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Bruce E. Aronson

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Reconsidering the Importance of Law in Japanese Corporate Governance: Evidence from the Daiwa Bank Shareholder Derivative Case

Bruce E. Aronson[†]

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Introduction

With all the talk of “structural reform,” is Japan really changing? In particular, is its system of corporate governance becoming one based more on legal rules and rights than on informal relationships? Commentators on comparative corporate law have constructed a familiar model of Japanese corporate governance based on informal relationships such as internal monitoring by main banks, *keiretsu* and lifetime employment. Corollaries to this view include insider-dominated boards with no supervisory function over management and informal consultations with powerful government bureaucrats rather than compliance with legal regulations. This model implicitly assumes a strong culturally based preference in Japan for informality over law—a proposition that persists despite criticisms from Japanese law specialists that it is oversimplified and exaggerated. The model also leads to skepticism about the possibility of change in Japan. Is all the talk of reform exaggerated and unlikely to have a real impact on corporate governance? Or is the dominant model of Japanese corporate governance now overdue for reevaluation in light of changes sweeping Japan similar to those experienced in the U.S. in the 1980s? If there has been real change, where are the “real cases” which evidence it?

This Article contributes to this ongoing debate on the role of law in Japanese corporate governance by examining the effects of derivative litigation in Japan. Specifically, I look at the landmark Daiwa Bank Shareholder Derivative Case¹ as an important milepost for measuring the results of the process of change and the likely future areas of debate and development.

In the Daiwa Bank 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.² 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 their duty of care.³ 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.⁴ The resulting “Daiwa shock” had a far-reaching effect in Japan similar to the combined impact the leading Delaware cases, *Van Gorkom*⁵ and *Caremark*,⁶ had in the United States.

1. *Nishimura v. Abekawa*, 1573 SHOJI HOMU 3 (Osaka Dist. Ct., 2000) [Daiwa Bank Case].

2. *Id.* at 4.

3. *Id.* at 5, 40–41 [Ko case or “First Case”].

4. *Id.* at 47 [Otsu case or “Second Case”].

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

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

We may look to the U.S. experience as an example in order to identify important elements in a transformation of corporate governance. During the 1980s, the model of corporate governance in the United States was undergoing a major change, from a system in which CEOs and other insiders often dominated corporate boards, to a system in which, at least in its idealized form, outside directors dominated boards, supervised management and in turn were themselves subject to monitoring by shareholders and external market forces.⁷ One factor supporting this transformation⁸ was the use of the shareholder derivative suit system to buttress the increased emphasis on an independent and effective board of directors. Although considerable skepticism remains in the United States about the efficacy of the derivative suit system in monitoring board performance, one would anticipate that at least those few cases establishing new or broader duties for directors would have a widespread impact on corporate governance practices.⁹

6. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

7. Such an idealized model of corporate governance should be used with caution, as it would be most applicable to a relatively small number of large public corporations in the United States, which have diverse shareholders and are subject to exchange rules, rather than to corporations generally. In Japan as well, the largest corporations would be most likely to conform to the best practices and theories of corporate governance.

8. The background for this transformation was the general economic malaise of much of the 1980s and an increase in mergers and acquisitions activity, often by financial purchasers, which highlighted the potential conflict of interest between entrenched management and shareholders. The rise of activist institutional shareholders also played a significant role. For a summary and evaluation of such changes in U.S. corporate governance, see, for example, Robert W. Hamilton, *Corporate Governance in America 1950-2000: Major Changes but Uncertain Benefits*, 25 J. CORP. L. 349 (2000) (citing growth of institutional investors, development and decline of takeover bids, disclosures of illegal campaign contributions following the Nixon scandals and numerous proposals for improved corporate governance as principal developments which led to changes in corporate governance).

9. A widely accepted view holds that strike suits are prevalent, with unmeritorious suits settled due to indemnification provisions and Directors and Officers' (D&O) insurance and with the true parties in interest being the plaintiffs' attorneys. Quantitative analysis indicates that there are no net economic benefits to shareholders and the evidence of indirect benefits (derivative suits acting as a backup monitor of management) are at best mixed. See generally Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991). This analysis has also been applied to Japan, with a similar finding that plaintiffs' attorneys are the true parties in interest there as well. See Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. Legal Stud. 351 (2001).

However, even accepting the results of such quantitative analysis with respect to the net benefits resulting from the derivative suit system, there is still room for certain cases to have a significant impact on corporate governance practices. Indeed, the above analysis notes an exception with regard to the few cases that formulate legal rules. These legal rules are public goods which affect the basis of contractual relations between managers and shareholders. See Romano *supra*. I view the Daiwa Bank Case as the most dramatic,

Is a similar transformation of the model of corporate governance now underway in Japan? Certainly the "lost decade" of economic stagnation in the 1990s prompted a general willingness to consider changing past practices. In addition, virtually all of the elements underpinning the popular view of Japanese corporate governance are undergoing significant change.

However, the possibility of a real transformation in the Japanese system of corporate governance invokes skepticism. Rather than looking for new developments in Japan,¹⁰ commentators on comparative corporate governance have proceeded directly to ruminations concerning convergence theory—i.e., whether the European/Japanese bank-monitoring system of corporate governance is evolving to become more like, or converging with, the "Anglo-Saxon" market-based model. This theory's classification of Japan as having an informal and internally oriented "bank-centered corporate governance" may itself serve to reinforce the popular view of a Japan as resistant to change. In addition, the historical and other factors cited by proponents of path dependence might provide modern clothing for old views concerning the importance of a presumably unchanging Japanese culture.

The greatest skepticism concerning transformation of Japanese corporate governance may still derive from our deeply embedded views concerning the role of law and the legal system in Japan. The debate about the role of law in Japan has a long history. Initial efforts by Japanese commentators to explain Japan's relative lack of litigation or other use of formal law, despite its economic advances, focused on Japan's underlying cultural values and supposed lack of "legal consciousness."¹¹ Generalists in comparative legal studies, many of whom have a European orientation, also utilize similar assumptions in classifying national legal systems based on cultural

and perhaps the only, derivative suit in Japan which provides such a legal rule/public good, and examine its significance and impact on Japanese corporate governance. It is also useful to note generally that settlement practices as well as indemnification and D&O insurance in Japan are less developed than and presumably less conducive to strike suits than those in the U.S.

10. As real change has begun only over the last several years, Japan's progress is gradual and uneven. Further, many significant reforms, such as mark-to-market accounting rules, are effective on a prospective basis and do not resolve outstanding issues such as the huge overhang of non-performing bank loans. In addition, there is no widely accepted standard for deciding whether Japan is "really" changing. Although this underlying issue is not addressed here, at a minimum one should suspend any disbelief concerning overall "structural reform" in Japan in order to judge changes in Japanese corporate governance on their own merits.

11. The best known and most frequently cited proponent of this view was Professor Takeyoshi Kawashima, a sociology of law expert at the University of Tokyo, see Takeyoshi Kawashima, *Dispute Resolution in Contemporary Japan*, in *LAW IN JAPAN: THE LEGAL ORDER IN A CHANGING SOCIETY* 41 (Arthur Taylor von Mehren ed., 1963); Takeyoshi Kawashima, *The Legal Consciousness of Contract in Japan*, 7 *LAW JAPAN* 1 (Charles Stevens trans., 1974). For an opposing view that the supposed historical lack of legal consciousness is a myth, see Frank K. Upham, *Weak Legal Consciousness as Invented Tradition*, in *MIRROR OF MODERNITY: INVENTED TRADITIONS OF MODERN JAPAN* 48 (Stephen Vlastos ed., 1998).

explanations—at least with respect to non-Western societies.¹² As the Japanese economic boom continued into and intensified in the 1980s, it gave rise to a new “Japanese” model of development, which continued to emphasize culture and informality in the context of close government-business consultation as the prevalent form of regulatory practice in Japan.

Meanwhile, Japanese law specialists challenged the validity of the assumption of the prevalence of cultural values by providing alternative explanations for Japan’s litigation rate and legal system’s role. These alternative explanations, such as institutional factors,¹³ economic analysis,¹⁴ and informal bureaucratic controls,¹⁵ come from a variety of perspectives which all included a greater appreciation of the role of law in Japan than was evident in the prior literature. Such views were generally not incorporated into the debate in the 1990s concerning whether various forms of corporate governance were headed for convergence.¹⁶ While several branches of convergence theory emerged,¹⁷ by the mid-1990s this debate

12. Such classification systems not only produce simplistic views of various legal systems, they are also inconsistent, as Japan has variously been characterized as belonging to a “Far Eastern” family and a civil law family, among others. See Annette Marfording, *The Fallacy of the Classification of Legal Systems: Japan Examined*, in *ASIAN LAWS THROUGH AUSTRALIAN EYES* 65 (Veronica Taylor ed., 1997); Frank K. Upham, *The Place of Japanese Legal Studies in American Comparative Law*, 1997 UTAH L. REV. 639.

13. Specialists advocating the institutional factors approach argued that court delays, a dearth of effective remedies, and a lack of lawyers created institutional barriers to litigation. See John Owen Haley, *The Myth of the Reluctant Litigant*, 4 J. JAPANESE STUD. 359 (1978); see generally JOHN O. HALEY, *AUTHORITY WITHOUT POWER: LAW AND THE JAPANESE PARADOX* (1991).

14. The economic analysis view emphasizes that the key point was not institutional barriers, but rather institutional successes—for example, the effective and predictable functioning of the court system allowed litigants to settle claims in traffic accident cases efficiently without resorting to court. See generally J. MARK RAMSEYER & MINORU NAKAZATO, *JAPANESE LAW: AN ECONOMIC APPROACH* (1999); J. Mark Ramseyer, *The Costs of the Consensual Myth: Antitrust Enforcement and Institutional Barriers to Litigation in Japan*, 94 YALE L.J. 604 (1985); J. Mark Ramseyer, *Opinion and Comment, Reluctant Litigant Revisited: Rationality and Disputes in Japan*, 14 J. JAPANESE STUD. 111 (1988).

15. The informal bureaucratic controls analysis found that bureaucrats utilized informal mechanisms to defuse and channel social conflict away from the court system. See generally FRANK K. UPHAM, *LAW AND SOCIAL CHANGE IN POSTWAR JAPAN* (1987); Takao Tanase, *The Management of Disputes: Automobile Accident Compensation in Japan*, 24 LAW & SOC’Y REV. 651 (1990).

16. See, e.g., John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999) (comparing and contrasting the “Anglo-Saxon” model of broadly dispersed share ownership and external market monitoring of management performance with the European/Japanese model of bank-centered shareholding and internal monitoring). Some commentators have also cited differences in common law versus civil law systems in support of the U.S.-U.K./Europe-Japan dichotomy. See, e.g., John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 38 (1999).

17. In one of the two main branches of convergence theory, neoclassical economists posited that market efficiencies would produce convergence as a result of international competition among systems of corporate governance (“convergence-from-competition” theory). See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991). The opposing view focused on the barriers to change in corporate structure imposed by political and historical factors as preventing convergence

arguably assumed an underlying tone that “convergence” meant the rest of the world becoming more like the United States.

When American comparative corporate law scholars initially sought to explain Japan’s economic success in the early 1990s they relied on economic analyses,¹⁸ and accepted as given that law played no real role in the Japanese system.¹⁹ Questions concerning the prevalent internal monitoring model of Japanese corporate governance are assuming greater urgency now that the model has undergone its first real “stress test” during Japan’s prolonged economic malaise of the 1990s. Each element of the internal monitoring model is now undergoing significant change,²⁰ and particularly over the past few years the model’s predictive value has arguably

(“path dependence” theory). See Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991); Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999).

Between these extremes was a view which emphasized the legal protections afforded minority shareholders as a method for comparing governance systems and as a condition for the development of liquid capital markets (“law matters” theory). See Rafael La Porta et al., *Investor Protection and Corporate Governance*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=183908 (last visited Mar. 27, 2003). Another intermediate view held that due to self-regulatory substitutes for formal law, functional convergence may occur even if formal convergence is blocked by legal or institutional barriers (“functional convergence”). See Coffee, *The Future as History*, *supra* note 16. For the origin of the emphasis on formal convergence versus functional convergence, see Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function* (Stanford Law and Economics Olin Working Paper No. 192, Columbia Law and Economics, Working Paper No. 174, May 2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=229517 (last visited Apr. 17, 2003).

18. The best known work was that of Masahiko Aoki, who cited the main bank and cross-shareholding as institutions which: (1) supported management’s promise of lifetime employment in an internally focused and stable system and; (2) would intervene in such arrangements only if the company fell into distress. See Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LIT. 1 (1990); see also Masahiko Aoki, *Monitoring Characteristics of the Main Bank System: An Analytical and Developmental View*, in *THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMICS* 109 (Masahiko Aoki & Hugh Patrick eds., 1994); Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 J. ECON. BEHAV. & ORG. 399 (1989).

19. See Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871, 899 (1993) (accepting the popular assumption that due to some combination of weak law and strong cultural values Japan needed to develop informal substitutes for long-term contracts and other legal mechanisms); see also sources cited *supra* note 18. Curtis Milhaupt thus describes the role of law in this prevailing view of Japanese corporate governance as being “conspicuous by its absence.” See Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture and the Rule of Law*, 37 HARV INT’L. L.J. 3, 4 (1996).

20. Among these, perhaps the most fundamental and clearly measurable change is the recent widespread unwinding of cross-shareholding. During the period from 1995-2000 the 31% share of public corporations held by banks and insurance companies fell to 22%, while the percentage of shares of public corporations held by foreign investors increased from 8% to 19%. See, e.g., *Zadankai: Kaishaho Daikaisei no Igi* [Panel Discussion: Significance of Major Revision to the Company Law] 1206 JURISTO 6, 7 (2001) (Speaker: Fukao). Similar trends can be seen for other “stable” shareholders and in 2001 trades by foreign investors constituted more than half of the trading volume on the Tokyo Stock Exchange.

failed.²¹ Despite efforts made by the limited number of Japanese corporate law specialists,²² the internal monitoring model of Japanese corporate governance continues to dominate comparative corporate law literature. As noted above, an emphasis on cultural values by both Japanese legal scholars and their Western counterparts, together with the Japanese model of development and, more recently, convergence theory, all served to reinforce the prevailing view that Japanese corporate governance and society emphasize informality over law.

