed and the impact of the dismissal on the employee's family.

Employers have the sole discretion to determine the criteria that they will use. They are not required to consult with their employees or the labor union beforehand. However, employers need to be extremely vigilant about keeping bias and subjectivity out of the equation.

(4) Adequacy of the Termination Process: Sufficient Explanation and Discussion

Before dismissing employees for the purpose of downsizing, an employer is required to provide the target employees (including their unions) with a full and complete explanation about the need to downsize and the importance of the downsizing efforts to the future of the company. Moreover, the employer must provide ample opportunities for employees to discuss the downsizing plans with the company. Ideally, of course, the objective is to have the employee fully understand the necessity of the company's actions. However, failing to achieve this lofty goal does not necessarily mean that the dismissal will be declared invalid. As long as the employer provides the targeted employees with both the opportunity and the means to learn about and understand the need to downsize, a court will likely find that the employer has taken adequate measures in preparation for the dismissal.

Specifically, employers need to describe the necessity, contemplated date and scale of the dismissals, as well as details about how the dismissals will be carried out. The employers should discuss these matters openly and in good faith. As part of this effort, employers should provide employees with documentation: (i) establishing that the downsizing is necessary; (ii) showing how the downsizing will benefit the company; and (iii) illustrating that the company has a viable plan to return to profitability. The company should also provide the employee with the company's current financial statements.

If an employer's explanation is lacking or if the employer unilaterally breaks off discussions with the employee prematurely, a court may find the dismissal invalid.

Final Pointers

It is not uncommon for targeted employees to join a union with significant know-how in dismissal matters before or soon after being dismissed. If, as often happens, the union requests that the employer explain and discuss the dismissal with the union, the company is required to comply with the request. Failure to do so may constitute unfair labor practices and invalidate the dismissal, so employers should not take union requests lightly. These unions typically have access to experts with vast knowledge of dismissal matters. Therefore, employers should consult with their own experts as early as possible regarding how to deal with labor unions.

It is also important to note that the restrictions applicable to ordinary dismissals also apply to dismissals for purposes of downsizing. Therefore, the company's work rules must set forth that employees are subject to being dismissed for purposes of downsizing. Furthermore, employers cannot dismiss employees who: (i) are on maternity leave and for 30 days thereafter; and (ii) are on medical leave to receive treatment for injuries or illnesses suffered in the course of employment and for 30 days thereafter.

Lastly, employers are required to take one of the following steps to validly dismiss their employees:

(i) provide the target employees with at least 30 days' written notice;
(ii) in lieu of 30 days' written notice, provide the target employees with at least 30 days' worth of pay; or
(iii) a combination of notice and pay (e.g., 15 days' written notice and 15 days' pay).

Illustrative Cases

To understand how the four factors are applied in practice, it is useful to review actual court cases involving dismissals for the purpose of downsizing. Below are summaries of selected cases where the court found in favor of the dismissed employees.

1. May 17, 2007 Judgment of the Osaka High Court

Kansai Kinzoku Kogyo Kabushiki-Kaisha ("Kankin") dismissed 10 regular "*seishain*" employees in 2004 for the purpose of downsizing. Kankin had been under extreme financial pressure. Its gross revenue plummeted by more than half from 5 billion JPY in 1992 to just 1.8 billion JPY in 2001. This steep drop meant that Kankin had been operating in the red since 1998. Plaintiff-employees challenged all 10 dismissals and sought both reinstatement to their positions and back wages. The Osaka District Court found for the employees, and Kankin appealed.

Prior to dismissing the employees, Kankin took the following actions:

(1) It slashed operating costs from 46 million JPY in 2001 to 31 million JPY in 2003.
(2) It let go 22 part-time and temporary employees, and furloughed its entire workforce three times in 2002.
(3) It cut employee bonuses starting in 1998.
(4) It cut pay for its officers and administrative employees in 2002.
(5) Kankin sought the voluntary retirement of 20 employees, and managed to get 26 to leave.
(6) Kankin implemented a turnaround plan in 2002 but the plan failed to achieve the desired results.
(7) Kankin sold its employee dormitory.
(8) Kankin explained to their employees and the union that unless it could convince six employees to resign voluntarily, it was considering dismissing six employees.

After taking steps (1) to (6), Kankin offered employees with more than 30 years of service the chance to voluntarily resign, saying that it was seeking the resignation of six such employees. The response was poor, however, and no employees offered to leave.

In response, Kankin on April 16, 2004 notified all employees with more than 25 years of service that Kankin would dismiss all such employees on May 20, 2004 for the purpose of downsizing. Kankin indicated that it would then re-employ the dismissed employees under less-favorable work conditions, but that the re-employment was not assured.

All of the targeted employees except for the 10 plaintiff-employees agreed to follow Kankin's plan. These employees were dismissed and then re-employed, as Kankin had indicated it would do. Kankin thereafter terminated all 10 plaintiff-employees on May 20, 2004.

