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Learing from Comparative Law in Teaching U.S. Corporate Law: Director's Liability in Japan and the U.S.

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Articles

Learning from Comparative Law in Teaching U.S. Corporate Law: Director's Liability in Japan and the U.S.

Bruce E. Aronson*

Abstract

This article demonstrates how a comparative law perspective can be usefully incorporated into the teaching of U.S. corporate law through a comparison of the director's duty of care in the U.S. and Japan. It focuses on the landmark Daiwa Bank shareholder derivative case decided in September 2000, in which the Osaka district court ordered eleven current and former directors of Daiwa Bank to pay a record $775 million in damages for breaches of fiduciary duty in two cases related to the bank's well-known trading loss scandal of 1995. The legal doctrine and aftermath of the *Daiwa Case* are compared to the leading Delaware cases of *Van Gorkom* and *Caremark.* In order to make broad functional comparisons and to provide an example of how comparative law could

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be utilized in the teaching of basic U.S. law courses, the article is written in the form of an introductory essay and a sample set of supplemental course materials.

In comparing directors' duties in the two legal systems, I find both surprisingly broad similarities and a number of interesting differences. Despite Japan's civil law system with statutory fiduciary duties, the courts in both countries played similar roles and encountered similar difficulties in interpreting broad formulations of the duty of care and reducing them to a clear standard of liability. The aftermath of both *Daiwa* and *Van Gorkom* included new legislation to limit directors' liability and the potential to exert an important impact on corporate practices. The biggest difference is the lack of separation of officers and directors in Japan, which leads Japanese courts to focus on the actions and responsibility of individual directors rather than the emphasis in U.S. courts on actions of the board as a whole. It also has led, in Japan, to legislation that explicitly distinguishes between the liability of inside and outside directors in an effort to increase the number and role of outside directors. In addition, although courts in both countries have created a business judgment rule, its procedural emphasis makes its application more difficult in Japan where there is limited corporate disclosure and discovery.

I conclude that a broader comparison of U.S. corporate law with other legal systems can, in fact, act both to provide a deeper examination of the legal doctrine and underlying policy considerations of our own system, and to aid in preparing students for encounters with other legal systems.

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I. Introduction

Whereas just 20 years ago several law firms touted "international" practice as a firm specialty, today it is an integral part of the practice of business (and many other) lawyers. In the age of globalization, few would argue with the general proposition that law schools need to prepare students to operate in an environment where they will regularly encounter foreign or multinational clients, cross-border transactions, and the interpretation of foreign regulations by non-U.S. attorneys. In many areas of teaching law, it is a challenge to move beyond covering a topic in specialized courses and infuse (or at least introduce) the valuable and increasingly important international perspective in basic courses. The question of the "internationalization" of the law school curriculum has received increased attention over the past few years, with a number of prominent law schools undertaking new and ambitious efforts in this area.[1]

The basic business organizations course would be an ideal course for the early introduction of a comparative perspective to law students generally, and to future business lawyers in particular. Theoretically, that course provides students with an understanding of corporate legal doctrine, a broad sense of underlying policy considerations, and practical business issues that are highly relevant to the role of business advisor. A broader comparison of U.S. corporate law with other legal systems, as opposed to the narrower comparison of the corporate laws of Delaware and the Revised Model Business Corporations Act, would encourage a deeper examination of the underpinnings of our own system and aid in preparing students for their inevitable encounters with other legal systems.

However, the basic business organizations course is also one of the

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1. Notable among recent efforts is Michigan Law School's requirement that all first-year students take an introductory survey course on transnational law.

most crowded subjects in the curriculum. Its core topics already require at least some introduction to economic theory, agency, partnership, finance, accounting, tax and other areas. Additionally, the importance of securities law to the basic course has been steadily increasing. There already are other competing topics worthy of inclusion or greater emphasis in the basic course, such as the professional ethics of business lawyers serving corporate clients. Accordingly, adding a special comparative law section to the basic course, such as comparative corporate governance, would probably be difficult.[2] Adding supplementary materials to complement existing topics would seem the most practical approach, but, to date, there has been a paucity of such materials. As a result, despite the general appeal of a comparative approach, apparently little headway has been made in bringing such an approach to bear on basic courses such as business organizations.[3]

In a modest attempt to address the lack of materials in this area, I have created a set of comparative supplemental materials focusing on the duty of care of corporate directors. Those supplemental course materials are set forth in Section II of this article. This area of law strikes me as being a good candidate for comparative analysis as the general requirement that directors perform their duties with reasonable care has proven to be quite difficult to reduce to legal principles and standards of liability. The balance sought by the business judgment rule—providing directors with broad discretion to make business judgments while also providing an incentive for the good faith performance of their duties—should be a policy concern of all corporate law regimes. The leading U.S. case in the area, *Van Gorkom*,[4] can be a cumbersome and difficult vehicle for shedding light and stimulating discussion on the underlying policy issues.[5] A comparative analysis might well be useful in this

2. *See* Lawrence A. Cunningham, *Essay: Fundamental Themes in Business Law Education: Comparative Corporate Governance and Pedagogy*, 34 GA. L. REV. 721 (2000). Cunningham speculates that comparative corporate governance will mature into a topic routinely covered by the basic course, but concludes that, at present, the benefits and costs are a "close call." He suggests the pursuit of "modest ways to conduct the introduction that still enable the benefits while keeping the costs low." *Id.* at 741.

3. A number of law teachers have made individual efforts to incorporate a comparative perspective into the basic courses which they teach. There have also been proposals in the past to teach comparative law as an integral part of courses throughout the curriculum. *See* Michael P. Waxman, *The Comparative Legal Process Throughout the Law School Curriculum: A Modest Proposal for Culture and Competence in a Pluralistic Society*, 74 MARQ. L. REV. 391 (1991). But despite widespread interest in the general idea, most law teachers find it difficult to cover the topics already included within their basic courses, let alone adding complementary comparative law subjects. *See, e.g.*, Michael P, Waxman, *Teaching Comparative Law in the 21st Century: Beyond the Civil/Common Law Dichotomy*, 51 J. LEGAL EDUC. 305 n.2 (2001).

4. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) [Trans Union Case].

5. The Delaware Supreme Court found directors' liability based on gross

regard.

To make a comparison, I utilized materials from Japanese law centering on fiduciary duties under the Japanese Commercial Code and the interpretation of fiduciary duties under *Nishimura v. Abekawa*, a recent landmark shareholder derivative suit related to the well-known Daiwa Bank scandal (hereinafter the *Daiwa Case* or the *Daiwa Bank Case*).[6] There are many reasons why the Japanese legal system is a good subject for comparative analysis.[7] As a unitary, civil law system, the relevant corporate laws are all national laws where the duties of directors are established by statute. Legal duties exist within a "legal culture" that most students perceive to be very different from that of the U.S. and Europe. The basic scheme of corporate law and director's duties, revised under the postwar U.S. occupation, is similar to that of the U.S. but retains some important German-inspired provisions. Also, despite the "lost decade" of the 1990s, Japan remains the world's second largest economy and a leading U.S. trade partner; and it is a non-Western legal system that students may well encounter during their professional careers. Japanese corporate law is in the midst of debate and change,

negligence due to the failure to make an informed judgment by utilizing all material reasonably available in approving a cash-out merger. Despite a complex fact pattern, involved issues of law, and being almost immediately overturned in Delaware by the legislature's enactment of a new state exculpatory charter provision, this case continues to generate wide comment and occupies the most prominent position in corporate law casebooks with respect to a director's duty of care and the business judgment rule. *See, e.g.*, Lawrence A. Hamermesh, *Fiduciary Duty, Limited Liability and the Law of Delaware: Why I Do Not Teach* Van Gorkom, 34 GA. L. REV. 477 (2000).