In this Article, I look to the dramatic example of the Daiwa Bank Case and its aftermath in order to examine the role of law in Japanese corporate governance. The court's decision sharply criticized the bank's reliance on informal consultations with the government and strongly emphasized the importance of directors' independent judgment in fulfilling their fiduciary duties. Thus, this decision shocked the business community. Its after-

21. A number of major Japanese corporations have collapsed and entered into bankruptcy proceedings under a new Civil Rehabilitation Law enacted in 1999. See generally *Minji Saisei Ho* [Civil Rehabilitation Law], Law No. 225 of 1999. This law encourages bankruptcy by providing for debtor-in-possession restructuring in contrast to the court-appointed trustee mandated under pre-existing law. In addition, these cases indicated that, not only has the main banks' purported ex ante monitoring function failed, but that even the heretofore unquestioned ex post workout function is no longer reliable.

22. Mark Ramseyer has directly attacked this prevailing model, arguing that many of its features, such as *keiretsu* and the main bank, are myths. See J. Mark Ramseyer, *Repeated Deals*, 20 J. LEGAL STUD. 91 (1991); J. Mark Ramseyer, *Explicit Reasons for Implicit Contracts: The Legal Logic To the Japanese Main Bank System*, in JAPANESE MAIN BANK SYSTEM, *supra* note 18, at 231; Yoshiro Miwa & J. Mark Ramseyer, Review Essay, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 LAW & SOC. INQUIRY 401 (2002) (reviewing, MASAHIKO AOKI, INFORMATION, CORPORATE GOVERNANCE, AND INSTITUTIONAL DIVERSITY, COMPETITIVENESS IN JAPAN, THE USA, AND THE TRANSITIONAL ECONOMIES (Stacey Jehlik trans., 2000)); Yoshiro Miwa & J. Mark Ramseyer, *The Fable of the Keiretsu*, 11 J. ECON. & MGMT. STRATEGY 169 (2002).

A more widespread criticism of the prevalent view of Japanese corporate governance is that it tends to be utilized as an idealized stereotype—by the time it was popularized in the 1980s the institutions it describes were arguably already in decline. Some commentators have sought to broaden this popular model by providing for a greater role for formal law and a more systematic method of accounting for non-legal social norms without relying on a vague concept of cultural values. See Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083 (2001); Milhaupt, *supra* note 19; Mark D. West, *Legal Rules and Social Norms in Japan's Secret World of Sumo*, 26 J. LEGAL STUD. 165 (1997). For a recent comment on this popular view of Japanese corporate governance and Ramseyer's criticism of it, see Curtis J. Milhaupt, *On the (Fleeting) Existence of the Main Bank System and Other Japanese Economic Institutions*, 27 LAW & SOC. INQUIRY 425 (2002).

Skepticism of the internal monitoring model of Japanese corporate governance is not limited to Japanese law specialists. See John C. Coffee, Jr., *Convergence and Its Critics: What Are the Preconditions to the Separation of Ownership and Control?* (Working Paper No. 179, 2000) Sept. 12, 2000 available at http://papers.ssrn.com/paper.taf?abstract_id=241782 (stating that banks prefer liquidity over control and that "financial institutions . . . do not naturally desire to perform the monitoring and oversight role accorded to them by the theorists of concentrated ownership") (last visited Apr. 17, 2003); Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Japan, Germany and the United States*, 48 STAN. L. REV. 73 (1995) (arguing that bank monitoring is for the purpose of protecting the bank's own fixed claims against its borrowers, which is critically different from monitoring on behalf of shareholders).

effects are likely to be significant and long-lasting, similar to the impact created by U.S. court decisions in the 1980s and 1990s. The Daiwa Bank Case utilized the formal legal system—shareholder derivative suits, courts, and lawyers—which is afforded little importance under the popular view of Japanese corporate governance. Significantly, I find that the Daiwa Bank Case dramatically highlights and strengthens an underlying trend that began during the 1990s, in which the formal legal system has gradually come to play an increasingly important role in Japanese corporate governance. I conclude that we must re-examine the role of law in corporate governance in light of the ongoing changes occurring in Japan.

This Article is divided into five parts. Part I provides the factual background of the Daiwa Bank Scandal, summarizes the relevant Japanese corporate law, and then examines an important preliminary ruling in the Daiwa Bank Case which may ease plaintiffs' burden of pleading in future derivative litigation. Part II covers the significance of the Daiwa Bank Case. Part III compares the Daiwa Bank Case with relevant U.S. case law, finding some striking similarities in approach. Part IV discusses the aftermath of the Daiwa Bank Case, which includes an increasingly important function for the shareholder derivative suit system, significant changes in corporate practices, impact on the market for directors' liability insurance and legislative reaction to the court's ruling. Finally, Part V reconsiders the importance of law in Japanese corporate governance and concludes that the role of law continues to increase in importance due to recent changes in Japan as exemplified by the Daiwa Bank Case. However, Part V also suggests caution in applying convergence theory to Japan's consideration and adaptation of certain elements of "American-style" corporate governance, a process which might be better characterized by means of traditional notions of legal borrowing.

I. Shareholder Derivative Suit System and the Daiwa Bank Scandal

A. The Daiwa Bank Scandal—Factual Background in the U.S. and Japan

The tale begins with the 1976 hiring of Toshihide Iguchi²³ as a local employee of the New York branch ("NY Branch") of Daiwa Bank Limited (Daiwa).²⁴ By 1984, Iguchi was in charge of both securities trading and

23. Iguchi moved from Japan to the United States to attend Southwest Missouri State University and majored in psychology. 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 prior experience in banking. According to 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).

24. Daiwa Bank is one of the smaller of Japan's eleven "city banks" or money center banks. In 1995, it was the tenth largest bank in Japan and the thirteenth largest in the world with total assets of some \$390 billion. As a foreign bank operating in the U.S., Daiwa was subject to banking regulations which essentially were similar to those applicable to domestic banks. Daiwa was supervised by a state regulator, the New York State Banking Department in the case of the NY Branch and its New York-charted trust subsid-

custody as well as some related back office functions.²⁵ Although Iguchi initially made a small trading profit, he soon began to accumulate steadily mounting losses which eventually—with some 30,000 trades—reached \$1.1 billion by the time the incident came to light in 1995. Iguchi then, in an attempt to conceal his losses that occurred throughout the period, ordered the unauthorized sales of \$377 million of customer securities, as well as other bank securities.

In July 1995, Iguchi wrote a confession letter to Daiwa's president.²⁶ Upon confirmation of the letter's contents, Daiwa's president decided the bank's basic position would be to maintain secrecy and cooperate with Iguchi in order to cover up the losses.²⁷ On August 8, the president and other top Daiwa executives met informally for dinner at the bank's guest house with Ministry of Finance (MOF) officials to report the matter and obtain approval for their approach. Daiwa continued to conduct business as usual at its NY Branch from early August until mid-September,²⁸ when it finally reported its losses to U.S. and Japanese bank regulators seven weeks after the receipt of Iguchi's first confession letter and five weeks after informally reporting the matter to the MOF.²⁹ U.S. bank regulators and prosecutors soon realized that the matter was far broader and more serious than

ary, and federal regulators, the Federal Reserve Board for the NY Branch and the Federal Deposit Insurance Corporation for its trust subsidiary.

25. *Nishimura v. Abekawa*, 1573 SHOJI HOMU 3, 22 (Osaka Dist. Ct., Sept. 20, 2000) [Daiwa Bank Case]. It is appropriate to separate securities trading and custody precisely because of the potential for wrongdoing, with a trader being in a position to obtain funding through the unauthorized sale or lending of custody securities. This was exacerbated by Iguchi also having responsibilities for some related back office functions such as trade confirmations, settlement of trades, and recordkeeping. *Id.* at 35-36.

26. This letter dated July 17, which Iguchi labeled his "honest confession," revealed the \$1.1 billion trading loss and other unauthorized actions, warned of the dire consequences of this information becoming public and went on to suggest methods to minimize the likelihood of discovery of the losses by U.S. authorities. His primary advice was to replace the missing securities and move the concealed loss out of the United States so that U.S. authorities would not handle the matter. See *United States v. Daiwa Bank Ltd.*, No. 95 Cr. 947, at 4-6 (S.D.N.Y. 1995) [Daiwa Indictment].

27. *Daiwa Bank Case*, 1573 SHOJI HOMU at 31. According to the decision in the *Daiwa Bank Case*, the bank's president decided that Daiwa's basic position would be as follows: (i) obtain the continued cooperation of Iguchi; (ii) obtain a complete picture of the unauthorized transactions and sales; (iii) carefully safeguard this information and maintain secrecy; (iv) examine whether the bank could write off the entire amount of the loss during the current fiscal half-year; and (v) obtain an appointment with the Ministry of Finance (MOF) for quick disclosure of the case. There apparently was no consideration of whether to report the losses to U.S. authorities. *Id.*

28. Numerous actions were also undertaken to conceal the losses, including the continuing sale of custody securities and creation of fictitious custody account statements as well as the filing of its regular quarterly call report with the Federal Reserve Board which contained some \$600 million of non-existent assets. In addition, management initiated a fictitious transfer of the missing securities to Daiwa's head office. *United States v. Daiwa Bank Ltd.*, No. 95 Cr. 947, at 13 (S.D.N.Y. 1995) [Daiwa Indictment].

29. 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. See 12 C.F.R. §§ 211.24(f) & 208.20 (1995). New York State banking regulations also require immediate reporting of losses. N.Y. COMP. CODES R. & REGS. tit. 3, § 300.1 (1995).

a mere \$1.1 billion loss.³⁰

The U.S. authorities reacted swiftly and decisively. Bank regulators first issued a notice of hearing and interim orders, then on the second of November, they levied the “death penalty” against Daiwa and its trust subsidiary by issuing consent orders requiring them to cease all U.S. banking business and surrender their banking licenses within ninety days.³¹ With respect to criminal liability, on the second of November a grand jury handed down a twenty-four count indictment of Daiwa³² and a two count indictment of the NY Branch’s general manager.³³ Meanwhile on October 19, 1995, Iguchi pleaded guilty to all six counts of his charge.³⁴

Daiwa entered into a plea bargain on February 28, 1996, in which it pleaded guilty to sixteen of the twenty-four counts in the indictment.³⁵ The bank agreed to pay a criminal fine of \$340 million, the largest criminal fine levied on a financial institution in U.S. history.³⁶ The NY Branch general manager also pleaded guilty, pursuant to a plea bargain, on October 25, 1996.³⁷

Fallout from the case in the United States was significant. Congressional committees in both houses held hearings on the Daiwa Bank Scan-

30. They discovered the involvement of the bank’s top management in a cover-up and its prior report of the matter to the MOF in Japan. They also learned for the first time of a prior similar case of unauthorized trading and unreported losses at Daiwa’s trust subsidiary and false statements to bank examiners about securities trading operations during the NY Branch’s examinations in 1992 and 1993. See *Daiwa Indictment*, at 31-34. Much of this information apparently came from Iguchi, who was arrested by the FBI on September 23, 1995, and later charged with six counts of embezzlement and financial fraud. See *United States v. Iguchi*, No. 95 Cr. 914 (S.D. N.Y. Oct. 19, 1995) [*Iguchi Indictment*].

31. See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, New York State Banking Department, Joint Statement (Nov. 2, 1995). The termination order was issued jointly by the Federal Reserve Board and the six state bank regulators in states where Daiwa maintained offices.

32. *Daiwa Indictment*, No. 95 Cr. 947.

33. See Complaint, *United States v. Tsuda*, No. 95 Mag. 2124 (S.D.N.Y. Nov. 2, 1995) (charging Tsuda with deceiving bank examiners and falsifying bank documents).

34. On December 16, 1996 Iguchi was sentenced to a four-year prison term and a two million dollar fine. See *Former Daiwa Trader Sentenced in Cover-Up of \$1.1 Billion Loss*, N. Y. TIMES, Dec. 17, 1996, at D12.

35. See Laurie Hays, *Daiwa Bank Pleads Guilty to Conspiring to Hide Loss: Japanese Firm Also to Pay U.S. a \$340 Million Fine in the Trading Scandal*, WALL ST. J., Feb. 29, 1996, at A3; *Nishimura v. Abekawa*, 1573 SHOJI HOMU 3, 5-7 (Osaka Dist. Ct., 2000) [*Daiwa Bank Case*].

36. 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. See U.S. Sentencing Guidelines Manual § 8C2 (1995).

37. At the time of Tsuda’s indictment, the U.S. attorney stated that if convicted, Tsuda faced a prison term of up to eight years and \$500,000 in fines. See, e.g., James R. Kraus, *Daiwa Wants Court To Drop Charges in Trading Cover-Up Case*, AMERICAN BANKER, Jan. 23, 1996, at 6. Under the plea bargain, Tsuda received two months imprisonment and a \$100,000 fine. See *Ex-Daiwa Manager Gets 2-Month Term*, N.Y. TIMES, Oct. 26, 1996, at 38.

dal and the failure of regulatory oversight. The themes of these hearings were Daiwa's violation of the basic trust necessary between banks and regulators,³⁸ and the failure of the Japanese MOF to disclose the matter to U.S. authorities despite international agreements on regulatory cooperation.³⁹ The Daiwa Bank Scandal shattered the underlying assumption that Japanese practices and banking regulation were fundamentally sound.

In Japan, Daiwa suffered business setbacks,⁴⁰ and the top executives of the bank resigned 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. An embarrassed MOF initiated its own sanctions against Daiwa Bank and pledged closer cooperation with U.S. bank regulators in the future. It suddenly became possible and even popular in Japan to advocate the break-up of the powerful MOF in conjunction with ongoing administrative reforms.⁴¹ On October 23, 1995, shareholders initiated a derivative action against all Daiwa Bank directors and statutory auditors for the period of 1984-1995 ("First Case").⁴² Following the bank's plea bargain in New York, shareholders filed an additional derivative suit against the directors and statutory auditors ("Second Case") on March 17, 1996.⁴³

B. Japanese Law on Directors' Duties and Derivative Suits

Notwithstanding some important formal differences, the basic scheme of Japanese corporate law and directors' duties is functionally similar to U.S. law. Japanese practice has departed substantially from its Commercial Code's theory, as evidenced by management's dominance over Japanese

38. Chairman Greenspan stated that "[t]rust is a principle of central importance to all effective financial systems. An assumption that most bankers are truthful should remain the rule not the exception. However, when a bank has shown through repeated actions that it cannot be trusted, even at the highest levels of the corporation, supervisors should resort to extraordinary regulatory measures." *U.S. Senate Banking Committee Hearing On The Daiwa Bank Of Japan And The Supervision Of Foreign Banks Operating In The United States*, 104th Cong. 4, 5, 14 (1995) (statement of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System).

39. In studied understatement, Greenspan noted that "[t]his lapse on the part of the Ministry of Finance is regrettable because open communication and close cooperation among supervisory authorities are essential to the maintenance of the integrity of the international financial system." *Id.* at 2. In a letter to Mr. Greenspan, committee chairman D'Amato was less circumspect, stating: "[t]he Japanese government's apparent collusion with Daiwa in withholding crucial information from U.S. authorities and allowing Daiwa to break U.S. laws is a serious breach of trust between our governments." *See* 65 *Banking Rep.* (BNA) No. 15, at 673 (Oct. 23, 1995).