On appeal, the court held that Kankin's downsizing efforts required a reduction of its head count by up to six employees, but that Kankin failed to prove it needed to dismiss 10. The court also held that Kankin failed to adequately explain to the target employees and their union why it was necessary to dismiss 10 employees.

Accordingly, all 10 of the dismissals were found to be invalid.

Practical Pointers

Employers need to specifically and concretely explain how, when and how many employees will be dismissed in order to validly conduct dismissals for the purpose of downsizing. In this case, Kankin failed to explain why the number of employees that it needed to terminate jumped from 6 to 10. For this reason, all 10 dismissals were invalidated. Of course, unexpected events can sometimes cause employers to increase the number of employees targeted for dismissal as part of its downsizing plans. When this happens, employers need to fully explain and discuss the amended plan with their employees and the union (if any) so that all involved will have a complete understanding of why more workers need to be let go.

Also, employers should prepare different scenarios in advance to deal with potential obstacles they may face in the dismissal process. Whether the problem is one of severance pay, timing of the dismissal, or assistance in securing new employment for the target employees, it is important for companies to be flexible and have alternate solutions ready to go in order to achieve the contemplated dismissals as smoothly and as efficiently as possible.

2. January 17, 2006 Judgment of the Nagoya High Court

Yamada Boseki Kabushiki-kaisha ("Yamada") operated both a real estate and a textile business. On November 15, 2000, Yamada filed an application to enter into civil rehabilitation proceedings, a common form of bankruptcy protection in Japan. Shortly thereafter, Yamada decided to focus on its real estate division and began the process of exiting the textile business. Accordingly, on February 20, 2001 Yamada terminated nearly all of its textile workers, which then totaled over 100 employees. The textile workers challenged the dismissals. They asked the court to reinstate them to their former positions and demanded back wages. The trial court found in favor of the workers.

On appeal, Yamada argued that the termination of the textile workers

should not be considered dismissals for the purpose of downsizing, but are instead easier-to-justify ordinary dismissals (as noted earlier, courts apply less stringent rules for ordinary dismissals). Yamada contended that by entering into civil rehabilitation proceedings, it effectively had no choice but to shut down its textile division; management had very little discretion to do otherwise. The court disagreed, however, holding that the dismissals were necessary only because of management missteps, not due to anything attributable to the employees. The court therefore concluded that the dismissals constituted dismissals for the purpose of downsizing.

The court then turned its attention to whether Yamada validly conducted the dismissals. As explained below, both the trial and appeals courts held that Yamada failed to satisfy any of the four factors.

(1) The necessity for downsizing

Yamada had been losing money from 1989 to 2000 (the losses ranged from between 187 and 956 million JPY). A large part of the blame for Yamada's poor performance was its textile division, which had become extremely unprofitable. Taken together, these two facts made it certain that Yamada would need to downsize. However, Yamada's sales from January to August 2000 totaled a not-insignificant 602 million JPY and it had lost only 861,036 JPY during this period. The court therefore disagreed with Yamada that it had to dismiss almost all the workers in its textile division. Moreover, Yamada's president made the decision to close its textile business on his own without first consulting with Yamada's board. Neither did he take into account Yamada's profitability numbers before ordering the dismissals. Under these circumstances, Yamada failed to prove that it needed to dismiss all of its textile employees.

(2) Efforts to avoid dismissals

Yamada failed to ask any of its employees to resign voluntary before dismissing them. Yamada also failed to consider transferring the textile employees to its real estate division or to one or more of its affiliates. Yamada therefore clearly did not make the requisite effort to avoid the dismissals.

(3) Reasonableness of selection of employees to be dismissed

Yamada failed to establish any standards whatsoever for the choice of employees to be dismissed.

(4) Adequacy of the termination process - sufficient explanation and discussion

After applying for civil rehabilitation on October 4, 2000, Yamada explained to its employees that it intended to maintain its textile business. However, as soon as the civil rehabilitation process formally began on November 15, 2000, Yamada abruptly changed course and promptly shut it down. Furthermore, Yamada did not disclose any information related to its financial affairs.

In light of the above, the court concluded that these dismissals for the purpose of downsizing were invalid.

Practical Pointers

When employers seek bankruptcy protection through such processes as civil rehabilitation (*minji-saisei*) or a corporate reorganization (*kaisha-kosei*), courts generally apply the four factors to determine the validity of any dismissals for the purpose of downsizing that may result. Admittedly, a rebuttable presumption that the employer is suffering a severe financial hardship may arise when a company seeks bankruptcy protection. This fact alone, however, does not automatically mean the employer has established the necessity for downsizing. On the contrary, courts will scrutinize every detail to see whether the employer has abused its right to dismiss employees under the cover of bankruptcy protection. Obviously, the prompt and efficient dismissal of employees is a crucial component of most reorganization plans, and a company should not risk undermining its own rehabilitation efforts by failing to properly dismiss the target employees. These companies should therefore consult with advisors that have expertise on how to best proceed with dismissals for the purpose of downsizing.

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