6. Nishimura v. Abekawa, 1721 HANREI JIHŌ 3 (Osaka Dist. Ct., Sept. 20, 2000). [hereinafter the *Daiwa Case* or the *Daiwa Bank Case.*] In this case, the Osaka district court, in a voluminous decision, ordered eleven current and former directors of Daiwa Bank to pay a total of $775 million in damages in two cases related to the bank's well-known 1995 trading loss scandal. In the first case, the court found that the Daiwa directors' failure to establish an appropriate internal control system, which could have prevented or discovered a $1.1 billion loss resulting from unauthorized trading in the bank's New York branch, was a breach of the oversight component of their duty of care. In the second case, the court found a breach of the directors' duty to comply with law in connection with concealment of losses and failure to report criminal activity to U.S. authorities in the timely manner that United States law requires. For an analysis of the decision, *see* Bruce E. Aronson, *Reconsidering the Importance of Law in Japanese Corporate Governance: Evidence from the Daiwa Bank Shareholder Derivative Case*, 36 CORNELL INT'L L.J. 11 (2003).

7. For a discussion of the merits of teaching Japanese law as a separate course, *see, e.g.*, Kenneth L. Port, *The Case for Teaching Japanese Law at American Law Schools*, 43 DEPAUL L. REV. 643 (1994). Globalization has sparked ambitious proposals concerning the importance of comparative law in legal education. *See, e.g.* Gloria M. Sanchez, *A Paradigm Shift in Legal Education: Preparing Law Students for the Twenty-First Century: Teaching Foreign Law, Culture, and Legal Language of the Major U.S. American Trading Partners*, 34 SAN DIEGO L. REV. 635, 679 (1997) (arguing that in the age of globalization, legal education in the United States "should include, at a minimum, courses on the law, culture and language of Canada, Mexico, and Japan").

often with specific references to U.S. law and corporate governance practices and interesting adaptations of U.S. approaches to local circumstances.

An examination of the current ferment in Japanese law leads to many interesting questions. How does a director's duty of care work in a system in which there was traditionally no separation of officers and directors? In a system with limited corporate disclosure and discovery in litigation, can such fiduciary duties be primarily procedural in nature? Should there be a lower level of liability for outside directors in order to encourage their widespread use? To what extent can directors rely on the performance of other directors, outside counsel or even informal advice from government agencies? Japan's struggle with these questions highlights interesting issues about our own legal system that might otherwise be taken for granted.

I have organized the comparative supplemental course materials into six subsections. Subsection A contains a brief note on Japanese law with an accessible diagram of the traditional Japanese corporate structure.[8] Subsection B summarizes the factual background of the *Daiwa Bank Case*. Subsection C summarizes the *Daiwa* decision and contains a series of excerpts from the court's judgment. Subsection D briefly summarizes a 2001 amendment to Japan's Commercial Code to limit directors' liability. Subsection E lists the parallels and differences between the Japanese law introduced here and comparable U.S. law. Subsection F provides sample questions and answers in order to make comparisons with U.S. statutory law and case law in *Van Gorkom* and *Caremark*[9] and to stimulate discussion.[10]

8. The diagram provides sufficient background to enable the reader to read and understand the *Daiwa* decision.

9. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996). *Caremark* is the leading Delaware case on the oversight/monitoring component of a director's duty of care. It involved directors failing to monitor violations of law and the resulting payment of substantial criminal and civil fines of some $250 million. In approving a proposed settlement, the Chancellor found that it was a director's duty to create reporting systems that will allow the board to make informed judgments with respect to compliance with law. *Id.*

10. It is assumed that students have read the *Van Gorkom* and *Caremark* cases and related statutory material.

II. Comparative Supplemental Course Materials

A. Note on Japanese Law

1. Corporate Law

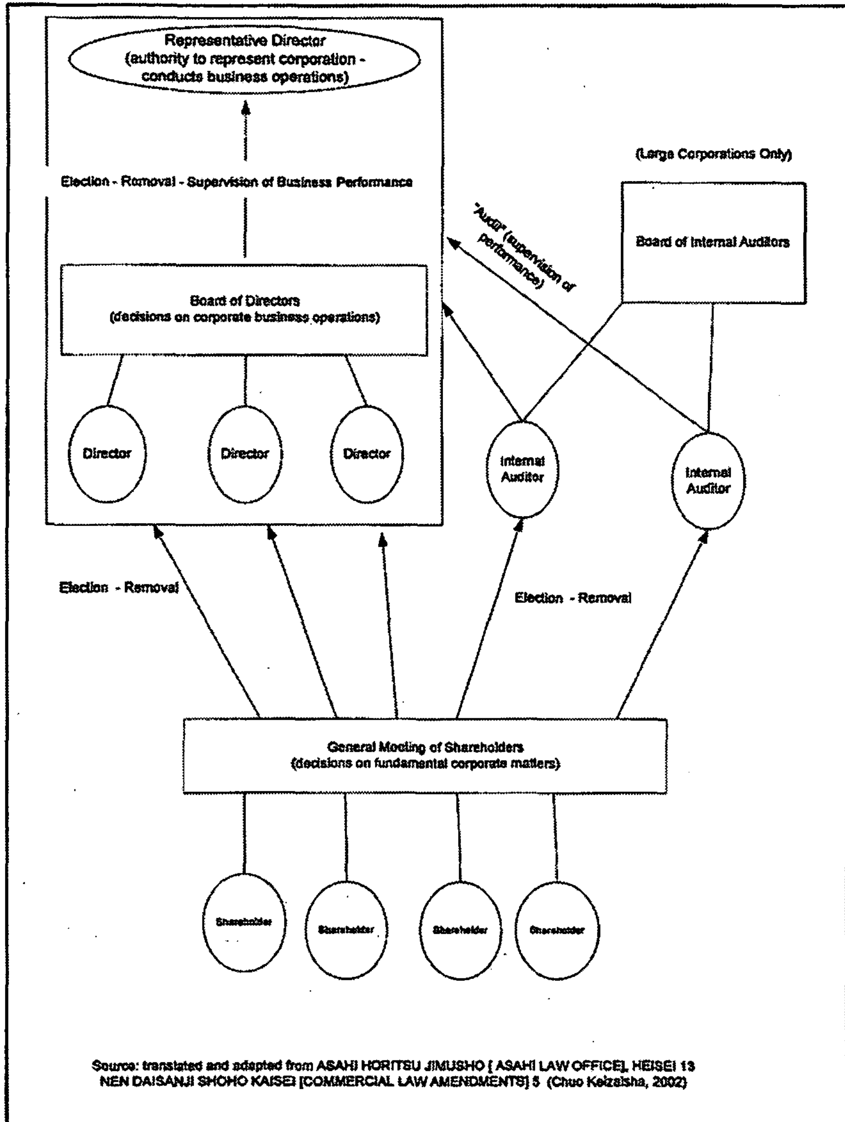
The Japanese Commercial Code, originally enacted in the late 19th century, was based on German law and rewritten in 1950 under the U.S. occupation. The basic scheme of corporate law and directors' duties is functionally similar to that of U.S. law, but contains important formal differences. Chief among these differences is the Commercial Code's retention of the German-inspired positions of representative director and internal corporate auditor ("Auditor"). Directors, who are elected by shareholders, choose one or more representative directors from their ranks and directors have a duty to monitor the performance of these representative director(s).[11] Much like a president, the representative director(s) is granted the authority to represent the corporation.

Traditionally, there was no provision for officers and no separation of managers and directors in Japanese corporations. Instead, directors were nearly all senior managers promoted from within the firm. Becoming a director was regarded merely as a step up in the chain of promotion. This led to large boards with hierarchical structures in which directors retain "line" responsibilities to manage or control a department of the corporation.