40. Daiwa's rating was downgraded two notches by Standard and Poor's. It sold its U.S. operations to Sumitomo Bank and did not participate in the reorganization of Japan's city banks into four major banking groups. It instead absorbed some local regional banks in an effort to become a "super-regional" bank and later formed a banking group with troubled Asahi Bank.

41. For citation to and discussion of articles in the popular press, see Mitsuru Misawa, *Daiwa Bank Scandal in New York: Its Causes, Significance, and Lessons in the International Society*, 29 *VAND. J. TRANSNAT'L L.* 1023 (1996).

42. *Daiwa Bank Case*, at 3, 5, 40-41 [*Ko case* or "First Case"].

43. *Daiwa Bank Case*, at 5, 47 [*Otsu case* or "Second Case"].

corporations with little effective oversight by other corporate organs.⁴⁴ This gap between legal theory and actual corporate practice, although also true in the United States at least until the 1980s, reinforced the view that Japanese corporate governance is an insider-based system removed from the Commercial Code's formal legal structure.

Like many early corporate laws, the Japanese Commercial Code (*Shoho*) was premised on a limited number of shareholders exercising relatively direct control over the corporation's business. When the Commercial Code was rewritten in 1950 under the U.S. occupation, it incorporated American methods of dealing with the fundamental issue of the separation of ownership and control in modern corporations by increasing directors' power to oversee the management of day-to-day business operations and giving shareholders new rights to monitor directors and prevent abuse of their authority.⁴⁵ Also, as a unitary civil law system, the relevant corporate laws are all national laws establishing the duties of directors by statute.

However, the Commercial Code also retains the German-inspired position of statutory auditor⁴⁶ and has no provision for officers. Traditionally, there is no separation of managers and directors in Japanese corporations.⁴⁷ However, the Commercial Code does provide for representative directors, who are elected by the board and have the authority to represent a corporation much like a president.⁴⁸

Shareholder-elected directors owe fiduciary duties, which are generally similar to those under U.S. law, to the corporation and its shareholders. Additionally, code provisions on directors' duties include a specific duty of compliance with laws and regulations.⁴⁹ The Commercial Code requires statutory auditors, who are also elected by shareholders, to monitor the

44. Many commentators have noted the gap between theory and structure under the Commercial Code and actual practice in Japan. See, e.g., Milhaupt, *supra* note 19, at 19 (stating that the shareholder-agency theory on which formal Japanese corporate law is based "bears little resemblance" to corporate practice).

45. The new postwar emphasis on shareholders' rights included shareholder access to corporate books and records, transferability of shares, cumulative voting and other voting rights, and the introduction of a board of directors and director liability. See SHOHO arts. 293-6, 204, 256-3, 254-269. See generally Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 Nw. U. L. REV. 1436, 1445-46 (1994). As a result, most aspects of Japanese corporate law, including provisions relating to directors, look familiar.

46. See SHOHO art. 274(1); see also *supra* note 45.

47. Instead, directors are virtually all senior managers promoted from within the firm; becoming a director is regarded merely as a step up in the chain of promotion. This has led to large boards with hierarchical structures in which directors retain "line" responsibilities to be in charge of a department of the corporation.

48. See SHOHO art. 261. Every corporation must have one representative director. Larger corporations often have several representative directors, any one of whom may bind the corporation.

49. SHOHO art. 266(1)(v) (specifically creating director's liability for failure to comply with laws, ordinances and the articles of incorporation), art. 254-3 (including in a director's fiduciary duty an obligation to comply with laws, ordinances, the articles of incorporation and resolutions of general shareholders' meetings).

directors' performance.⁵⁰ Although the statutory auditors' basic function is to act as a check on directors' conduct, their role is not identical to that of a German Supervisory Board.⁵¹

Like shareholder derivative suit systems elsewhere, the Japanese system recognizes that the suits depart from normal corporate decision-making and tries to strike a balance between affording directors sufficient discretion to make business decisions and providing directors with an incentive for good faith performance of their fiduciary duties. The fear of abuse of derivative litigation is probably even stronger in Japan than elsewhere due perhaps to the past role of "sokaiya" racketeers⁵² in extorting money from corporate management and a general reluctance to place substantial liability on individual directors who, in most cases are merely employees who have risen through the ranks.

Since 1950, the Commercial Code has contained provisions allowing derivative actions by shareholders against corporate directors and statutory auditors for any breach of duty owed to the corporation.⁵³ However, until the mid-1980s, the derivative suit provisions were virtually dormant. The reasons for their disuse seem to be due economic and institutional factors,

50. *Id.* arts. 273-280. Statutory auditors also owe a duty of care to the corporation, but not a duty of loyalty under the theory that they are not involved in conducting the corporation's business and would therefore not have any conflicts of interest. Although they have no direct duty with respect to compliance with laws, their duty to audit the performance of directors would include monitoring of the directors' compliance with laws. Their function is to oversee the performance of directors generally, and does not focus on accounting issues or financial statements. The powers of Japanese statutory auditors under the Commercial Code include the right to request business reports, to conduct investigations, and to enjoin illegal or *ultra vires* conduct by directors. *Id.* arts. 274(2), 275-2. Statutory auditors are also obligated to review proposals and documents to be submitted to general meetings of shareholders. *Id.* art. 275. Directors are obligated to report immediately to statutory auditors upon the discovery of facts that may lead to a significant loss to the corporation. *Id.* art. 274-2. By amendment of the Commercial Code in 1993, every large corporation must have at least one statutory auditor who was not a director or employee of the corporation during the preceding five years.

51. Although based on a Supervisory Board (Aufsichtsrat) under German law, statutory auditors in Japan have a weaker position than their German counterparts vis-à-vis the board of directors. A German Supervisory Board typically appoints the members of the Board of Management (Vorstand). Statutory auditors in Japan, while elected by shareholders, have no corresponding power of appointment of directors, who are also directly elected by shareholders.

52. In a relatively closed system, the biggest "shareholder" challenge to management came from *sokaiya*, or racketeer shareholders, who essentially extorted money from corporate management in exchange for silence or support, particularly at general shareholders' meetings. See generally Mark D. West, *Information, Institutions and Extortion in Japan and the United States: Making Sense of Sokaiya Racketeers*, 93 Nw. U. L. REV. 767 (1999).

53. See SHOHO arts. 267-268-3. Although there is a universal requirement for making a demand to the corporation prior to instituting suit, refusal of a shareholder demand is not awarded any particular deference by courts. See *id.* art. 267. For specific rules concerning derivative suits in Japan, see, for example, Shiro Kawashima & Susumu Sakurai, *Shareholder Derivative Litigation in Japan: Law, Practice, and Suggested Reforms*, 33 STAN. J. INT'L. L. 9, 23 (1997); West, *supra* note 9.

rather than to any cultural aversion to litigation.⁵⁴

The first successful derivative suit in 1986,⁵⁵ the collapse of the bubble economy, and an important revision to the Commercial Code in 1993, which greatly reduced filing fees for derivative suits, set the stage for change.⁵⁶ The resulting increase in the number of derivative suits in the 1990s was far greater than anticipated.⁵⁷ To weed out abusive cases the courts began to utilize a dormant "security for expenses" provision of the Commercial Code, interpreting it as only requiring proof of the low likelihood of the plaintiffs prevailing on the merits of the case, rather than as requiring the establishment of subjective bad faith.⁵⁸

In many motions decided during the 1994-96 period, the courts followed this standard and ordered plaintiffs to post substantial amounts as security for expenses, thus effectively ending the derivative litigation.⁵⁹ Plaintiffs only survived defendant's claim for security for expenses when they were able to overcome Japan's ineffective discovery system by piggybacking on a record created by a criminal or other official investigation. Similarly, plaintiffs were only successful in obtaining settlements in cases

54. One obvious element is that the strong economic performance of many Japanese companies in the postwar period gave shareholders little cause for complaint. The Japanese system also provided economic disincentives to instituting derivative litigation in the form of filing fees and attorneys' fees. See West, *supra* note 45 (arguing that the lack of economic incentives generally, and the attorney's lack of economic incentive under the Japanese system in particular, was the critical factor in the extremely low rate of derivative litigation in Japan before 1993). Defendants prevailed in the few derivative suits which were brought.

55. Mizuno v. Ariyoshi, 1194 HANREI JIHO 33 (Tokyo Dist. Ct., May 29, 1986) [Mitsui Mining Case], *aff'd*, 1188 SHOJI HOMU 36 (Tokyo High Ct., July 3, 1989), *aff'd*, 47-7 MINSHU 4814 (Sup. Ct., Sept. 9, 1993).

56. U.S. pressure for transparent corporate governance in Japan as part of trade policy under the Structural Impediments Initiative combined with domestic pressures for change to produce this revision. The amount of the filing fee (literally a stamp tax or "inshidai") had often been calculated as a percentage of damages claimed. This was changed to an insignificant fixed fee of 8,200 yen which had been applied to non-monetary claims. See SHOHO art. 267(4).

57. In addition to an increased number of suits, the amount of damages claimed generally increased and the focus of cases shifted from closely held corporations to large public corporations. See Comment, *Kabunushi no Daihyo Soshu wo Meguru Jokyo [Circumstances Surrounding Shareholders' Derivative Litigation]*, in *Kabunushi Daihyo Soshu no Genjo to Kadai [The Present Condition and Task of Shareholder Derivative Litigation]*, 173 BESSATSU SHOJI HOMU 4, 5 (1995); see also Kawashima & Sukurai, *supra* note 53, at 43.

58. See *Noguchi v. Kotani*, 125 SHIRYOBAN SHOJI HOMU 184 (Tokyo Dist. Ct., July 22, 1994) [Janome Sewing Machine]. The Japanese Supreme Court had previously found the filing of a lawsuit to be a wrongful act where such filing was essentially an abuse of the court system without specifying the applicable requirements. See *Nagano v. Hirohara*, 42-1 MINSHU 1 (Sup. Ct., Jan. 26, 1988); 1281 HANREI JIHO 91 (1988).

59. While this trend was welcomed by many, others argued that it went too far and would impinge upon shareholders' rights by including some non-frivolous cases within the scope of the security for expenses provision. See, e.g., Shunsaku Iwahara, *Daihyo Soshu to Kabunushi no Akui [Derivative Litigation and Bad Faith of Shareholders]*, 948 HANREI TAIMUZU 134 (1997). For similar reasons, in the U.S. a security for expense provision was dropped from the Model Business Corporation Act when it was revised in 1984. See MODEL BUS. CORP. ACT (1984).

where directors took illegal action (e.g., paying off *sokaiya* or bribing government officials), and even in those cases the settlement amounts were for a small fraction of the plaintiffs' claim.⁶⁰

C. Significance of the Preliminary Ruling in the Daiwa Bank Case

The Daiwa plaintiffs were also subject to a preliminary motion for security for expenses, which was initially granted by the Osaka District Court.⁶¹ As in many derivative suits, the plaintiffs' factual allegations were based entirely on published news accounts of the Daiwa Bank Scandal, raising the issue of whether application of the security for expenses provision was going beyond the purpose of weeding out abusive suits⁶² and depriving the plaintiffs of their day in court.⁶³

However, the Osaka high court reversed on appeal and denied the defendants' motion for the plaintiffs to post bond.⁶⁴ This ruling not only allowed the case to proceed on the merits, but also served to check a growing tendency by courts to grant liberally defendants' motions for security for expenses and set an important precedent for further expanding the use

60. For the low success rate, see West, *supra* note 9, at 357-58.

61. In a ruling on April 18, 1997, the Osaka District Court ordered the plaintiffs to post security for expenses in the amount of 20 million yen for each of 35 defendants in the First Case, totaling 700 million yen or 5.6 million dollars, and 12 million yen for each of forty-eight defendants in the Second Case, totaling 576 million yen or over 5 million dollars. *Abekawa v. Nishimura* ("First Case") and *Hiraiwa v. Nishimura* ("Second Case"), 158 SHIRYOBAN SHŌJI HŌMU 54 (Osaka Dist. Ct., Apr. 18, 1997). The court concluded that the plaintiffs' factual allegations were "extremely insufficient," giving rise to an inference that plaintiffs' legal and factual allegations are unlikely to be proven and that plaintiffs were aware of this when filing suit. [An exchange rate of 120 yen to one dollar is used in this Article.]

62. The Daiwa Bank Case was not an obviously abusive suit, as the lead plaintiff was a former employee of Daiwa Bank, whose last position, ironically enough, was deputy general manager of the bank's Inspection Division, and who had knowledge concerning internal controls and bank examination issues. For his view of the Daiwa Bank Case, see Ichiro Nishimura, *Daiwa Ginko Tadori to no Wagatoso* [My Struggle Against the President of Daiwa Bank], 80 BUNGEI SHUNJU 318 (2002). It is also true, however, that there reportedly was a perception that one of the plaintiffs' attorneys had previously filed derivative suits without making any real attempt to prove his case.

63. This criticism may have been buttressed by a perception that the initial flow of derivative cases after 1993 contained a fair amount of *sokaiya*-type suits, which resulted in dismissal due to the plaintiffs' inability to provide security, but that subsequent more meritorious suits were now also being dismissed. See Tomotaka Fujita, *Kabunushi Daihyo Soshō no Teiki ga Akui ni deta mono to shite Tanpo Teikyo ga Meijirareta Jirei-iwayuru Daiwa Ginko Jiken* [Case which ordered Provision of Security for Filing of a Shareholders' Derivative Lawsuit in Bad Faith—The So-Called Daiwa Bank case], 1144 JURISTO 117 (1998). In prior cases, courts had made factual findings contrary to the plaintiffs' arguments, so that in American terms, the court's action was close to a summary judgment. In no Japanese case to date had a court granted a defendant's motion to post bond based primarily on vagueness in the plaintiffs' allegations without engaging in any fact-finding. See *id.*

64. *Nishimura v. Abekawa* (First Case), 166 SHIRYOBAN SHŌJI HŌMU 138 (Osaka High Ct., Dec. 8, 1997); *Nishimura v. Hiraiwa* (Second Case), 165 SHIRYOBAN SHŌJI HŌMU 291 (Osaka High Ct., Nov. 18, 1997). The court ruled for the first time that the directors' duty of care included a duty to establish an overall policy on internal controls, and that the plaintiffs' allegations were therefore sufficient for this stage of the case. *Id.*

of shareholder derivative suits.⁶⁵

II. Court Decision in the Daiwa Bank Case

Ultimately, on September 20, 2000, the Osaka District Court ordered eleven current and former directors of Daiwa Bank to pay a total of \$775 million in damages in the two related cases.⁶⁶ Both sides initially appealed the case to the Osaka high court. However, the parties ultimately settled the case pursuant to an in-court compromise on December 20, 2001. In the compromise, the plaintiffs accepted a small fraction of the awarded damage amount in return for making the district court's decision on directors' liability into a final judgment and for obtaining some payment from each of the original forty-nine defendants.⁶⁷

A. First Case—Director Oversight and Internal Controls

The Daiwa Bank court's decision with respect to the First Case is notable for its rulings on three issues: (1) a director's liability for a failure of oversight as opposed to an action taken by the director; (2) a corporate board's obligation to establish an overall policy for internal controls, including risk management and compliance with laws, and to oversee the formulation and implementation of specific components of such policy; and (3) a negligence standard for directors' liability without any application of Japan's version of the business judgment rule.⁶⁸

A theoretical duty of oversight was established in Japan in the 1970s.⁶⁹

65. This more cautious approach to granting motions for security for expenses as articulated by the Osaka high court appears to have found favor, at least among legal scholars. For example, the current edition of a widely used code book with case annotations cites two leading cases with respect to the interpretation of bad faith and the security for expenses provision—Nagoya high court ruling in a case involving Tokai Bank and the Osaka high court ruling in the Daiwa Bank case. Both of these cases state that a negligent filing of a lawsuit would not, by itself, constitute bad faith. HANREI ROPPO HENSHU IINKAI [Case Precedent Basic Codes Editing Committee] MOHAN ROPPO [Annotated Basic Codes] 1191 (2001).