All corporations are required to have Auditors, and since 1993, large corporations must have a board of auditors with at least one outsider. Auditors, who are also elected by shareholders, are required by the Commercial Code to monitor the directors' performance. The Auditors' function is to oversee the performance of directors generally, rather than to focus on accounting issues or financial statements. Unlike a German Supervisory Board, Auditors in Japan have no power to appoint directors. Critics of the Japanese system complain that no real supervision of management exists; generally, directors do not supervise representative directors, and, in practice, Auditors have not effectively fulfilled their assigned function of overseeing the performance of directors.

11. *See* Traditional Structure of Japanese Corporate Governance diagram *infra*.

Traditional Structure of Japanese Corporate Government



2. Fiduciary Duties

Japanese directors owe fiduciary duties to the corporation and shareholders. Such duties are generally similar to those mandated by U.S. law. In addition, code provisions regarding directors' duties include a specific duty of compliance with laws and regulations. Under the theory that Auditors are not involved in conducting the corporation's business and would, therefore, have no conflicts of interest, Auditors

owe a duty of care to the corporation, but not a duty of loyalty. Because the Japanese system is a unitary, civil law system, the duties of directors and Auditors are established by statute, and all of the relevant corporate laws are national. Civil litigation is utilized for the application of such statutes to specific cases.

This traditional structure of Japanese corporate governance has been undergoing considerable change over the past few years. A substantial minority of public corporations have taken action to reduce the size of the boards of directors, add a new class of executive officers with the stated intention of achieving separation between management and the board of directors, and add some outside directors to the board. An amendment to the Commercial Code in November 2001 sought to strengthen the independence of Auditors by requiring, *inter alia*, that at least half of the Auditors be outsiders. A separate overhaul of the Commercial Code enacted in May 2002 provides for a new, optional, "American-style" form of corporate governance under which the German-inspired positions of representative director and Auditor are abolished and replaced by a new representative executive officer and three committees (audit, nominating and compensation) of the board of directors.

3. Key Commercial Code Provisions

Duty of Care The Commercial Code states that "[t]he relationship between the company and the directors shall be governed by the provisions relating to mandate."[12] This also applies to Auditors under article 280(1). Under the Civil Code, "[a] mandatary is obligated to manage the entrusted affairs with the care of a good manager in accordance with the tenor of the mandate."[13] Regarding liability, the Commercial Code states, "directors . . . shall be jointly and severally liable . . . to the company . . . where they have done any act which violates any law, ordinance or the articles of incorporation."[14]
Duty of Loyalty Regarding a director's duty of loyalty, the Commercial Code requires that "[t]he directors shall comply with laws, ordinances, and the provisions of the articles of incorporation, as well as resolutions adopted at a general meeting, and shall perform their duties faithfully on behalf of the company."[15]

12. SHŌHŌ, art. 254, para. 3.
13. MINPŌ, art. 644.
14. SHŌHŌ, art. 266, para. 1, no. v.
15. SHŌHŌ, art. 254-3.

4. Shareholder Derivative Suits

Since 1950 the Commercial Code has contained provisions allowing derivative actions by shareholders against a corporation's directors and Auditors for any breach of duty owed to the corporation.[16] The number and importance of such suits began to increase significantly following the collapse of the bubble economy and an important revision to the Commercial Code in 1993 that greatly reduced filing fees in derivatives suits. Prior to the *Daiwa Bank Case*, however, courts often utilized a "security for expenses" provision of the Commercial Code, and ordered plaintiffs to post substantial bonds. This effectively ended derivative litigation. Plaintiffs could avoid posting security for expenses only when they were able to overcome the lack of an effective discovery system by piggybacking on the record created by a criminal or other official investigation. Plaintiffs were successful in obtaining settlements only in a narrow set of cases where directors took illegal action (e.g., paying off racketeers or bribing government officials). Yet, even in those cases the settlement amounts were for only a tiny fraction of the plaintiffs' claim.

B. Factual Background to the Daiwa Bank Case

The tale begins with the 1976 hiring of Toshihide Iguchi[17] as a local employee of the New York branch of The Daiwa Bank Limited ("Daiwa"). The following year Iguchi was put in charge of the securities custody department. As with many foreign banks, the actual custody of securities was entrusted to a sub-custodian, in this case, Bankers Trust, which received instructions from and sent account statements to Daiwa's New York branch. In February of 1984, Iguchi was promoted to be the only trader, and placed in charge of a new effort in the bank's securities business—trading a small volume of U.S. treasuries for the bank's own account (in an attempt to obtain trading profits) as opposed to merely executing orders on behalf of customers. Presumably due to the miniscule size of the operation, Iguchi was left in charge of both securities trading and custody as well as some related back office functions.[18]

16. SHŌHŌ, arts. 267 to 268-3, 280, para. 1

17. Mr. Iguchi moved from Japan to the United States to attend college, majoring in psychology at Southwest Missouri State University. Upon graduation in 1975, he briefly sold used cars and then joined the New York Branch of Daiwa bank. Thus, he did not have the "elite" resume of a typical managerial employee of a major Japanese bank and had no experience in banking. According to Mr. Iguchi's book, written later while in prison, he obtained a job at Daiwa through his father's personal connections. *See* TOSHIHIDE IGUCHI, KOKUHAKU [THE CONFESSION] 116 (1997).

18. It is appropriate to separate these areas precisely because of the potential for wrongdoing, with a trader being in a position to (illegally) obtain funding for trading

Although Iguchi initially traded within the established position limit and made a small profit, he soon began to accumulate losses. In an attempt to recover the loss, and out of fear that reporting this loss to his superiors would result in a halt to the new trading operation, he engaged in unauthorized trades above the established limit. Nevertheless, losses steadily mounted and reached $1.1 billion by the time the incident was revealed in 1995. To conceal the growing losses, Iguchi began issuing unauthorized instructions to Bankers Trust to sell customers' and the bank's securities. Iguchi's unauthorized trading and sales of securities went undetected for eleven years and eventually involved some 30,000 transactions.[19] He ultimately sold some $377 million of customer securities.

Iguchi wrote a series of confession letters to Akira Fujita, the president of Daiwa, and other top officials in mid-July to early August of 1995. The very first of these letters to Daiwa's president, dated July 17, which Iguchi labeled his "honest confession," revealed the $1.1 billion trading loss and other unauthorized actions, and warned of the dire consequences of this information becoming public. He suggested a "solution" to the problem: replace the missing securities and move the concealed loss out of the United States to prevent U.S. authorities from handling the matter. The bank's receipt of this first letter on July 24th marks a critical juncture in the case. Up to that point, Daiwa had been primarily a victim of unauthorized and unlawful actions by Iguchi. However, the actions of top management would soon result in a new and legally more significant cover-up phase of the case.

A Daiwa executive flew to New York to meet Iguchi and to confirm the losses. Iguchi showed him the actual Bankers Trust account statements and the fictitious ones he had created to conceal the losses. Upon the executive's return to Japan, Daiwa's president decided the bank's basic position: maintain secrecy, cooperate with Iguchi, and

activities through the unauthorized sale or lending of custody securities. This was exacerbated by Iguchi also having responsibilities for some related back office functions (trade confirmations, settlement of trades, and record keeping). Back office personnel would normally be in a position to check trading and custody activities. The importance of such internal controls came to be emphasized later in the 1990s, and was given a huge boost by the *Daiwa Case* and other scandals, such as Baring Bank, in 1995.

19. The precise mechanism for the execution and concealment of unauthorized trades and sales of securities is not entirely clear. It is likely that Iguchi was given considerable leeway because he was reporting substantial profits. It appears that Iguchi entered into the branch's books certain unauthorized profitable trades or profitable aspects of complicated trades without entering his much larger losses. In an interview with Time magazine Iguchi claimed that he was responsible for "more than half" of the branch's profits, despite the fact that the authorized trading of U.S. treasuries within Daiwa's established limits should have been a relatively low risk/low return activity. *See* William Dowell, *I Didn't Set out to Rob a Bank*, TIME, Feb. 10, 1997, at 20.

report informally to the Japanese Ministry of Finance ("MOF"). There was reportedly no discussion of contacting U.S. authorities. On August 8, the president and other top executives of Daiwa met for dinner at the bank's guest house with the director general and the relevant section chief of MOF's Banking Bureau to report the matter. They described Iguchi's letter and the losses and inquired about the timing of their write-off of the loss and public disclosure. The director general's reported reply was that this was the worst time for such a financial scandal to be made public due to recent problems at a number of financial institutions and more general concerns about the state of the Japanese banking system. Daiwa's management believed that the government had agreed with its approach.

From early August until mid-September, the Bank continued to conduct business as usual at its New York branch without acknowledging Iguchi's significant losses. Numerous actions were also undertaken to conceal the losses, including the continuing sale of custody securities and creation of fictitious custody account statements, filing of the bank's regular quarterly call report on assets and liabilities with the Federal Reserve Board containing some $600 million of non-existent assets, and undertaking a fictitious transfer of the missing securities to Daiwa's head office. Toward the end of August, Daiwa's own U.S. planning office advised that U.S. bank regulators would react harshly to this kind of problem, and it should be reported as quickly as possible. Daiwa finally reported the losses to other Japanese bank regulators and to U.S. bank regulators in mid-September, some seven weeks after the receipt of Iguchi's first confession letter and five weeks after reporting the matter to the MOF.[20] Fearing that the matter would become public knowledge once it reported to the U.S. authorities, Daiwa made a public announcement on September 26, 1995, rather than waiting until after the end of its fiscal period on September 30.

Once U.S. bank regulators and prosecutors learned of the loss and began to gather evidence, they realized that the matter was far broader and more serious than the mere fact of a $1.1 billion dollar loss. They discovered the involvement of the bank's top management in a cover-up and its prior report to the MOF in Japan. They also learned, for the first time, of a prior, similar case of unauthorized trading, unreported losses at Daiwa Trust,[21] and false statements to bank examiners about securities

20. Federal bank regulations set a maximum thirty-day limit for reporting suspected criminal activity and require immediate notification by telephone in the case of emergencies. New York State banking regulations also contain a provision for the notification of criminal or suspicious activity, which always requires immediate reporting of losses.

21. Daiwa Trust was a separate New York-chartered trust subsidiary of Daiwa.

trading operations during examinations of Daiwa's New York branch in 1992 and 1993. Much of this information apparently came from Iguchi, who was arrested by the FBI on September 23, 1995, and pleaded guilty on October 19, 1995 to all six counts against him.[22] The reaction of U.S. authorities was swift and decisive. Bank regulators first issued a notice of hearing and interim orders; on November 2, 1995, they levied the "death penalty" against Daiwa and Daiwa Trust, issuing consent orders requiring them to cease all U.S. banking business and surrender their banking licenses within 90 days. On the same date, a grand jury indicted both Daiwa (24 counts) and the New York branch's general manager (two counts).

Pressure on Daiwa gradually increased and it ultimately entered into a plea bargain on February 28, 1996, pleading guilty to 16 of the 24 counts in the indictment. The bank agreed to pay a criminal fine of $340 million, the largest criminal fine levied on a financial institution in U.S. history. The bank also incurred some $10 million in legal fees. Although Daiwa and the branch general manager initially plead not guilty, claiming they were acting under the instructions of the Japanese government, they each entered into a plea bargain to resolve the matter and, in the case of Daiwa, to avoid the possibility of a truly staggering criminal fine under the U.S. Sentencing Guidelines.[23]

Fallout from the case was significant in both the United States and Japan. In the U.S., congressional committees in both houses held hearings emphasizing Daiwa's violation of the basic trust necessary between banks and regulators and dismay at the failure of the MOF to disclose the matter to U.S. authorities despite international agreements on regulatory cooperation. The *Daiwa Case* shattered the underlying assumption that Japanese practices and banking regulation were

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22. Iguchi was sometimes portrayed in the media as a "rogue trader," acting on his own and out of a mistaken notion of loyalty to the bank (i.e., going overboard in an effort to recover the initial trading losses rather than acting for personal gain). In reality, however, in perpetrating his scheme for 11 years, Iguchi obtained the cooperation of other bank personnel (one count of his charge is entitled "trading conspiracy" and makes several references to Iguchi's "co-conspirators") and pleaded guilty to embezzlement from the bank (for $520,000). The bank essentially turned in Iguchi to the authorities when they finally reported the scandal to U.S. bank regulators. Iguchi, who had no advance notice of his impending arrest, felt the bank betrayed him by violating their agreement to cooperate, and the information he provided to U.S. authorities ultimately brought down the bank.

23. Daiwa faced a potential fine of over a billion dollars under the U.S. Sentencing Guidelines. The range of fines for a particular offense is calculated according to a "base fine," i.e., the amount of the pecuniary loss or gain multiplied by a factor based on the culpability of the organization. In this case Daiwa would receive the highest culpability score, resulting in a multiplication of the customer losses ($377 million) by a factor of two to four.

fundamentally sound. In Japan, Daiwa suffered business setbacks (including a two-notch downgrade of its debt by Standard and Poors), and the resignation of top executives of the bank in October 1995, shortly after the public announcement of the incident. The market began to assess a premium on Japanese banks for inter-bank loans. It suddenly became possible, and even popular, to advocate the break-up of the powerful MOF in conjunction with ongoing administrative reforms.

On October 23, 1995, shareholders instituted a derivative suit in Japan, accusing all 47 of the bank's directors and Auditors who served during the period of 1984-1995 of breach of their duty of oversight by their failure to establish a risk management system designed to prevent and detect such employee misconduct. The plaintiffs demanded that the defendants reimburse the corporation for the entire amount of the $1.1 billion trading loss (Trading Loss Case (Case A)).

On March 17, 1996, following the bank's plea bargain with respect to its criminal case in New York, shareholders filed a second derivative action in Japan alleging that the directors and Auditors breached their duty under the Commercial Code to comply with "laws, ordinances and the articles of incorporation" and demanded that the defendants pay the entire amount of the fine and legal fees ($350 million) to the corporation (Violation of Law Case (Case B)).

C. *The Court's Decision*

1. Summary of Court's Decision

On September 20, 2000, the Osaka District Court, in a voluminous decision, ordered eleven of the defendants to pay a total of $775 million in damages in the two related cases. In the Trading Loss Case (Case A), the court found that the three directors who had been in charge of the New York branch during this time period and one Auditor were in breach of their duties. Proof of damages was found only for one defendant. He was found liable for the entire amount ($530 million) of the increase in Iguchi's trading losses which occurred during his tenure as director in charge of the New York branch. In the Violation of Law Case (Case B), the court found breaches of the duties of care and loyalty for eleven directors for specific illegal acts and failure to report, or cause the representative director to report, to U.S. authorities. Each of the eleven defendants was ordered to pay 20-70% of the total of $350 million (i.e., $70 million-$245 million).

Although both sides appealed from the judgment of the district court, on December 20, 2001, a settlement was reached to end the dispute. Pursuant to the settlement agreement, the plaintiffs accepted a

small fraction of the awarded damage amount (250 million yen or roughly $2 million) in return for payment from each of the original 47 defendants and preservation of the district court's legal findings on directors' liability.