66. Daiwa Bank Case, at 4. The defendants filed a motion with the Osaka District Court for stay of execution on the judgment pending appeal; this motion was granted upon condition that defendants post bond in an amount over 829 million yen (\$6 million).

67. See *infra* notes 121-23 and accompanying text.

68. In the First Case, the court found that the three directors who had been in charge of the NY Branch during this time period were in breach of their duty to establish specific internal control policies, and one statutory auditor, who on one occasion had accompanied Daiwa's outside Japanese accounting firm on an audit of the NY Branch and, accordingly, had an opportunity to discover and correct this shortcoming, had breached his duty of oversight. Proof of damages was found only for one defendant, and he was 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 NY Branch.

69. The early cases involved the failure of closely held companies and non-functioning boards, focusing on the liability of nominal directors to third-party creditors. A Supreme Court case in 1973 established a duty of oversight, which was subsequently incorporated into the Commercial Code in 1976. See *Hashimoto v Kobayashi*, 27-25 MINSHU 655 (S. Ct., May 22, 1973); SHOHO art. 260(1). At that time, the code also granted directors new rights to convene or demand a board meeting in order to aid the

In the context of a large corporation, oversight was primarily meaningful in the context of creating policies and systems to prevent and detect employee wrongdoing. Upon finding that appropriate systems designed to prevent wrongdoing were in place, a court would examine whether the director in charge of the relevant area exercised appropriate supervision over his subordinate employees. Thus, from an American perspective, the lack of separation of directors and officers might result in an inquiry seeming to focus more on officer-type liability than on directors' liability.⁷⁰ In any case, directors were not actually found liable for failing to monitor corporate activities.⁷¹

The Daiwa Bank court initially discussed the duty of the board of directors to establish an appropriate risk management system.⁷² The court also recognized the principle of reliance, noting that board members will not be liable for their subordinates' mistakes unless special circumstances raised doubts about the performance of delegated responsibilities.⁷³

The court's view of the board's duty to establish internal control policies, however, conflicted with existing Japanese practice. Japanese banks did not generally deal with internal controls and compliance policies at the

exercise of such oversight function. SHOHO art. 259(2)(3). A subsequent Supreme Court decision in 1980 extended this oversight duty to nominal outside directors. See *Daidō Sanso Kabushiki Gaisha v. Suga*, 971 HANREI JIHO 101 (S. Ct., Mar. 18, 1980). See generally Tetuso Shimabukuro, *Torishimariyaku no Kanshi Gimu to Shoho* 266-3 [Oversight Duty of Board Directors and Commercial Code 266-3], 149 BESSATSU JURISTO 122 (1998).

70. The inquiry concerning directors' liability thus typically tends to focus on the individual director's duty of supervision over his subordinate employees or on the representative director rather than the duty of oversight as exemplified by action or inaction by the board as a whole. For a discussion of the distinction between these two roles ("duty of oversight" versus "duty of supervision"), see, for example, Jokai Kaishaho no Kenkyū—Torishimariyaku (2) [Research on Company Law—Board Directors (Part II)] 200 BESSATSU SHOJI HOMU 1, 46-49 (1997) and *id.* (Part 4), 219 BESSATSU SHOJI HOMU 1, 55-57 (1999).

71. See *Aoki v. Nasu* 182 SHIRYOBAN SHOJI HOMU 244 (Tokyo Dist.Ct., Mar. 4, 1999) [Tokyo Electric Power Case]. In this case, shareholders filed a derivative action against the president of Tokyo Electric Power for his failure, as representative director, to supervise employees who embezzled corporate funds through a scheme of false and padded orders sent to printing companies. The court discussed the necessity of establishing means to prevent and detect such behavior, ruling that "[a director's] duty of supervision over employees, such as detecting illegal and improper acts of employees or preventing these in advance, is included within the duty of care." *Id.* at 252. It found, however, that the company had appropriate policies and systems in place and that, absent special circumstances, in such a large organization the representative director could rely on his subordinates to implement the policies. *Id.*

72. It decided that since the board of directors is charged with deciding important matters based on SHOHO art. 260(2), it must decide the basic policy for risk management. The court found that the board of directors has a duty to establish overall risk management policies, the representative director and director in charge have the duty to establish specific risk management policies, other directors have a duty of oversight with respect to the primary directors fulfilling their duty and auditors have a duty of oversight with respect to the board as a whole. *Daiwa Bank Case*, 34. This is consistent with the approach generally taken by Japanese courts. See *Tokyo Electric Power Case*, 182 SHIRYOBAN SHOJI HOMU at 244.

73. See *Tokyo Electric Power Case*, 182 SHIRYOBAN SHOJI HOMU at 244.

board level, viewing them as issues specific to their U.S. or other overseas offices. Despite the court's emphasis on the board's responsibility to establish overall policies regarding internal controls, it never examined whether Daiwa's board in fact did so. Had the court conducted such an examination, it presumably would have found that no overall risk management policy existed and, at least in theory, could have found all of the bank's directors and statutory auditors liable for the bank's failure to establish such a policy.⁷⁴

Instead, the court next turned to the specific question of whether Daiwa's directors and auditors fulfilled their duties by creating an appropriate risk management system for the NY Branch. The court concluded that Daiwa's system of internal controls was insufficient due to an inappropriate method of confirming custody account balances.⁷⁵

The court essentially utilized a negligence standard and focused on whether there was any "neglect of job responsibility" by each of the defendants. By focusing on a narrow accounting issue, the court never directly addressed the defendants' argument that the NY Branch had an adequate system that Iguchi's unusually clever scheme managed to circumvent. On the other hand, the court's utilization of a negligence standard may also be viewed as an attempt to balance the plaintiffs' heavy evidentiary burden with a lower standard of liability.⁷⁶

The absence of a fully consistent approach reflects the prior lack of necessity to carefully consider the standard of liability, analysis of which had previously been largely theoretical. With the Daiwa Bank Case decision providing the first instance of director liability in an oversight context, or for that matter in any context outside of a narrow range of bribery cases, this question is now the subject of active debate in Japan.

74. A general distinction exists between the courts' approach to director liability in the United States, where it typically focuses on a director's action or inaction with respect to a board resolution or to a board's failure to act, and Japan, where it tends to focus on an individual director's supervising particular employees. For the former, see *infra* sections IV. A & B; for the latter, see *supra* note 70 and accompanying text.

75. The NY Branch utilized a typical reconciliation procedure by which it compared the custodian's account statements with its own books and records. But since the custodian's account statements were obtained through Iguchi, this confirmation method left room for concealment by a trader. The court emphasized that the confirmation of account balances is the most basic and effective method of controlling the risk inherent in the custody business and that it requires physical confirmation of securities or, as in this case, where securities are undocumented book-entry securities it requires obtaining account statements directly from the custodian actually holding the securities. Daiwa Bank Case, at 39.

76. See Shinsaku Iwahara, *Daiwa Ginko Daihyo Soshu Jiken Isshin Hanketsu to Daihyo Soshu Seido Kaisei Mondai* [Trial Court Decision in the Daiwa Bank Derivative Suit Case and Question of Revision of the Derivative Suit System (Part I)], 1576 SHOJI HOMU 4, 12 (2000) (cautioning against a strict application of the burden of proof, under which plaintiffs could be required to prove that changes in the internal control system of Daiwa's NY Branch would have prevented the trading losses, as such a requirement would make proof of any internal control inadequacies extremely difficult).

B. Second Case—Violation of Law and Administrative Guidance

In the Second Case, the court ruled that compliance with foreign law was included in a director's duty of care and went on to find, based on negligence, that eleven directors breached their duties of care and loyalty for specific illegal acts and the failure to report or to cause the representative director to report to U.S. authorities.⁷⁷ The Commercial Code specifically provides that directors shall be liable to the corporation for "any act which violates any law, ordinance or the articles of incorporation."⁷⁸ There has been an ongoing debate in Japan over whether the Japanese term for law and ordinance, *horei*, was intended to cover all violations of law or only certain "important" violations.⁷⁹ The Daiwa Bank court found that the Commercial Code required compliance with foreign law if a company expands its business overseas and establishes overseas offices.⁸⁰ Dismissing the defendants' argument that they did not know U.S. banking laws and regulations, the court concluded that the defendants, as managers of a bank with U.S. operations, were negligent in their failure to investigate U.S. law in a timely manner.⁸¹

Although there is no statutory basis in the Commercial Code or elsewhere requiring any deference to the business judgment of directors, Japanese courts have in fact afforded deference to business judgments.⁸² While

77. Although the board of directors approved the plea bargain by passing a resolution and paying a \$340 million criminal fine to U.S. authorities, no defendant was found liable for approving or failing to object to the board's resolution. Rather, the court examined the individual circumstances of each defendant and looked to see if and when a defendant learned of the cover-up from the president, i.e. representative director, of Daiwa and failed to exercise his duty as a director or auditor by objecting to the plan in a timely manner. As no one objected to the plan, all of the directors who were involved in formulating and implementing the cover-up were found to be liable. See *Daiwa Bank Case*, at 43-44.

78. SHOHO art. 266-1-5.

79. The more popular view was that this concept was intended, as literally stated, to cover all violations of law. See *Kawashima & Sakurai*, *supra* note 53, at 23-24. However, there is some question as to the practical difference in result between these two approaches, as they both presumably require at least negligence in order to find director's liability. The leading case in this area is the *Nomura Securities Loss Compensation Case*, a derivative suit centering on Nomura's payments to certain large shareholders in compensation for losses in their brokerage accounts. Although the Japanese FTC subsequently ruled that this practice violated Japanese antitrust law, the courts found no director's liability because directors had no knowledge and presumably could not have readily obtained knowledge that the action was illegal. The Supreme Court decision in this case clearly embraced the "unlimited theory," deciding that violation of any law would subject directors to liability. See *Kameda v. Tabuchi*, 54-6 MINSHU 1767 (S. Ct., July 7, 2000), 1729 HANREI JIHO 28 (2000) [*Nomura Securities Loss Compensation Case*]. Nevertheless, the *Nomura Securities Loss Compensation Case* suggested to some that directors in Japan would not be held to a high standard for violations of law, which were not "knowing" violations.

80. *Daiwa Bank Case*, at 42.

81. *Id.* at 47. The court was also unwilling to believe that the Daiwa directors were unaware that filing false call reports with the FRB and creating false Bankers Trust account statements was against U.S. law even if they were not completely familiar with the detailed provisions. *Id.*

82. As the business judgment rule is not as clearly defined as in the United States, Japanese commentators proposed many variations of standards which were utilized in

the formulation of a standard for the business judgment rule remains an issue in Japan,⁸³ most applications of the business judgment rule have resulted in the rejection of directors' liability.

In the Daiwa Bank Case, the defendants contended that their conduct involved difficult judgments relating to the bank's predicament, was done in good faith and was within the discretion afforded to them by the business judgment rule. Despite ruling that the business judgment rule was inapplicable, the court went on to formulate a standard for the business judgment rule⁸⁴ and then reject the defendants' arguments for its application, even voicing doubts about Daiwa's intention to inform U.S. regulators and the public about the incident.⁸⁵ It further concluded that Daiwa's president 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.⁸⁶ The case thus sounds in gross negligence, because the court found liability on the part of the defendants regardless of the application or non-application of the business judgment rule.

One of the most striking aspects of the Daiwa Bank Case, which is of particular interest to American readers, is the court's departure from prior practice concerning the bank's informal consultations with bureaucrats, which are popularly referred to as "administrative guidance." The defendants in the Daiwa Bank Case sought to rely on administrative guidance from the MOF to excuse the bank's failure to report its losses to U.S. authorities in a timely manner. However, the Daiwa Bank court not only rejected this argument, it also demonstrated a clear hostility to the practice

court decisions. Most Japanese commentators have advocated following an ALI-based approach. Courts in Japan have tended to include in their business judgment standard some examination of the reasonableness of the substantive business judgment. In Japan, traditional views hostile to public disclosure of confidential corporate processes, together with the absence of an effective discovery system, would make it difficult for the plaintiffs or the court to have sufficient information on the decision-making process to focus only on procedural issues as do courts in Delaware.

83. Although formulations differ somewhat, one oft-cited example of a standard for the business judgment rule from the Tokyo district court's decision in the Nomura Securities Loss Compensation Case looks at whether "a careless mistake in understanding of the factual premises of the decision was made or if the process of decision-making based on these facts was markedly unreasonable as an ordinary businessman . . ." See Nomura Securities Loss Compensation Case, at 1469 HANREI JIHO 30.

84. The Daiwa Bank court emphasizes that directors must use discretion in making business judgments, and accordingly, finding liability on the part of directors for breach of the duty of care or loyalty requires "that, at the time the measure was taken, there was an important and careless mistake in understanding of the factual premises of the director's decision or the process, substance of decision-making is especially unreasonable or inappropriate as a business manager." See Daiwa Bank Case, at 45. Compared to past formulations, the standard of the business judgment rule in the Daiwa Bank Case clearly includes a review of the substance of decision-making to the same extent (i.e., reasonableness) as procedural aspects. Although this has been noted by Japanese commentators, as discussed above, it is unclear whether it would result in a different substantive outcome under the Japanese system.

85. *Id.* at 46.

86. *Id.* at 47.

and the underlying mindset of permitting corporate directors to follow government suggestions rather than make independent judgments in the best interests of their corporation.

This regulatory practice of administrative guidance, utilized in conjunction with industrial policy, is largely responsible for the widespread view that Japan has a “unique” culturally based administrative system.⁸⁷ However, administrative guidance is not a legal concept and has never been satisfactorily defined.⁸⁸ Although formulations differ, administrative guidance is generally described as government agencies obtaining informal cooperation from industries, companies or individuals to take or refrain from taking some action.⁸⁹ Despite its historical prevalence, businesses and commentators in Japan have recently joined in the international call for replacing administrative guidance in Japan with “transparent,” rule-based administration.⁹⁰ Administrative practices in several important

87. See, e.g., CHALMERS JOHNSON, *MITI AND THE JAPANESE MIRACLE* (1982) (citing the popularity of, but disagreeing with, this culturally based view). This view emphasizes close government-business relations in Japan which are buttressed by the practice of “*amakudari*,” whereby retired government bureaucrats join and play important roles in private enterprises. *Id.* See Meryll Dean, *Administrative Guidance in Japanese Law: A Threat to the Rule of Law*, *J. BUS. L.*, Jul. 1991, at 398, 403 (1991) (defining administrative guidance as “a tool that provides maximum administrative flexibility within a framework of minimum legal formality and is sustained by a uniquely Japanese system of consensus bonding.”)

88. See generally Mitsuo Matsushita, *The Legal Framework of Trade and Investment in Japan*, 27 *HARV. INT'L. L.J.* 361, 376 (1986). Attempts to formulate a legal definition often wind up characterizing it by what it is not—it is not formal administrative action (i.e., “*shobun*” or disposition) which would be subject to judicial review. See generally John O. Haley, *Japanese Administrative Law*, 19 *LAW JAPAN* 1 (1986). Even this assumption of non-reviewability by courts is challenged by Mark Ramseyer, who focuses on a line of successful tort claims by real estate developers against local governments that regulated development informally through administrative guidance. In his view, the real issue is a political one, as informal administrative actions by leftist-dominated local governments are reviewed “brutally” by courts when such local actions “challenge the preferences of the ruling party.” J. Mark Ramseyer, *Rethinking Administrative Guidance*, in *FINANCE, DEVELOPMENT AND COMPETITIVENESS IN JAPAN 199* (Masahiko Aoki & Gary R. Saxonhouse eds., 2000); see Takehisa Nakagawa, *Administrative Informality in Japan: Governmental Activities Outside Statutory Authorization*, 52 *ADMIN. L. REV.* 175, 205-07 (2000) (drawing a hypothetical analogy between ways American and Japanese courts handle cases of administrative law).

89. As an example of the travails which beset a small businessman who attempted to defy the bureaucracy, see Frank K. Upham, Review Article, *The Man Who Would Import: A Cautionary Tale About Bucking the System in Japan*, 17 *J. JAPANESE STUD.* 323 (1991) [reviewing TAJI SATO, *ORE WA TSUSANSHO NI BARASARETA!* (1986)]. American commentators analyzing Japanese regulatory tactics have tended to view administrative guidance as a form of private ordering which features bargaining and negotiation among interested private parties. See generally Michael K. Young, *Judicial Review of Administrative Guidance: Governmentally Encouraged Consensual Dispute Resolution*, 84 *COLUM. L. REV.* 923 (1984); Frank K. Upham, *Privatized Regulation: Japanese Regulatory Style in Comparative and International Perspective*, 20 *FORDHAM INT'L L.J.* 396 (1996).

90. For example, by the mid-1990s, Japan's leading business organization was publicly calling for “eliminating administrative guidance as much as possible” and for the establishment of rule-making procedures which permit public participation. See *Keidanren, Request for Deregulation: Basic Philosophy*, Oct. 28, 1996, available at <http://www.keidanren.or.jp/english/policy/pol054/basic.html> (last visited Mar. 31, 2003) (in English).

areas, such as financial services, have been reevaluated and modified in the last few years.⁹¹

There have also been a limited number of cases, like the Daiwa Bank Case, where defendants sought to use administrative guidance to excuse actions which otherwise would give rise to civil or criminal liability, particularly with respect to alleged violations of Japan's antimonopoly law. However, in contrast to the outcome in the Daiwa Bank Case, defendants were generally successful. Although courts ruled that informal administrative guidance had no legal effect, they nevertheless were sympathetic to administrative guidance and ultimately relied on it as a significant factor in finding no liability on the part of defendants.⁹²

In the Daiwa Bank Case, the Osaka District Court adopted a strikingly hostile attitude towards administrative guidance. The defendants in the Daiwa Bank Case did not claim that compliance with oral advice from the MOF constituted an independent legal defense. Rather as in prior cases, they contended that it should excuse their failure to disclose losses to U.S. authorities in a timely manner as a legitimate exercise of their business judgment.⁹³ The court rejected the defendants' argument that they were bound by requests or suggestions from the MOF, ruling that there was insufficient evidence that the MOF had taken any action based on its legal authority.⁹⁴ The court criticized the defendants for attempting to "adhere

91. For example, the Financial Services Agency was established in 1998 in large part due to a desire to have rule-based regulation and supervision over the banking, securities and insurance industries. In 1999, the agency published its first Bank Examination Manual, in contrast to prior practice of maintaining secret internal regulations (*naiki*) on such matters.

92. For example, in the well-known Oil Cartel Cases, courts found no liability in two criminal and two civil lawsuits where defendants sought to use administrative guidance to excuse violations of Japan's antimonopoly law. See generally Ramseyer, *Costs of the Consensual Myth*, *supra* note 14. Translations of portions of decisions in the two criminal cases appear in J. Mark Ramseyer, *The Oil Cartel Criminal Cases: Translations and Postscript*, 15 LAW JAPAN 57, 57-66 (1982); see also Upham *supra* note 15, at 184-88.

The leading recent case in this area is the Nomura Securities Loss Compensation Case, in which the defendant directors cited administrative guidance by the Ministry of Finance as leading them to believe that it was appropriate to provide compensation to certain large customers for securities losses. Japanese courts cited this administrative guidance as one factor in reaching the determination that Nomura directors were not negligent and accordingly would not be liable in violating the Antimonopoly Law. See *Kameda v. Tabuchi*, 54-6 MINSHU 1767 (S. Ct., July 7, 2000), 1729 HANREI JIHO 28 (2000) [Nomura Securities Loss Compensation Case].

93. Daiwa Bank Case, at 45.

94. There is no doubt that the MOF had the necessary legal authority, as like bank regulators elsewhere it has broad discretion to regulate the "safety and soundness" of banks and to issue legally enforceable orders based on such concerns. See GINKO HO [Banking Law] (Law No. 59 of 1981) art. 26. Thus, this is not a case where the regulator could be accused of relying on a broad enabling statute in order to assert administrative authority over matters not clearly contemplated by law to fall within its jurisdiction. The court characterizes the defendants' argument as being based on requests (*yōbō*) or suggestions (*shisa*) from the MOF but does not directly utilize such characterizations in its own judgment. In this regard, it should be noted that prior cases involving administrative guidance, such as the oil cartel cases, tended to involve an entire industry, with the guidance sometimes being in written form. By contrast, the Daiwa Bank Case involved oral discussions with only one bank. Perhaps in order to compensate for this weakness,

to unofficial local rules” despite the fact that the Japanese economy “has been developing and expanding on a global scale” and for relying on the government instead of fulfilling their role as directors by reaching their own independent decisions.⁹⁵

Among Japanese commentators, the court’s approach to causation and damages was one of the most controversial aspects of the court’s decision among.⁹⁶ A lack of legal causation between director’s acts and the resulting damages was a popular argument of defendants in shareholder derivative suits in Japan, and it was particularly so in the Daiwa Bank Case. Defendants argued that \$350 million dollars in damages were not foreseeable because they resulted from a plea bargain and the general U.S. doctrine of vicarious liability for which there are no Japanese equivalents.⁹⁷ However, the court found that legal causation existed, as it had already found causation between the defendants’ acts and their payment of the U.S. criminal fine, and because there were no special circumstances such “as the process and results of the plea bargain being markedly different from that which is normally anticipated.”⁹⁸

In calculating the amount of damages, the court looked specifically at the liability of each defendant with respect to each count of the indictment. Since the four representative directors were only involved in certain counts (1-7) of the indictment, the court concluded that damages should be based on each defendant’s degree of contribution to the facts which gave rise to the criminal penalty, rather than bearing joint and several liability for the entire amount. Using this method, the court arrived at a number of \$105 million for each of the defendants.⁹⁹

III. Comparison with U.S. Law

A comparative look at similar U.S. cases and statutes illuminates some of the policy considerations behind the court’s decision and the issues that will be debated in Japan in the aftermath of the Daiwa Bank Case. The

the defendants emphasized the crisis engulfing Japan’s entire financial system as justification for the ministry’s advice and their reliance on it.

95. Daiwa Bank Case, at 46.

96. See, e.g., Iwahara, *supra* note 76 (Part II), 1577 SHOJI HOMU 4, 8 (2000); Tatsuo Uemura, *Torishimariyaku ga tai Kaisha Sekinin wo Ou baai ni okeru Songai Baisho no Hani* [The Scope of Compensatory Damages in cases where a Director is liable to the Corporation], 1600 SHOJI HOMU 4 (2001).

97. It was repeatedly argued that under Japanese law a corporation would not be liable for the wrongdoing of an individual, and that actions such as false reports and false entries in bank records would likely result only in a regulatory violation with a modest administrative fine. See generally Ken Kawamura, *Daiwa Ginko no Daihyo Soshu Hanketsu ni Omou* [Thinking about the Court Decision in the Daiwa Bank Derivative Suit], TORISHIMARIYAKU NO HOMU 4, 6 (Oct. 25, 2000). Another argument was that Japanese courts should refuse to enforce such a fine as being against Japanese public policy, as had occurred in a prior case involving punitive damages in tort. *Id.*

98. Daiwa Bank Case, at 47.

99. The other defendants who were found liable were subject to a similar scrutiny, with the results that three defendants were each liable for \$70 million, one for \$157.5 million and two for \$245 million. *Id.* at 48.

significance of the Daiwa Bank Case in Japan might best be explained by viewing its effect as equivalent to the combined impact of the two most controversial cases in U.S. corporate law during the last twenty years, *Smith v. Van Gorkom*¹⁰⁰ in the 1980s and *In re Caremark International Inc. Derivative Litigation*¹⁰¹ in the 1990s. As in these cases, unexpected findings of new duties and actual liability in the Daiwa Bank Case upset well-established expectations concerning the previously limited grounds for directors' liability and generated tremendous controversy.

A. *Van Gorkom* and the Business Judgment Rule

Perhaps the best-known and most contentious court decision in U.S. corporate law is *Van Gorkom*, in which the Delaware Supreme Court found a violation of the directors' duty of care in apparent disregard of the business judgment rule.¹⁰² The business community was greatly alarmed at the apparent uncertainty the *Van Gorkom* decision created—with its potential effects on the availability of directors' insurance and willingness of qualified candidates to serve as directors. The following year the Delaware legislature enacted a new charter exculpatory provision under which corporations may limit director liability to certain specific circumstances by adding a provision to the corporation's articles of incorporation.¹⁰³

Among the issues raised by *Van Gorkom* commentators, the question of hindsight bias is highly relevant to the Daiwa Bank Case. A fundamental underpinning of the business judgment rule is the concern about the adequacy of the litigation process to judge the reasonableness of directors' decision-making in hindsight. The court in the Daiwa Bank Case acknowledged this danger and explicitly stated that it must not apply current standards concerning internal controls retroactively to Daiwa's directors during the 1984-95 period. The Daiwa Bank court nevertheless found a breach of directors' duties by narrowly focusing on a detailed aspect of internal controls that may not have been considered significant under the standards prevailing during that period. It appears that Japanese courts will now face the same issues relating to standards for liability and the business judgment rule which have troubled U.S. courts,¹⁰⁴ although recent legislation

100. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

101. See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

102. The Delaware Supreme Court found directors' liability based on gross negligence due to the failure to make an informed judgment in approving a cash-out merger by utilizing all material reasonably available. 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 Hamermesh, *Fiduciary Duty, Limited Liability and the Law of Delaware: Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477 (2000).

103. See DEL. GEN. CORP. LAW §102(b)(7). This approach has been adopted with some variation by most states and has been accepted by the model business corporation act and the ALI.

104. In both countries, the business judgment rule represents legal doctrine that seeks to achieve a balance between providing directors with discretionary authority to

enacted in response to the Daiwa Bank Case has essentially institutionalized the business judgment rule in Japan.

Rather than legal doctrine, however, the comparison with *Van Gorkom* is most relevant in relation to the broad impact of the court's decision on business, legislatures and markets. In both the Daiwa Bank Case and *Van Gorkom* the prior perception of business was that prevailing standards of liability were sufficient to avoid directors' liability in instances where directors were simply exercising their normal business judgment. Liability would only occur in exceptional cases which did not merit the protection of the business judgment rule in the U.S. or which represented instances of clear misconduct by directors in Japan. Both the Daiwa Bank Case and *Van Gorkom* cast serious doubt on the proposition that the small subset of derivative suits that are likely to result in directors' liability was well-established and stable. Similarly, intense reaction by businesses, adoption of new legislation to curb derivative suits, and significant change in insurance markets occurred in both countries.

B. *Caremark*, Compliance and the Duty of Oversight

The other highly relevant U.S. case is *Caremark*, which is the leading Delaware case on the oversight/monitoring component of a director's duty of care.¹⁰⁵ A decade after *Van Gorkom*, the *Caremark* decision shocked the business community by creating a new potential liability for corporate directors—an affirmative duty of oversight to “attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists.”¹⁰⁶ This might be functionally similar to the

make business judgments and providing an incentive to ensure good faith performance of their duties. The difficulties in formulating and implementing a standard to achieve this balance 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 or enough of a “safe harbor” in light of the broad discretion directors are expected to exercise. This dilemma goes far in explaining the procedural emphasis in *Van Gorkom* and the ongoing debate over what extent, if any the business judgment rule covers the substance of business decisions. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

105. Like the Daiwa Bank Case, *Caremark* 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. See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

106. *Id.* at 970. In finding an affirmative duty of oversight, the Delaware Chancellor characterized the prior *Graham v. Allis-Chalmers Mfg. Co.* decision as a reliance case in which directors and executors may assume the honesty of employees absent any grounds for suspicion. See *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963). Having established a duty of care, the Chancellor then proceeded to emphasize how difficult it would be to prove a violation of this duty generally and the “very low probability” of plaintiffs proving their case on the merits. See *Caremark*, 698 A.2d at 971. As *Caremark* had enacted an exculpatory charter provision, presumably the only basis for liability would be a knowing violation of law or a lack of good faith; neither was found in the case. *Id.* The Chancellor nevertheless approved the proposed settlement as providing a benefit to the corporation. *Id.* at 972. The only immediate consequence of the litigation

requirement in the Daiwa Bank Case that the board of directors establish policies with respect to internal controls and compliance with law. Any overall policy adopted at the board level would presumably consist of a brief mission statement followed by a division of responsibilities among management and some system for the board to receive reports. It would thus be relatively brief and primarily procedural in nature, although requiring a board resolution would assure that the board was involved in the initial division of responsibilities and relevant procedures.