2 Excerpts from the Court's Decision in the *Daiwa Bank Case*[24]

Judgment

[One defendant in Case A and eleven defendants in Case B were found liable for breaches of their duties of care and loyalty and ordered to pay various amounts in damages and interest to the corporation. The remaining claims were dismissed.]

Facts and Reason

Disputed Issue #1: Whether there was an act of neglect of job responsibility on the part of defendants with respect to the Construction of an Internal Control System.[25]

[1. **Duty of oversight and duty to establish a risk management system.**]

Conducting sound corporate management requires accurately assessing conditions of various kinds of risk which are produced in accordance with the type and nature of the business purpose, . . . and . . . establishing a risk management system (so-called internal control system) in response to the scale and nature, etc. of the business conducted by the corporation. Since the board of directors must pass a resolution for the performance of important business matters (Commercial Code, art. 260(2)), the overall policy of a risk management system, which relates to the fundamentals of corporate management, requires the board of directors to pass a resolution. The representative director and director in charge (of a business department or function), who are in charge of business performance, bear the responsibility to decide specifically, based on the overall policy, the risk management system for the department(s) for which he is in charge. In this sense, directors, as members of the board of directors, and also as a representative director or director in charge, bear a duty to construct a risk management system, and, in addition,

24. *Nishimura*, 1721 HANREI JIHŌ 3. The following section contains the author's translated excerpts of the court's decision in the *Daiwa Bank Case*. The author has added some headings and subdivisions.
25. *Id.*

bear a duty to monitor whether or not the representative director and director in charge are performing their duty to establish a risk management system, and this also should be said to constitute the contents of the duty of care and duty of loyalty as a director. Auditors, since they bear the job responsibility of auditing business operations, bear a duty to audit whether or not the directors are carrying out the construction of a risk management system, and this also should be said to constitute the contents of the duty of care as an Auditor.[26]

[2. **Decision standard for Daiwa's risk management system/risk of hindsight bias.**]

However, the contents of the risk management system to be created are gradually realized through the accumulation of experience in which risk materializes and causes various cases and incidents, and through progress on research concerning risk management. Accordingly, it would not be appropriate to take the level of risk management system which is currently required of financial institutions from the standpoint of ensuring sound and appropriate management of business in light of various financial scandals, and making it the decision standard in this case. Also, what should be the contents of the risk management system to be created is a question of business judgment, and we must be mindful that broad discretion is granted to directors who are specialists in corporate management. . .[27]

[3. **Evaluation of Daiwa's risk management system.**

The court next turned to the specific question of whether there was an appropriate risk management system in Daiwa's New York branch and whether the directors and Auditors of Daiwa had fulfilled their duties with respect thereto. The court found that the system of internal controls was insufficient with respect to the appropriate method for confirming custody account balances. The New York Branch utilized a reconciliation procedure by which it compared the custodian's account statements with its own books and records. But since the custodian's (Bankers Trust's) account statements were obtained through Iguchi (and not directly from Bankers Trust), this confirmation method left room for concealment by a trader. With respect to the defendants' argument that this method of confirmation was the same as the one generally employed in the industry, the court found:]

26. *Id.* at 32-33.
27. *Id.* at 33.

> [I]t is difficult to consider that financial institutions conducting custody business were generally using an examination system with an important shortcoming and that definitive proof sufficient to support this contention was not submitted (to the court). And, so long as the examination system has an important shortcoming, even if, *arguendo*, it were true that other financial institutions were using the same method, it does not mean that Daiwa Bank's examination method would be assessed as [having been appropriate].[28]
>
> [4. **Liability for inappropriate internal controls/principle of reliance.**]
>
> In a large-scale enterprise which has a vast structure like Daiwa Bank, having the president or the deputy president directly supervising each business (department or function) is, of course, inappropriate from the standpoint of efficient and rational management and is also not possible. With respect to confirmation of the custody account balances for U.S. treasuries, the Inspection Department and the New York Branch which are in charge of this have been established, and an organization has been created which anticipates that the directors in charge of both of these departments will, on their responsibility, conduct appropriate performance of their business. The president and deputy president are permitted to entrust the conduct of such business to each director in charge, and so long as there are no special circumstances which raise doubts about the contents of the business performance of each director in charge, it is reasonable to understand that they will not bear liability for neglect of supervision of business. In this case, there are no allegations or proof of such special circumstances.[29]
>
> **Disputed Issue #2:** Whether there was an Act of Neglect of Job Responsibility on the part of the Defendants with respect to Violation of U.S. law.[30]
>
> [C]ompliance with law is a fundamental principle of corporate management. Article 266(1)(5) of the Commercial Code not only requires directors to comply with the laws of Japan, but if a company expands its business overseas and establishes bases overseas such as branches or representative offices, then it must also comply with foreign law.[31]

28. *Id.* at 37.
29. *Id.* at 38.
30. *Id.*
31. *Id.* at 39.

[5. **Defendants' intent or negligence for violation of law.**]

[E]ven assuming they did not sufficiently understand the detailed contents of U.S. banking laws, an incident in which one suffers a large loss of some 1.1 billion dollars due to unauthorized trading and unauthorized sales . . . should have prompted an immediate investigation and examination of U.S. laws relating to such a rare and unusual case. But it was on the 25th of that month [August] that they first queried a U.S. law office via a Japanese law office and conducted an investigation. It must be said that the investigation was indeed late and a lost opportunity. . . . Even assuming that the . . . defendants did not know at the time . . . that each such act violated U.S. federal codes, it is clear that they are negligent as managers of a bank which is developing business in the United States. . . .[32]

[6. **Japan's business judgment rule.**]

[T]o pursue liability against a director for a past management measure as a violation of the duty of care and duty of loyalty requires that, at the time the business measure was taken, there was an important and careless mistake in grasping the facts which form the basis of the director's judgment or the process, [and/or] substance of decision-making was especially unreasonable or inappropriate as a business manager. However, although directors are granted broad discretion, in conducting corporate management they are required to comply with laws and ordinances, including foreign law . . . and . . . are not granted discretion about whether or not to comply with laws and ordinances, including foreign laws. . . . Even considering the difficult situation of Daiwa Bank at the time, [the defendants] made an extremely unreasonable and inappropriate business judgment as corporate business managers in violation of directors' duties of care and loyalty.[33]

[7. **Whether administrative guidance from government bureaucrats could excuse defendants' violations of law.**]

Defendants in the Violation of Law Case argue that there was no possibility (kitai kanosei) of going against the requests and suggestions of the Ministry of Finance (MOF) and reporting to U.S. authorities the facts of the unauthorized trading and unauthorized sales in this case. However, there is not sufficient evidence submitted to this court to find that MOF, based on its authority, gave defendants Akira Fujita et. al. instructions or orders that they not report to U.S.

32. *Id.* at 43.
33. *Id.* at 42, 44.

authorities. Rather, as long as Daiwa Bank conducted banking business in the United States, they had an obligation to observe United States' laws and regulations affecting banks. As managers of a bank, defendants Akira Fujita et. al. were responsible for making appropriate business judgments on their own. Even though the Japanese economy has developed and expanded on a global scale, defendants Akira Fujita et. al. adhered to informal local rules which are accepted only in Japan. The defendants sought to overcome Daiwa Bank's crisis by relying on the prestige of the Director General of MOF's Banking Bureau. As a result, they suffered harsh treatment from United States authorities. The argument of the defendants in the Violation of Law Case that there was no possibility (kitai kanosei) means that it is permissible to conduct banking business by relying on the decisions and instructions of the MOF without making decisions based on their own judgment and at their own responsibility. We naturally reject such an argument.[34]

Disputed Issue #3: Existence, Scope of Damages for which the Defendants should Compensate.