It is interesting to note that the Chancellor in *Caremark* found no knowing violation of law despite a number of indictments and substantial fines. In addition to the board having overseen the establishment and implementation of appropriate compliance and ethics policies, the Chancellor also found that there was no complicity by the board or senior management in any wrongdoing,¹⁰⁷ and that there was consultation with, and appropriate reliance on the advice of outside counsel with respect to the corporation's contracting practices.¹⁰⁸ Daiwa's practices may have failed on all these counts.

While setting forth a general rule concerning a director's duty of corporate monitoring, the *Caremark* case also made clear that it would be difficult to establish directors' liability. Liability for failure to act would only occur if the plaintiffs were successful in establishing the directors "utter failure to attempt to assure a reasonable information and reporting system."¹⁰⁹ In the First Case, which dealt with trading losses,¹¹⁰ the Daiwa Bank court found liability for four defendants and damages for one director in this type of situation, seemingly going beyond U.S. court decisions to date. In the Second Case, which dealt with violation of law,¹¹¹ the Daiwa Bank court found liability for a violation of law without reference to the business judgment rule. Unlike *Caremark*, Daiwa was not aided by its ex post and seemingly grudging consultation with lawyers—a subject of great importance to which I now turn.

may have been an award for the plaintiffs' attorneys' fees of \$816,000 plus \$53,000 in expenses, because even though the settlement was approved its substance did not have a real impact on *Caremark*. *Id.*

107. The Chancellor emphasized a stipulation in sentencing in one of the indictments that "no senior executive of *Caremark* participated in, condoned, or was willfully ignorant of wrongdoing in connection with the home infusion business practices." *Caremark*, 698 A.2d at 965.

108. *See id.* at 971. With respect to knowing violation of the statute, the Chancellor's decision notes that "the Board appears to have been informed by experts that the company's practices, while contestable, were lawful. There is no evidence that reliance on such reports was not reasonable." Justified reliance on the advice of outside legal counsel thereby assures that there was no knowing violation of law which would give rise to director's liability. *Id.*

109. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

110. *Daiwa Bank Case*, at 40-41 [*Ko* case or "First Case"].

111. *Daiwa Bank Case*, at 47 [*Otsu* case or "Second Case"].

C. Role of Outside Experts

One striking comparison between the U.S. cases and the Daiwa Bank Case is the issue of the directors' use of outside counsel and other experts in reaching board decisions or exercising oversight functions. U.S. law allows the use of outside experts, if they are selected with due care and relied upon in good faith.¹¹² In *Van Gorkom*, while the Delaware Supreme Court 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,¹¹³ 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.¹¹⁴ New emphasis on effective compliance programs that adhere to U.S. Sentencing Guidelines as well as a greater direct role for the board in oversight of compliance policies clearly imply the potential for an even greater role for legal counsel in formulating, implementing, and monitoring compliance policies.

By any measure, Japanese corporate governance has not traditionally emphasized consultation with outside experts to aid a board of directors in making board decisions or in otherwise fulfilling its fiduciary obligations to the corporation. On the contrary, when Japan appeared all-powerful in the 1980s, Japanese business leaders regularly cited Americans' overemphasis on lawyers and neglect of product quality and manufacturing processes as a major obstacle to their international competitiveness. The practices of administrative guidance discussed above left little room for the application of formal legal rules and, accordingly, no significant role for lawyers. Traditional views of maintaining strict confidentiality for business information also militated against early and effective consultation with lawyers.

Prior to the collapse of the bubble economy and the increase in derivative litigation which began in 1993, there was no particular need to consider the issue of legal advice as a matter of law or practice. Thereafter, the use of outside counsel by corporate managers and boards in Japan began to gradually increase. Legal doctrine also began to develop, particularly in the late 1990s, culminating with the Daiwa Bank court's recognition of directors' right of reliance on other directors, statutory auditors, and employees. The Daiwa Bank court was the first court to deal with the the issue of reliance on outside counsel.

112. See DEL. CODE ANN., tit. 8, § 141(e) (1991); MODEL BUS. CORP. ACT § 8.30(c) (1984) (expressly preventing a director from "hiding his head in the sand" when he has actual knowledge that would make his reliance upon certain information, opinions, reports or statements unwarranted).

113. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)

114. *Caremark*, 698 A.2d at 971. In *Van Gorkom*, the defendants also argued that they approved the proposed transaction upon advice of counsel, but the court rejected their contention. See *Van Gorkom*, 488 A.2d at 880.

The clash between traditional business attitudes and changing practices and legal doctrine are evident in the Daiwa Bank Case. The bank felt no need to consult with counsel in Japan upon discovery of the trading losses in July of 1995, since its responsibility would depend on its informal relations with the MOF. There was also little initial focus on U.S. law, other than the desirability of avoiding it by moving the losses out of the United States and the jurisdiction of U.S. regulators. Daiwa officials in Japan consulted with U.S. counsel indirectly in late August and directly in early September, but only after being urged to do so by the bank's U.S. headquarters.

One irony of the Daiwa Bank Case is that timely and full consultation with a U.S. lawyer may have allowed Daiwa to escape both expulsion from the United States and criminal liability.¹¹⁵ A second even greater irony is that in the derivative suit in Japan Daiwa argued that its directors should not be liable for violations of U.S. law because they did consult with U.S. counsel concerning their proposed timetable for the disclosure of losses to U.S. bank regulators and that they tried in good faith to comply with U.S. law following consultation with an attorney. The court rejected Daiwa's argument, essentially characterizing the consultation with U.S. lawyers as being "too little, too late" in light of the unusual trading loss. Finally, as discussed above, the Daiwa Bank court gave short thrift to the defendants' excuse of administrative guidance, and went on to castigate the defendants for attempting to rely on informal agency advice rather than fulfilling their fiduciary duty to make an independent judgment in the best interests of the corporation.¹¹⁶

If cynics call *Van Gorkom* a decision calling for "full employment for investment bankers," both the *Caremark* and Daiwa Bank Case decisions could similarly be characterized as full employment measures for lawyers. In the Daiwa Bank Case, the question of consultation with lawyers arose in the broader context of the defendants' intent or negligence in the violation of U.S. law, rather than directly as a right of reliance issue. Nevertheless, the Daiwa Bank Case discusses this question for the first time, creating an expectation that such reliance would likely be permitted. Whatever the precise formulation or application of such a right of reliance,¹¹⁷ it would undoubtedly prove quite valuable to defendants in derivative suits and might change corporate practices in Japan regarding the use of outside experts, which are explored in Part IV.

115. If Daiwa had promptly reported Iguchi's crimes and cooperated with U.S. authorities, it "stood a very good chance of never being indicted." See Steven A. Miller, *How Daiwa Self-Destructed*, 113 *BANKING L.J.* 560, 575 (1996). This would require, however, Daiwa to have consulted with U.S. counsel on a timely basis and to have been prepared both to provide the necessary factual information to counsel and abide by the resulting legal advice. See *id.*

116. *Nishimura v. Abekawa*, 1573 *SHOJI HOMU* 3, 46 (Osaka Dist. Ct., 2000) [Daiwa Bank Case].

117. The few cases in Japan that discuss the right of reliance do not contain any qualifiers concerning the reasonableness or good faith in the exercise of such reliance. See Iwahara, *supra* note 76, at 13-14.

D. Role of Courts and Legal System

The conundrum of directors' liability—how to allow directors to proceed unhindered with their business responsibilities but nevertheless provide an incentive for good faith performance—may be largely responsible for the current state of derivative suit practice in the United States. As previously noted with respect to Delaware courts, it is not necessary for courts to rule in favor of plaintiff shareholders in order to influence corporate behavior.¹¹⁸ Courts enunciate principles that could theoretically lead to director's liability, at least under an egregious fact pattern. In reality, significant procedural and substantive barriers, such as the demand requirement and the business judgment rule (including exculpatory charter statutes) mean that plaintiffs lose the bulk of derivative suits at an early stage based on defendants' motion to dismiss, often with no or only limited discovery. The few cases that survive a motion to dismiss are generally settled by the defendant directors because directors, including outside directors, would be subject to the full burden of discovery by being called as witnesses despite their limited knowledge of the subject matter. Further, settlement in which directors typically admit no liability or wrongdoing virtually assures that the corporation's indemnity of the directors and Directors and Officers' (D&O) liability insurance will take effect.

This pattern in the United States has led to the widespread criticism that the derivative suit system does not effectively improve corporate governance.¹¹⁹ However, any court decision which is seen as departing from this pattern and opening up new potential avenues for director's liability can have an outsized impact. One could argue that *Van Gorkom*, *Caremark*, and *Daiwa Bank* were all unusual cases that should not be of undue concern to a conscientious board.¹²⁰ Yet, these cases invoked tremendous corporate responses, including legislative efforts to limit directors' liability, because they appeared to threaten industry's perceived certainty of the standard of liability.

118. See generally Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

119. See Romano, *supra* note 9.

120. *Van Gorkom* involved an egregious fact pattern and the liability found there could presumably have been avoided by 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 contained measures concerning compliance policies that were consistent with corporate initiatives already underway at the time. *Daiwa* also involves egregious facts, which are unlikely to be repeated. In addition, the outcomes of the latter two cases were also affected by their procedural posture. If *Caremark* had been judged on the merits, rather than as approval of a settlement, it is possible that there would not be a duty of oversight in Delaware law today. Similarly, the *Daiwa Bank* Case first went to the Osaka high court in the form of a security for expenses motion by the defendants, which if granted, as had been done by the district court, would have resulted in the dismissal of a well-known and significant suit (a huge banking scandal with acknowledged criminal liability) without giving plaintiffs their day in court. Instead, the high court recognized that the duty of oversight included a duty to formulate an overall policy of internal controls, thereby deciding that the plaintiffs' pleadings were sufficient for that stage of the litigation and allowing the case to proceed on the merits.

Viewed in a positive light, these court decisions could have an educational effect by improving corporate governance practices. Executives' strong reaction to and fear of such cases, combined with the role of lawyers in advising corporations on new risks and preventative measures, can act as an important tool for improving corporate governance practices.¹²¹ Although some claim that lawyers overstate such risks when advising corporate clients,¹²² one would expect clients to pay close attention to any potential risk, no matter how remote, of personal liability that would not be subject to corporate indemnification. Regardless of whether Delaware courts consciously count on this effect when rendering decisions, the result is that corporate governance practices can be affected and presumably improved by means of a very small number of cases which find potential or actual liability on the part of directors.

From their published opinions it is generally difficult to ascertain the presence of a similar role for Japanese courts. Their judgments are generally short, do not cite court precedents other than Supreme Court cases, and rarely engage in the kind of policy discussions which are fairly common in U.S. decisions. For example, the court in the Daiwa Bank Case, unlike the *Caremark* court,¹²³ does not justify the imposition of a duty of oversight by discussing any underlying legal and societal changes. Instead, the Daiwa Bank court treats the duty of oversight as established law. However, something clearly is going on in the Daiwa Bank Case—it is unlikely a coincidence that a decision that grants an enormous damage award based on a duty of oversight for the first time is also an amazingly lengthy decision, particularly by Japanese standards.¹²⁴ One certainly suspects that the Daiwa Bank court had motivations, akin to those sometimes ascribed to Delaware courts, of setting corporate norms and showing the “bad” behavior of defendants to legitimize its exercise of judicial power.¹²⁵ The role of the Daiwa Bank court is also striking in light of the more conservative approach of Japanese courts to date in somewhat analogous circum-

121. See Rock, *supra* note 118; see also Deborah A. DeMott, *Organizational Incentives To Care About the Law*, 60 LAW & CONTEMP. PROB., Autumn 1997, at 39, n. 102 (1997).

122. See Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375 (1997).

123. In support of his view, the Chancellor cited three changes since the *Graham* decision of 1963: (1) the seriousness of the board's role in corporate law under Delaware case law; (2) the necessity of the board's obtaining information in order to fulfill its basic management function under Delaware corporate law; and (3) the federal organizational sentencing guidelines which raised the stakes with respect to corporate compliance with law and increased the importance of corporate reporting systems. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 969-70 (Del. Ch. 1996).

124. The court's decision was over 300 pages or some 50 printed pages when reprinted in legal journals. This is probably some ten times the length of a typical court decision in Japan.

125. See Rock, *supra* note 118; see also *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) [Trans Union Case]. The Daiwa Bank court highlights the defendants' inappropriate behavior, explicitly expressing skepticism, for example, that the bank's management ever intended to report the bank's losses to U.S. regulators. See *Nishimura v. Abekawa*, 1573 SHOJI HOMU 3, 45 (Osaka Dist. Ct., 2000) [Daiwa Bank Case].

stances.¹²⁶ U.S. commentators have already noted the educational role of the Daiwa Bank court's decision.¹²⁷

IV. Aftermath of the Daiwa Bank Case

A. The Shareholder Derivative Suit System

The Daiwa Bank Case will have a significant impact on the functioning of Japan's shareholder derivative suit system in the two related areas of pleadings and settlement. Prior to the Daiwa Bank Case, many derivative suits were dismissed on the basis of a defendant's demand for plaintiffs to post security for expenses. Substantial amounts awarded under this rubric at the pleading stage ended the litigation before it started. The standard for granting security for expenses went beyond the doctrine's stated purpose of weeding out abusive litigation and substantially burdened plaintiffs in Japan where corporate information is closely guarded and not generally available. The Osaka high court's reversal of the district court's decision granting the defendants' demand for security for expenses is a significant precedent for other plaintiffs in derivative suits because it may encourage courts to apply the prevailing standard flexibly so as not to end seemingly non-abusive suits at a preliminary stage.

Similarly, the Daiwa Bank Case will also likely affect Japanese practices concerning the settlement of derivative litigation. As noted above, one popular view of U.S. practice is for defendants to quickly settle the relatively small number of derivative suits that survive defendants' motions to dismiss. In Japan, on the other hand, defendants have displayed a willingness to settle only a limited set of cases, namely those involving director misconduct where plaintiffs had a realistic chance of victory in court. Following this prevailing practice, the defendants in the Daiwa Bank Case were not prepared to settle allegations relating to violation of a duty of oversight, even after the plaintiffs' suit survived the defendants' motion for security for expenses.

126. It is interesting to contrast the approach taken by the Daiwa court with the earlier Nomura Securities Loss Compensation Case. See *Kameda v. Tabuchi*, 54-6 MINSHU 1767 (S. Cl., July 7, 2000), 1729 HANREI JIHO 28 (2000) [Nomura Securities Loss Compensation Case]. Both cases presumably represent relatively new areas—internal controls and compliance with law in the Daiwa Bank Case and treating all securities customers equally in the Nomura Securities Loss Compensation Case—in which Japanese corporate practices should be improved. The Nomura Securities courts took a conservative approach, declining to find director liability for a number of reasons, including the MOF's administrative guidance. Perhaps the courts felt secure in the knowledge that, in any event, Japanese securities laws were already amended to outlaw the practice on a prospective basis and, incidentally, remove any possible defense of lack of knowledge of a violation of law in any future derivative actions. In reality, however, despite the change of law, Japan has continued to be plagued by cases in which securities companies compensate favored customers for losses. One suspects that the additional factor of a finding of individual director's liability in the derivative suit would have aided in altering this corporate practice.

127. See Milhaupt, *Creative Norm Destruction*, *supra* note 22, at 2116 (including a discussion of the Daiwa Bank Case in this context).

One would expect that the previously prevailing Japanese practice would become somewhat more like existing U.S. practice—a quick settlement would at least be considered for any suit that survives or that is likely to survive defendants' demand for security for expenses. This change already appears to be occurring. Following the court's decision in the Daiwa Bank Case, the defendants in the well-known Sumitomo copper trading scandal quickly agreed to a substantial settlement.¹²⁸

Subsequently, settlement was also reached quickly in the appeal of the Daiwa Bank Case itself by means of an in-court compromise.¹²⁹ The settlement was spurred by a looming reorganization of Daiwa Bank, thus raising the possibility that plaintiffs would lose their standing in the derivative suit.¹³⁰ As a result, in order to preserve the legal findings concerning directors' liability in the district court decision, plaintiffs accepted a total amount in damages of some 250 million yen (\$2.08 million), a significantly lower amount than had been anticipated.¹³¹ However, the plaintiffs

128. The settlement agreement and related materials are reprinted in 205 SHIRYOBAN SHOJI HOMU 162 (2001). In this well-known case, a Sumitomo Corporation employee, Yasuo Hamanaka, caused some \$2.2 billion (280 billion yen) in losses due to copper trading. Shareholders filed a derivative suit against the representative director (for 200 billion yen) and four other directors (for 100 million yen each) alleging breach of duty of care with respect to the trading loss. The suit was originally filed in the Osaka District Court on April 8, 1997. Settlement negotiations began upon the court's recommendation in November 2000 (shortly after the district court's decision in the Daiwa Bank Case in September of that year). The five defendants, while denying legal liability, agreed to pay 430 million yen (\$3.58 million) in settlement. The company also announced reforms of its procedures for general shareholders' meetings (the derivative action was filed following the company's failure to explain the trading scandal at its general shareholders' meeting in June 1996). *Id.*

129. Wakai Chosho [Settlement Agreement] 2000, No. 3654, 3655 shareholder derivative suit, joint litigation participation appeal case (Osaka High Ct., Dec. 10, 2001), reprinted in 1618 SHOJI HOMU 44 (2002).

130. The holding company structure is relatively new in Japan. The Commercial Code has no provision concerning the position of a shareholder in a derivative suit that, due to reorganization, ceases to be a shareholder of the defendant corporation and instead becomes a shareholder of a new holding company. In a recent case of first impression involving the Industrial Bank of Japan converting to a subsidiary of Mizuho Holdings Co. Ltd., the Tokyo District Court, in a literal interpretation of article 267(1) of the Commercial Code, ruled that the plaintiff lost its status as a shareholder upon the corporate reorganization. See *Tatsuya v. Kurosawa* (IBJ case), 205 SHIRYOBAN SHOJI HOMU 109 (Tokyo Dist. Ct., Mar. 29, 2001).

It was widely recognized that this decision led to the undesirable result that directors could escape liability in shareholder derivative suits, and that this might have been avoided by a broader interpretation of the Commercial Code requirement for being a shareholder. Nevertheless, this was also considered an appropriate interpretation of the existing code provision. See, e.g., Mugi Sekido, *Saikin no Daihyo Soshō no Hanrei kara* [From Recent Court Decisions in Derivative Litigation], 553 JICPA J. 48, 50 (2001); *Kabunishi Daihyo Soshō Q&A: Daihyo Soshō chu no Mochikabu Gaisha e no Iko* [Shareholder Derivative Suit Questions and Answers: Change to Holding Company during Derivative Litigation] 1616 KIN YU HOMU JJO 61 (2001).

131. According to press reports, the judges in the Osaka high court proposed a total damage award in the range of one to two billion yen (\$8-16 million). This amount may have been based on the view that the settlement amount should exceed the amount in the Sumitomo copper trading case and on the financial resources of the forty-nine defendants. In an unusual development, defendants rejected the court's proposal; ulti-

succeeded in their original purpose of having all forty-nine defendants make some payment, as opposed to merely the eleven directors found liable in the district court's decision.

This anticipated change in settlement practices is noteworthy because the internal monitoring model of Japanese corporate governance affords no possible role to external monitoring by derivative suits utilizing the formal legal system. The Daiwa Bank court's finding of a violation of the duty of oversight based on a standard of negligence and a violation of foreign law, despite governmental administrative guidance, together with the record-breaking damage awards, should have a real impact on settlement practices. Further, these aspects of the Daiwa Bank Case give derivative litigation the potential to have an impact on corporate governance practices in Japan.

B. Changes in Corporate Practices

It is difficult to measure in any definitive way the effect of the Daiwa Bank Case on corporate practices, since any changes in such practices are ongoing and are a result of multiple causes. Nevertheless, we can easily identify areas of expected change and at least point to anecdotal evidence, which suggests that such changes may well be occurring. As in the *Caremark* case, corporations appear to be responding to the Daiwa Bank Case in three areas: (1) a greater emphasis on compliance policies and internal controls; (2) a greater involvement by the board of directors in this area; and (3) a greater involvement by outside counsel with respect to both the substance of compliance policies and the relevant procedures, including board involvement. As in the United States, there has been a wealth of articles and seminars advising corporations on methods of improving their compliance policies and internal controls. The Daiwa Bank Case has been featured prominently, not only in the mass media, but also in business law publications.¹³² Shortly after the Daiwa Bank Case, a prominent Japanese private group announced an overall revision of its principles of corporate governance, which included a new principle on internal controls and inter-

mately the plaintiffs accepted a settlement on financial terms proposed by the defendants just two days prior to the date of incorporation of Daiwa Bank's new holding company. However, plaintiffs rejected the defendants' demand for a denial of liability in the settlement agreement which instead is silent on defendants' liability. See *Mochikabu Gaisha Semari Kyuten Chokka* [Pressured by Holding Company; Sudden Plummet in Amount], *NIHON KEIZAI SHINBUN*, Dec. 12, 2001, at 39.

132. For example, the court decision was reprinted in its lengthy entirety in a special issue of the leading business law journal (*SHOJI HOMU*), despite also appearing in a related publication which reprints relevant court decisions (*SHIRYOBAN SHOJI HOMU*). It is true that commentators and legal journals had been emphasizing the importance of compliance issues since the Daiwa scandal first arose in 1995, and were also tracking litigation trends on director's liability. A number of them, including *SHOJI HOMU*, told its readers that they should not be surprised by the result in the Daiwa Bank Case. See *Daiwa Bank Case* (preface), 1573 *SHOJI HOMU* at 3. However, it was nevertheless a great shock to the business community and the public at large, partially due to the enormous amount of damages. I cannot recall any other recent case which commanded the entire cover of an issue of *SHOJI HOMU*.

nal audit inspired largely by the decision.¹³³

A closely related issue is whether Japan has the additional transmission mechanism provided by a corporate bar advising its clients. The traditional image of a Japanese attorney, i.e., a solo practitioner who focuses on domestic litigation, shows little promise in fulfilling such a corporate role. The modest increase in the number of lawyers and legal professionals in the 1990s would seem insufficient, despite the now widespread recognition that much more needs to be done.¹³⁴ However, it appears that preventive legal counseling is increasingly being provided both by traditional domestic attorneys¹³⁵ and the steadily growing number of Japanese lawyers who work at large internationally oriented law firms.

Corporations generally, and banks in particular, are being advised to formulate their overall compliance framework and procedures in a general policy approved by the board of directors, and there is evidence that attorneys are becoming more actively involved in such matters. A recent well-known example is the decision by Nomura Securities to add two outsiders to their board of directors—one of them being the best-known Japanese attorney in the area of corporate law and governance practices.

Although there is some anecdotal evidence of increased consultation with corporate lawyers as a direct result of the Daiwa Bank Case,¹³⁶ I con-

133. See Nihon Koporeto Gabanansu Foramu, Nihon Koporeto Iinkai, Kaitei Koporeto Gabanansu Gensoku [Corporate Governance Committee, Corporate Governance Forum, Revised Principles of Corporate Governance] (Nov. 2001), reprinted in 1612 SHOJI HOMU 8 (2001). New principle eleven is entitled “Internal Controls” and calls for the relevant corporate organs to strengthen the internal control and internal audit functions, with the CEO taking the lead and the audit committee of the board of directors whose creation is called for in the principles reviewing such policies. *Id.* at 21. An accompanying article by the principal drafter of the revised principles cites the Financial Services Agency’s examination manuals for financial institutions (1999) and the Daiwa Bank Case (Sept. 2000) as reasons for the principles’ emphasis on internal controls and internal audit. See Tatsuo Uemura, *Kaitei Koporeto Gabanansu Gensoku no Tokucho* [Characteristics of the Revised Principles of Corporate Governance], 1612 SHOJI HOMU 4, 7 (2001). The examination manuals are available on the FSA’s website. www.fsa.go.jp (general) or www.fsa.go.jp/manual/manualj/yokin.pdf.

134. Changes in the importance of legal professionals in the 1990s could be measured in any number of ways: the increase in the number of lawyers, increase in the number of legal department staff in corporations, the current plan to overhaul the Japanese legal education system and establish graduate-level “law schools” in 2004, etc. For an approach which measures this trend by analyzing examination rates for the bar exam and the elite public servants’ exam, see Curtis J. Milhaupt & Mark D. West, *Law’s Dominion and the Market for Legal Elites in Japan* (forthcoming, LAW & POL’Y INT’L BUS. 2003).

135. The potential for a change in the role of Japanese lawyers was recognized by some at an early stage. See Takao Tanase, *The Urbanization of Lawyers and Its Functional Significance: Expansion in the Range of Work Activities and Change in Social Role*, 13 LAW JAPAN 20 (1983) (arguing that the high concentration of lawyers in the metropolises of Tokyo and Osaka was due to the attractive prospect of expanding their traditional range of work activities and social role).

136. For example, a number of lawyers who deal with derivative litigation and corporate governance issues reported a large number of inquiries following the Daiwa Bank Case. See, e.g., *Kyogaku Baisho, Boei e Kigyo Hashiru—Sonpo, Gendogakuage ni Nanshoku* [Huge Damage Amounts, Companies Run to Defend—Casualty Insurance, Reluctance to Raise Coverage Amounts], NIHON KEIZAI SHINBUN, Oct. 23, 2000. Although many compa-

sider it to be a dramatic exclamation point to an existing trend by Japanese corporations to improve corporate governance through consultation and the adoption of more formal, rule-based policies.¹³⁷ Such trend would include the reform of general shareholders' meetings,¹³⁸ dealings with *sokaiya*,¹³⁹ and a gradual increase in the role of lawyers.¹⁴⁰

C. Explosion in Demand for D&O Insurance

While exact data are unavailable,¹⁴¹ public and industry sources provide clear evidence of a sudden surge in demand for D&O insurance following

nies consulted with outside experts following the Daiwa Bank Case, such experts were not necessarily lawyers. The Daiwa Bank Case involved issues of both compliance and internal controls, the latter being an area of expertise of accountants and business consultants.

137. This trend is related to the bursting of the bubble economy and the resulting greater appreciation of the risk inherent in business transactions, together with the corresponding need to take measures to limit such risk and avoid potential corporate and individual responsibility for bad business decisions. The increase in derivative litigation in the 1990s is also a factor in leading to both a new perception of risk and changes in corporate governance.

138. These days, one is more likely to find some genuine give-and-take between shareholders and management as opposed to past practices where management routinely packed the meetings with employees and friendly *sokaiya* and gave a scripted performance. For example, when asked if he had noticed any change in such practices, one manager at a large utility responded that "for the past five years, practices have been changing every year." Interview with Hiroyuki Kobayashi, Manager, Chubu Electric Power Co. Inc., in Nagoya, Japan (Nov. 6, 2001). This was also the immediate cause of, and a major point of contention in, derivative litigation related to the Sumitomo Copper Trading Case. See *supra* note 128 and accompanying text.

139. As a general matter, companies had already reformed their relationships with *sokaiya* prior to the Daiwa Bank Case as a result of previous derivative litigation involving bribes to *sokaiya*. Interview with Toshiaki Yuki, Manager, Osaka Gas Co. Ltd., in Osaka, Japan (Dec. 2001).

140. Although only a portion of the lawyers I interviewed reported any new legal consultations resulting directly from the Daiwa Bank Case, they unanimously cited a general underlying trend in which Japanese corporations more frequently consulted with lawyers. One aspect of this trend has been the increasing use of legal opinions for both proposed board actions and business transactions generally in light of the heightened perception of risk. See *supra* note 137 and accompanying text. In some cases, lawyers were even asked to confirm that a proposed board action constituted a valid exercise of the board's business judgment. Interview with Koichi Takeuchi, Partner, Nagashima, Ohno & Tsunematsu, in Tokyo, Japan (Jan. 17, 2002). I am not aware of any instance where the legal implication of such an opinion was tested in court.