[The author has omitted Case A. In Case B, the court discusses legal causation (i.e., foreseeability of the result of a plea bargain and the U.S. doctrine of vicarious liability):]

As long as neglect of job responsibility on the part of the defendants is found concerning the facts related to counts of the indictment in this case to which [the defendants] pleaded guilty, even if a plea bargain is intervening, so long as there are no special circumstances found, such as the process and results of the plea bargain being markedly different from that which is normally anticipated, legal causation between acts of neglect of job responsibility and damages resulting from payment of the criminal fine will not be denied. There is no allegation or proof of such special circumstances.[35]

3. Aftermath of the Daiwa Case

The resulting "Daiwa shock" had a far-reaching effect in Japan similar to the combined impact the leading Delaware cases, *Van Gorkom* and *Caremark,* had in the United States. The aftermath of the Daiwa Bank case includes important substantive legal doctrine, a seemingly more activist role for courts, increased importance of preventive legal advice, a breakdown in the market for directors' liability insurance and

34. *Id.* at 43.
35. *Id.* at 44.

new legislation to limit directors' liability and address issues of corporate governance.

D. *Commercial Code Limitation on Directors' Liability*

Following the Daiwa case, an amendment to the Commercial Code was enacted in November 2001 that limits directors' liability in shareholder derivative suits and takes certain measures to increase the Auditors' independence. The provisions concerning directors' liability, which appear in new paragraphs 7 through 23 of article 266 of the Commercial Code, provide for the following:

- Introduction of exculpatory charter provisions limiting the amount of directors' liability for damages and a corresponding procedure for an after-the-fact release of directors from liability
- In both cases, limitation of liability is predicated on the consent of Auditors and shareholders through a special resolution (i.e., approved by two-thirds of shareholders)
- In both cases, acts not done in good faith and gross negligence are excluded from coverage and directors' liability is not limited
- In both cases, where directors' liability is properly limited, the maximum amount of liability for directors is based on annual compensation: two years for outside directors, four years for inside directors and six years for representative directors
- For an after-the-fact release from liability, the board of directors may pass a resolution to such effect, but such board resolution may be challenged by any shareholder(s) holding 3% of the corporation's shares.

E. *Parallels and Differences Between U.S. and Japanese Law*

1. Parallels Between the U.S. and Japan

- **Directors' Duty of Care:** Both the U.S. cases and the *Daiwa Case* placed new emphasis on directors' duty of care (in cases of both board action and inaction) and seemingly expanded the potential scope of directors' liability
- **Aftermath of Cases:** The aftermath of *Van Gorkom* and *Daiwa* each included new legal doctrine, new importance for preventive legal advice, a breakdown in the market for directors' liability insurance and new legislation to limit

directors' liability

- **Shareholder Derivative Suit**: These cases evidence the shareholder derivative suit system operating in a surprisingly similar manner in the U.S. and Japan, with the potential for at least certain "big" cases to exert a real impact on corporate practices
- **Role of Courts:** The role of courts in interpreting broad liability standards for the duty of care looks surprisingly similar in the U.S. and Japan, despite Japan's civil law system and statutory fiduciary duties
- **Difficulties in Standards of Liability:** There are similar difficulties in both countries in reducing the duty of care to a clear standard of liability, as concepts such as negligence and gross negligence are not very useful in defining proscribed conduct

2. Differences Between the U.S. and Japan

- **Board action or inaction vs. individual job responsibilities:** Whereas U.S. courts tend to focus on board action or inaction when considering director's liability, Japanese courts closely examine the individual job responsibilities and actions of each director due to the lack of separation of officers and directors in Japan
- **Legislation:** Japanese legislation to limit directors' liability protects outside directors more than inside directors, while U.S. legislation protects all directors equally
- **Reliance on outside counsel:** The lack of reliance on outside counsel in the *Daiwa Bank Case* is a striking contrast to recent U.S. cases such as *Caremark*
- **Business judgment rule:** A business judgment rule that focuses exclusively or primarily on procedural considerations creates difficulties in Japan due to limited corporate disclosure and discovery in litigation.

F Comparison with U.S. Law—Questions and Answers

1. Director's Liability; Separation of Directors and Officers

Q. You are a judge in the *Daiwa Bank Case* and wish to apply the fiduciary duties set forth in the Commercial Code in a meaningful way to directors and Auditors in the Daiwa Bank scandal. You are also aware that Daiwa Bank, like most Japanese corporations, has a large,

hierarchical board in which virtually all directors maintain management responsibilities. Would you hold all board members and Auditors liable for board action (approving settlement of the U.S. criminal case in Case B) or inaction (failure to establish an overall risk management policy in Case A)? Or would you consider each director's individual job responsibility and involvement in the matter? Is there a similar issue under U.S. law?

A. Although the theoretical duties of care (including the oversight/monitoring component) seem functionally similar in the U.S. and Japan, there is a major difference in courts' applications of these duties to individual directors.

In Case A, while the *Daiwa* court ruled that it is the duty of the board as a whole to formulate and implement policies and internal systems to deal with compliance and other concerns, it never actually examined whether the board of directors passed a resolution establishing an overall risk management policy. Instead, it pursued an inquiry that focused on which individual directors were in a position, due to their job responsibility, to devise and implement specific policies to prevent and detect the wrongdoing at issue. In Case B, where there was a board resolution (required by U.S. prosecutors) approving the plea bargain under which Daiwa paid a $340 million criminal fine, no defendant was found liable for approving or failing to object to the board resolution. Rather, the court examined the individual circumstances of each defendant to see if and when a defendant learned of the cover-up from the president or other top executives of Daiwa and failed to exercise his fiduciary duty as a director or Auditor by objecting to the cover-up plan in a timely manner. All eleven directors who were involved in formulating and implementing the cover-up were found to be liable. It was determined that other directors lacked the information or management position necessary to enable them to object to the cover-up. In the U.S., one would expect, as occurred in *Van Gorkom*, that all directors would potentially bear liability for board action or inaction for any breach of their fiduciary duty. Logically, the same result could be reached in Japan for both directors and Auditors. However, the traditional lack of separation of officers and directors in Japan may make it seem unduly harsh or "unfair" to hold all directors liable when both policy-making and board decision-making is essentially controlled by top management. Instead, as in the *Daiwa Case*, Japanese courts focus their inquiry on directors and Auditors who have job responsibilities in the relevant areas and/or involvement in the decision-making on the matter in question.[36]

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36. This is a good example to help students truly appreciate the oft-cited importance

2. Principle of Reliance

Q. Could Daiwa have avoided liability for violation of U.S. law through reliance on timely advice from outside counsel? How do you think a U.S. court would have viewed Daiwa's argument that it should be permitted to rely on the informal advice of Japanese government (MOF) officials?

A. In the *Daiwa Case*, reliance on other directors, Auditors and employees is permitted unless there are special circumstances that raise doubts about such reliance. This is the reason most directors were not found liable in the Trading Loss Case (Case A), and generally resembles U.S. law in the *Graham* case.[37] However, as this is a relatively new doctrine in Japan, there is no specific reference in Japanese cases to conditions for such reliance, such as selection with due care or reliance in good faith.

Directors' use of outside counsel and other experts in reaching board decisions or exercising oversight functions is an important issue in the area of director's liability. While the Delaware Supreme Court, in *Van Gorkom,* explicitly rejected the notion that the board was required to obtain an outside expert's opinion of the fair value of Trans Union's shares, it nevertheless seems clear that such outside advice would have been important in assuring that the board reached an informed decision. Similarly, in *Caremark,* the Chancellor cited the board's consultation with its legal counsel as evidence that its directors were highly unlikely to have been found liable for monetary damages for a breach of their duty of oversight, despite large criminal fines assessed against Caremark.

Reliance on outside counsel was also a potentially important issue in the *Daiwa Case.* The bank initially consulted with the MOF, and there was little initial focus on U.S. law. Daiwa officials in Japan did consult with U.S. counsel indirectly in late August (1995) and directly in early September only after being urged to do so by the bank's own U.S. headquarters. Ironically, timely and full consultation with a U.S. lawyer might have allowed Daiwa to escape expulsion from the United States and criminal liability. In the Japanese derivative suit, Daiwa argued that its directors should not be liable for violations of U.S. law precisely because they consulted with U.S. counsel concerning their proposed

of the separation of officers and directors in the U.S. and the general U.S. practice of having small, active boards. It also illustrates the difficulties of enforcing fiduciary duties in a corporate law system that lacks such separation of officers and directors.

37. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963) (in which the Delaware Supreme Court established the principle that directors have no affirmative duty to establish and maintain a corporate monitoring system "absent cause for suspicion" and there would be no liability unless there were "obvious danger signs of employee wrongdoing" that went unheeded).

timetable for the disclosure of losses to U.S. bank regulators and tried in good faith to comply with U.S. law thereafter. The court rejected their argument, essentially characterizing their consultation with U.S. lawyers as being "too little, too late" in light of the unusual trading loss, which led to criminal liability. In the *Daiwa Case*, the question of consultation with lawyers arose in the broader context of the defendants' intent or negligence with respect to the violation of U.S. law, rather than directly as a right of reliance issue. Nevertheless, the *Daiwa Case* discusses this question for the first time and creates an expectation that reliance on outside counsel would likely be permitted.

Widely quoted in newspapers, this "MOF defense" appeared to be the main theme of the defendants' American attorneys in both of the original criminal actions in New York against Daiwa Bank and its New York branch general manager. Perhaps this "defense" was meant partly to take advantage of the American perception of the prevalence of such informal practices in Japan and their supposed link to ingrained "cultural values." In any event, as both of those actions were settled by means of plea bargains, the issue was never tested in U.S. courts. If it had been argued in the U.S., presumably an American court would have taken the same approach as the *Daiwa* court, requiring proof of government "policy," i.e., actions taken by the agency based on its legal authority and binding on Daiwa Bank. Although the *Daiwa* court made no finding on this point, its discussion implies that Daiwa might have sought informal MOF approval for its predetermined course of action, rather than being a "victim" of heavy-handed bureaucratic interference.

3. Business Judgment Rule

Q. Do courts in the *Van Gorkom*, *Caremark* and *Daiwa* cases apply the business judgment rule, misapply it or ignore it? Are courts in a position to evaluate business decisions fully and accurately? Does the business judgment rule cover only procedural issues or does it extend to the substance of business decisions? Should the Japanese rule be any different from the one in the U.S.?

A. The various views of *Van Gorkom*[38] highlight the difficulty of

38. A widespread critical view held that the court, in reversing the initial decision of the chancellor to find director's liability despite any allegation of a lack of good faith, had in fact departed significantly from prior jurisprudence focusing on the business judgment rule. *See, e.g.*, Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom after* Van Gorkom, 41 BUS. LAW. 1 (1985). It should be noted that one school of thought held that *Van Gorkom* was consistent with prior cases, and the unusual result was based on an egregious fact pattern under which the board of directors completely deferred to the chief executive officer and virtually abandoned its

formulating a clear legal rule that reflects the conflicting considerations underlying the business judgment rule.

In both the U.S. and Japan, the business judgment rule represents legal doctrine that seeks to achieve a balance between providing directors with discretionary authority to make business judgments and providing an incentive to ensure good faith performance of their duties. This dilemma goes far in explaining the procedural emphasis in *Van Gorkom* and the ongoing debate over to what extent, if any, the business judgment rule covers the substance of business decisions. Although most Japanese commentators have advocated following a procedurally based approach, as utilized in the U.S., courts have not clearly done so. Attempting to focus on decision-making processes (adequate information gathering, review, use of outside experts, etc.) in Japan would squarely encounter traditional views hostile to public disclosure of confidential corporate processes. This obstacle, compounded by the absence of an effective litigation discovery system, would make it difficult for the plaintiffs or the court to obtain sufficient information on the decision-making process. Such circumstances might require or justify a greater emphasis in Japan on a court's reviewing the substance of business decisions. In Japan, courts tend to include in their business judgment standard some examination of the reasonableness of the substantive business judgment in ruling on this issue.

At the same time, however, a review of substantive business decisions would highlight the troubling question of hindsight bias, which is an issue raised by commentators on *Van Gorkom* and is highly relevant to the *Daiwa Case.* A fundamental underpinning of the business judgment rule is concern about the adequacy of the litigation process to retrospectively judge the reasonableness of directors' decision-making. The *Daiwa* court acknowledged this danger and explicitly stated that it must not retroactively apply current standards concerning internal controls to Daiwa's directors during the period from 1984 through 1995. It nevertheless found a breach of directors' duties by focusing narrowly on a detailed aspect of internal controls that arguably may not have been considered significant under the prevailing standards during that period. Technically, the court did not apply the business judgment rule (in Case

responsibility to make an independent judgment in the best interests of the corporation. *See, e.g.*, Barry F. Schwartz & James G. Wiles, TRANS UNION: NEITHER "NEW" LAW NOR "BAD" LAW, 10 DEL. J. CORP. L. 429 (1985). Another approach regarded *Van Gorkom* as a precursor to subsequent Delaware decisions, which required greater care by directors in the context of change of control decisions. *See, e.g.,* Jonathan R. Macey and Geoffrey P. Miller, TRANS UNION RECONSIDERED, 98 YALE L.J. 127 (1988). There is language in the *Caremark* decision that supports this latter view, as *Van Gorkom* is referred to as the first in a line of recent Delaware Supreme Court cases on "jurisprudence concerning takeovers." 698 A.2d at 970.

A, because in an oversight context the board had not acted, and in Case B, because the court found that a violation of law was not within directors' discretion). It appears that Japanese courts will now face the same issues relating to standards for liability and the business judgment rule that have troubled U.S. courts, although recent legislation enacted in response to the Daiwa case has essentially institutionalized the business judgment rule in Japan.

4. Statutes and Courts

Q. In Japan, fiduciary duties of directors are set forth in the Commercial Code, while in many states, such as Delaware, they are developed through case law. Is there any real difference? Even in Japan, the doctrines of reliance and the business judgment rule result from court decisions. Does this surprise you?
A. Although the question of judge-made law versus legislative standards is highly debated in the U.S. with respect to the director's duty of care, in either case the standard of liability will be very broad. Rather, the issue is the future development of the application of such principles because proponents of judge-made law believe courts can be more flexible in the law's application and development in response to changing societal conditions. However, even with a legislative standard, as in Japan, judges still have an opportunity to be flexible in their application and interpretation. Despite our image of Japan as a civil law system with conservative judges, in recent years, courts have been innovative in developing rules such as the business judgment rule and the principle of reliance to apply in duty of care cases. Perhaps someone might say that judicial intervention on behalf of corporate directors is conservative in a political sense rather than in the sense of judicial restraint.

5. Standard of Liability

Q. Does a standard of negligence seem harsh for the duty of oversight in the Trading Loss Case (Case A)? How about the same standard for the Violation of Law Case (Case B)? The court discusses negligence, but is that really the standard of liability? Would the result have been different if the court had used a standard of gross negligence? Good faith? When thinking about directors' conduct, how meaningful is the difference between negligence and gross negligence?
A. A finding of liability (and $530 million in damages) based on negligence appears harsh in the oversight context, and goes beyond *Caremark* and other U.S. decisions. This illustrates that even in the absence of a business judgment, policy considerations similar to those

underlying the business judgment rule would seem to warrant a standard higher than ordinary negligence for director liability. The court, by focusing on a narrow accounting issue, never directly addresses the defendants' argument that Daiwa's New York branch had an adequate system of internal controls but that Iguchi's unusually clever scheme managed to circumvent it.

On the other hand, the *Daiwa* court's approach is not internally consistent with respect to a standard of liability. Despite ruling that the business judgment rule was inapplicable, in the Violation of Law Case (Case B), the court went on to find that President Fujita and the other defendants "made an extremely unreasonable and inappropriate business judgment as corporate business managers" in violation of their duties of care and loyalty. It thus sounds as if this case could also be treated as one of gross negligence, in which liability was found on the part of the defendants regardless of the application or non-application of the business judgment rule. Furthermore, an argument could be made that although the defendants were presumably unaware of the details of American law initially, by initiating a cover-up, they demonstrated a lack of good faith. The *Daiwa* court did not reach this issue, as the inquiry was phrased in terms of negligence and the business judgment rule.

The difficulties in formulating and implementing a standard to achieve the balancing of interests under the business judgment rule are reflected in the widespread criticism of concepts such as "negligence" or "gross negligence" on the basis that they represent ex post characterizations of director behavior, which do not provide sufficient certainty in light of the broad discretion directors are expected to exercise. The Daiwa case provides a good illustration of this often-made point.

6. Limits on Directors' Liability

Q. To what extent does the 2001 amendment to the Commercial Code limit directors' liability? What would be the result in the *Daiwa Bank Case* if the amendment had been in effect and Daiwa Bank had enacted an exculpatory charter provision? How do you view the amendment's distinction between liability limits for inside directors and outside directors? Is this a good idea for Japanese law? Should it be utilized in U.S. law?

A. The 2001 amendment excludes cases involving a knowing violation of law, bad faith or gross negligence from both the exculpatory charter provision and the release provision. The exclusion of gross negligence does not go as far as the exculpatory charter provisions in the U.S. This may reflect the Amendment's origin as a proposal by business groups—

they originally asked for, among other matters, a codification of Japan's version of the business judgment rule. It may also reflect Japan's limited experience to date with lawsuits holding directors liable. Additionally, it may be the result of considerable opposition to the amendment by some legal commentators and, initially, by the political opposition parties. Industry groups agreed with this limited approach only upon receiving assurances that it would constitute only the first step in a series of measures designed to address industry concerns. It is questionable whether the existence of an exculpatory provision based on the amendment would have affected the outcome in the *Daiwa Case* because the court's decision would presumably have found liability under a standard of gross negligence.

In the U.S. there is no distinction between inside directors and outside directors. The focus is on action or inaction by the board as a whole, and it is considered necessary to provide outside directors with the same incentive for faithful performance of their duties as inside directors. The distinction under the Delaware exculpatory charter provision is rather between directors and officers, since only actions "as a director" may be protected through limitations on personal liability.

In Japan, the *Daiwa* decision already suggests that directors whose job responsibilities would not place them in a position to deal with a potential problem are far less likely to bear personal liability; as outside directors are perhaps the only directors without any line responsibilities, they would presumably benefit. Perhaps, from a functional standpoint, one could even think of Japanese directors with line responsibilities as "officers" in American terms and outside directors as being the only "true" directors. The 2001 amendment establishes, for the first time, an explicit legal distinction between the liability of inside and outside directors. Arguably, such a distinction is useful in the Japanese context, given the traditional focus on directors' job responsibilities in Japan, the recent interest in increasing the number and role of outside directors, and the legal requirement under the 2002 amendment that all listed companies have at least one outside director.

7. Effect of Lawsuits on Corporate Practices

Q. To what extent do the results in a particular derivative lawsuit have a broader impact on actual corporate practices or act to improve corporate governance? How might they do so?

A. The comparison between *Van Gorkom* and *Daiwa* is most relevant in relation to the broad impact of the court's decision on business, the legislature, and markets. Both cases appeared, to industry, to cast serious doubt on the proposition that the small subset of derivative suits likely to

result in directors' liability was well established and stable.[39] These cases leave in their aftermath a fear that qualified individuals will be unwilling to serve as directors, a concern about the availability of directors and officers (D&O) insurance, new legislation to limit directors' liability and consultation with outside experts, and changes in practices in an effort to reduce the future risk of liability.

One could argue that *Van Gorkom*, *Caremark* and *Daiwa* were all unusual cases that should not concern a conscientious board of directors. *Van Gorkom* involved an egregious fact pattern and liability could presumably have been avoided by means of modest information gathering and consultation with outside experts. The Delaware Chancellor approved the *Caremark* settlement only because it did not involve director's liability for compensatory damages, and it contained measures concerning compliance policies that were consistent with corporate initiatives already underway at the time. *Daiwa* also involves egregious facts that are unlikely to be repeated. Yet all of these cases, particularly *Van Gorkom* and *Daiwa*, invoked tremendous corporate responses, as they nevertheless appeared to threaten industry's perceived certainty concerning the director's standard of liability.

There is a widely held view in the U.S. that shareholder derivative suits generally are not an effective means of monitoring board performance or improving corporate governance because the true parties in interest are often the plaintiffs' attorneys and even unmeritorious suits are often settled due to the availability of indemnification provisions and insurance. However, even if this is true for the typical derivative suit, *Van Gorkom*, *Caremark* and *Daiwa* indicate that the few derivative suits establishing new or broader duties for directors can have an outsized impact on corporate governance practices. This might be particularly true when industry's reaction provides an opportunity for lawyers to advise corporations on new risks and preventive measures and thus to amplify the impact of a court's decision on directors' duties.

III. Conclusion

Despite the significant differences between Japan and the U.S., including Japan's civil law system in which directors' duties are prescribed by statute, and a "legal culture" that is generally perceived to be quite different from that of the U.S. and Europe, there are surprising similarities between court decisions on the fiduciary duties of directors in Japan and the U.S. The courts played similar roles and encountered

39. For example, liability would only occur in exceptional cases that did not merit the protection of the business judgment rule in the U.S., or that represented instances of clear misconduct by directors in Japan.

similar difficulties in interpreting broad formulations of the duty of care and reducing them to a clear standard of liability. In addition, the aftermath of the *Daiwa Bank Case* is far-reaching and similar to the combined impact in the U.S. of the leading Delaware cases of *Van Gorkom* and *Caremark*: new substantive legal doctrine, a seemingly more activist role for courts with the potential for improvement of corporate practices, and new legislation to limit directors' liability and address issues of corporate governance. Although the parallels are striking, significant differences remain. The landmark *Daiwa Bank Case* arguably may have held directors to a higher standard than U.S. court decisions, but this was likely influenced by the relative paucity of cases in Japan in the past and the corresponding unimportance of the standard of liability heretofore utilized in court decisions. In other areas, such as the principle of reliance and the business judgment rule, court-formulated legal doctrine in Japan is either poorly developed, compared to U.S. case law, or it encounters difficulties in meshing with prevalent disclosure and discovery practices in Japan.

The materials presented herein demonstrate that, although by no means a simple task, it is possible to add a comparative perspective to basic courses such as business organizations without adding new sections devoted specifically to comparative law. I believe that such an approach, by providing a starker contrast with a different legal system, effectively highlights distinctive features of the U.S. system. It brings to life core concepts such as the separation of officers and directors and the role of outside directors by means of comparison with a Japanese legal system that has traditionally lacked such concepts, and in which courts are struggling to decide personal liability for directors based on the acts of individual directors rather than, as in the U.S., on actions of the board as a whole. Hopefully we will continue to address and make progress on the challenging but rewarding task of adding a comparative perspective to basic courses in the law school curriculum.