141. Aggregate industry data, published annually by the trade association of property/casualty insurers can be found at the website of the Marine & Fire Insurance Association of Japan, Inc., at <http://www.sonpo.or.jp/english/english.html> (last visited Apr. 6, 2003). Although industry data are itemized for most lines of insurance such as automobile insurance for example, D&O insurance is included in the catchall "miscellaneous" category. As a result, each insurance company regards its data as highly confidential. The reason for this treatment of D&O insurance is not clear. Even prior to the Daiwa Bank Case, D&O insurance premiums for the industry as a whole were substantial, and were widely reported to reach some 7.4 billion yen (\$61.7 million) a year. See, e.g., *Tai Kabusushi Daihyo Soshu no Hokenryo, Sakunendo 74 Oku Yen de Kako Saiko ni, Kigyo, Boei ni Kuryo* [Insurance Premiums for Shareholder Derivative Suits, 7.4 billion yen last year is the Highest to Date, Companies Worried about Defense], NIPPON KEIZAI SHINBUN, Aug. 5, 1999. One could speculate that the industry's reticence is based on a combination of warnings from commentators and others that insurance companies

the Daiwa Bank Case, which overwhelmed the capacity of Japan's insurance industry. Initially introduced in 1993, D&O insurance previously occupied an unimportant role in Japan. There were a number of reasons for its initial unpopularity. First, the U.S.-inspired basic form for D&O insurance was complex and contained numerous exemptions from coverage.¹⁴² Further, payouts by insurance companies under D&O policies were rare because defendants typically won derivative suits, often winning on preliminary motions and without any settlement. Given the increase in derivative litigation and the amounts claimed therein, the percentage of large Japanese corporations who obtained some kind of D&O coverage gradually increased to an estimated 80% of listed companies during the 1990s.¹⁴³ However, these corporations often obtained minimal amounts of coverage. Their coverage typically ranged from 500 million–1 billion yen (\$4.2–8.3 million) for the entire board.¹⁴⁴

The “Daiwa shock” fundamentally changed Japanese corporations' perceptions concerning the necessity of D&O insurance. Despite the rapidly rising cost of insurance premiums after the Daiwa Bank Case, there were huge increases in the coverage levels. Large companies often requested ten times their previous amount of coverage, and a substantial number of companies sought coverage for the first time.¹⁴⁵ This increased

should be cautious in “rescuing” directors for “bad” acts, and the high profitability of D&O insurance to date is due to the rarity of payouts.

142. D&O insurance was first introduced in Japan through the hurried joint efforts of Mitsui Fire & Marine, Co., Ltd. and AIG. The two companies directly translated AIG's form into Japanese. The form was approved by the MOF and, at the time, bound all other insurers in Japan to use the same form. See Kabunushi Daihyō Soshō to Kaisha Yakuin Baishō Sekinin Hoken (D&O Hoken) no Kaisetsu [Commentary on Shareholder Derivative Suits and Directors Liability Insurance (D&O Insurance)] (Mitsui Kaijō Kasai Hoken Kabushiki Gaisha ed., 1994) [Mitsui Marine & Fire Insurance Co., Ltd. ed.] (providing a complete commentary on the standard D&O insurance form); Nobuhiro Awaji, *Kabunishi Daihyō Soshō to Yakuin Baishō Sekinin Hoken no Shikumi* [The Structure of Shareholder Derivative Suits and Directors Liability Insurance], in *KABUNUSHI DAIHYO SOSHO TAIKEI* [Structure of Shareholder Derivative Suits] 353 (Hideyuki Kobayashi & Mitsuo Kondo eds., 1996) (providing a general introduction to D&O insurance in Japan). For a look at the standard D&O insurance form, see Awaji, *supra*, at 403.

143. See, e.g., *Kyogaku Baishō*, *supra* note 136.

144. An additional reason for the low coverage limits was that the payment of insurance premiums were typically split 90% for the corporation and 10% by the individual directors, and there was reluctance to add to the financial burden of directors. See *Kyogaku Baishō*, *supra* note 136.

145. See *Kyogaku Baishō*, *supra* note 136. One insurer indicated to me that his company's increase in D&O premiums for existing customers was in the range of 10–20% and that insurance premiums for new customers represented an additional increase in the same range of 10–20%. This is quite substantial and, of course, only represents additional coverage that the insurance company was willing and able to provide. A substantial number of requests for coverage were also declined. Due to the sudden surge of requests for coverage following the Daiwa Bank Case, insurance companies did not need any marketing strategy to take advantage of changed perceptions; rather they were preoccupied with trying to meet the new demand for coverage from both existing and new customers. Interview with Takumi Matsumae, Deputy Manager, Tokyo Marine & Fire Insurance Co. Ltd., in Tokyo, Japan (June 10, 2002).

demand quickly overwhelmed the capacity of the Japanese insurance industry to provide coverage.

The industry was overwhelmed because in order to avoid unhedged risk Japanese insurance companies underwrite D&O coverage only to the extent that they can obtain appropriate reinsurance. However, during the period following the Daiwa Bank Case, the capacity of the reinsurance industry, which is centered in the United States and Europe, was contracting due to numerous claims arising from the bankruptcy of dot-com companies. This trend only worsened following the September eleventh terrorist attack.¹⁴⁶ The result was that numerous requests for D&O coverage by Japanese companies could not be met by the Japanese insurance industry in the Daiwa Bank Case's aftermath.¹⁴⁷

D. Legislative Response to the Daiwa Bank Case and the Debate on Corporate Governance

Outraged reaction to the Daiwa Bank Case by business groups resuscitated a prior industry-sponsored proposal,¹⁴⁸ which resulted in a new amendment to the Japanese Commercial Code in December of 2001 (the "Amendment") aimed at limiting directors' liability in shareholder derivative suits and increasing the independence of statutory auditors.¹⁴⁹ The Amendment contrasts with the broader approach in a separate overhaul of Japan's

146. An increase in securities-fraud litigation, related primarily to dot-com companies, is also cited as the primary cause of a substantial increase in rates for D&O coverage in the U.S. During 2001-2002, rates increased 25-40% for financially sound companies. In addition, Reliance Group Holdings, Inc., the sixth largest underwriter of D&O insurance in 1999, went bankrupt. See Christopher Oster, *When the Boss Caused the Loss, Who Pays?: 'D&O' Insurance Is Supposed to Cover Management Mistakes, but Not if Insurer Is in Trouble Too*, WALL ST. J., June 13, 2002, at C1.

147. Reinsurers allocated their capacity among Japanese insurers with whom they had relationships; Japanese insurers, in turn, allocated D&O coverage among their existing and new customers. A manager from Mitsui Marine & Fire, relating how he contacted a London reinsurer in an attempt to obtain additional D&O coverage, is quoted as saying, "[m]aybe they were surprised by the Daiwa Bank Case decision. They were very cautious and their response was stingy." See *Kyogaku Baisho*, *supra* note 136. As a result, when insureds requested large increases in coverage, they were told that "[f]or 10 billion yen or more of coverage, we cannot underwrite it except for important customers." *Id.*

148. See Keizai Dantai Rengokai, Kōporçto Gabanansu Tokubetsu linkai, Kōporçto Gabanansu no Arikata ni kansuru Kinkyū Teigen [Corporate Governance Special Committee, Japan Federation of Economic Organizations, Emergency Proposal regarding the Form of Corporate Governance] (Sept. 10, 1997), reprinted in 1468 SHOJI HOMU 30 (1997). Keidanren's website offers an English translation, *Urgent Recommendations Concerning Corporate Governance*, available at <http://www.keidanren.or.jp/english/policy/pol067.html> (last visited Apr. 17, 2003).

149. See Shoho oyobi Kabushiki Gaisha no Kansato ni kansuru Shoho no Tokurei ni kansuru Horitsu no Ichibu wo Kaisei suru Horitsuan [Bill to Amend a Portion of the Commercial Code and Act Regarding Special Rules of the Commercial Code Concerning Auditing, etc., of Stock Corporations], reprinted in 1614 SHOJI HOMU 5 (2001). This bill and a complementary bill were introduced on May 20, 2001 as a Diet (Parliament) member's bill as opposed to the bulk of legislation, which is sponsored by the government. Upon deliberation that fall, the ruling coalition accepted certain opposition-proposed amendments and the Lower House passed the bills on November 29, 2001. The Upper House passed the bills as amended on December 5, 2001.

Commercial Code enacted in May 2002 (the "Overhaul"), which provides, among other measures, for an increased role for outside directors and an optional provision that enables Japanese companies to adopt an "American-style" board system in order to improve corporate governance.¹⁵⁰ These amendments, both the products of political compromise, are the first steps in an ongoing debate over corporate governance. The method selected to achieve management oversight, i.e., the traditional means of statutory auditors or "American-style" means of independent directors and board committees, will have a profound impact on the fundamental future direction of corporate governance in Japan.

The Amendment provides for exculpatory charter provisions limiting the amount of directors' liability for damages based on the director's compensation and sets forth a corresponding procedure for an after-the-fact release of directors from liability.¹⁵¹ However, both provisions require consent of the statutory auditors and shareholder approval.¹⁵² Further, the Amendment excludes cases involving a knowing violation of law, bad faith, or gross negligence from both the exculpatory charter provision and the release provision.

These limitations on the Amendment's application may reflect its origin, as a proposal by business groups that originally asked for, among other matters, a codification of a Japanese version of the business judgment rule.¹⁵³ The limitations may also be the result of initial resistance by the political opposition parties and considerable opposition by some legal commentators.¹⁵⁴ Industry groups only agreed with this limited approach

150. See *infra* note 156.

151. The Amendment provides for maximum liability of six years' compensation for representative directors, four years for other inside directors and two years for outside directors. Proponents of the Amendment asserted that a limit on directors' liability related to annual compensation followed "U.S. law," as the ALI permits charter provisions which reduce directors' and officers' liability to one year's compensation, but does not permit the complete elimination of such liability. See A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.19 (1994). However, the vast majority of states in the United States have adopted director protection statutes based on Delaware law and the Model Business Corporation Act, which do not involve dollar limits on directors' liability. Opponents of the Amendment also cited U.S. law for their own purposes. See *infra* note 154.

152. The exculpatory provision to limit directors' liability to a maximum based on said director's compensation requires a special (i.e., two-thirds) resolution of shareholders. If the board of directors passes a resolution for an after-the-fact release of a director from liability, shareholders holding 3 % of the company's shares may object to the board's action. The Amendment also seeks to make the statutory auditors more independent by, among other measures, providing that for large corporations at least half of the statutory auditors must be outside auditors.

153. That is essentially what the Amendment provides. Accordingly, it does not go as far as Delaware's exculpatory charter provision. It is also questionable whether such a provision, if it had been in effect, would have affected the outcome in the Daiwa Bank Case since the court's decision would presumably have found liability even under a standard of gross negligence. *Kabunushi Daihyo Soshō: Torishimariyaku no Baisho ni Jogen* [Shareholder Derivative Litigation: Upper Limit on Directors' Damages], *NIHON KEIZAI SHINBUN*, Nov. 23, 2001.

154. According to this view, the Daiwa Bank Case, like *Van Gorkom*, is a highly unusual decision that is unlikely to be repeated. There were three basic grounds for opposi-

after they received assurances that it was only the first step in a series of measures designed to address industry concerns.¹⁵⁵

In contrast to the specific goals and fairly narrow focus of the Amendment, the Japanese government also began an effort to carry out the first major overhaul of the Commercial Code in over fifty years. An advisory panel to the Ministry of Justice published an interim draft in April of 2001, which culminated in enactment of the Overhaul in May of 2002.¹⁵⁶ Although neither comprehensive nor even wholly consistent, the Overhaul departs from past practice and approaches corporate law in a spirit that is more enabling than mandatory.¹⁵⁷

The heart of the Overhaul's corporate governance section essentially creates a new optional "American-style" system of corporate governance.¹⁵⁸ It calls for the creation of three board committees: an audit committee, a nominating committee, and a compensation committee, as well as for the introduction of a system of executive officers.¹⁵⁹ Application of the section would result in the separation of directors and officers and the elimination of the two important German-inspired features of Japanese corporate law—

tion to the Amendment: (1) that the Delaware exculpatory charter provision primarily protects outside directors, not insiders as under the Amendment; (2) any limitations on director liability, for example for outside directors, should be left to the courts; and (3) the Amendment's focus on statutory auditors as a method of improving Japanese corporate governance is misguided and counterproductive. See generally Kabunushi Daihyo Soshō Seido Kenkyukai [Shareholder Derivative Lawsuit System Study Group], 1605 SHOJI HOMU 36 (Part I) (2001); *Kabunushi Daihyo soshō oyobi Kansayaku Seido ni kansuru Shohoto Kaisei Hoan ni taisuru Iken* [Opinion on Bill to Amend the Commercial Code concerning Shareholder Derivative Litigation and the Statutory Auditor System, etc.], 1606 SHOJI HOMU 17 (Part II) (2001).

The characterization of the Delaware exculpatory charter provision as primarily protecting outside directors would not be readily accepted in the United States. Delaware law protects director's actions "as a director," as opposed to an executive function, regardless of whether the director in question is an inside or outside director. The group's point, however, derives from a strong concern for encouraging the use of outside directors and a belief that they are the group worthy of special protection to limit their liability. As discussed previously, Japanese courts tend to examine directors' liability in the context of each director's line, or executive responsibilities. See sources cited *supra* note 96 and accompanying text. In the Japanese context, protection of a director's actions as a "director" may be viewed as affording greater protection to outside directors who have no line responsibilities.

155. Interview with Shinsaku Iwahara, Professor, University of Tokyo Faculty of Law, in Tokyo, Japan (June 3, 2002).

156. See Homu Sho Minjikyoku Sanjikanshitsu [Councillors' Office, Civil Bureau, Ministry of Justice], *Shohoto no Ichibu wo Kaisei suru Horitsuan Yōkō Chukan Shian* [Outline of Interim Draft of Bill to Amend a Portion of the Commercial Code, etc.] (Apr. 18, 2001), reprinted in 1206 JURISTO 165 (2001).

157. The bill to enact the Overhaul was divided into four major sections, stock (corporate finance), corporate organs (governance), corporate accounting-disclosure, and other (including electronic meetings and reporting and foreign corporations). Unlike prior revisions to the Commercial Code after 1950, it is not a focused response to a specific scandal or problem. Rather, it constitutes the first attempt in Japan to deal with the question of what is the most appropriate form of corporate governance for Japanese corporations.

158. See Shohō oyobi Kabushiki Gaisha, *supra* note 149.

159. *Id.*

the representative director and statutory auditor. A representative officer with authority to bind the corporation would replace the representative director, and directors serving on the audit committee would replace the statutory auditors.¹⁶⁰

However, there is far from unanimous agreement that this or any other proposal represents the best form of corporate governance for Japanese corporations.¹⁶¹ Significantly, the Overhaul is completely silent concerning the function of statutory auditors, and its only improvement in corporate governance for corporations which choose to retain that system is a largely symbolic requirement that each large corporation must have at least one outside director.¹⁶² Japanese companies are moving forward to meet this outside director requirement. However, early indications suggest that they remain very cautious about adopting the “American-style” board system, which despite its benefits (such as greater board control over corporate finance) theoretically cedes control over fundamental personnel issues (such as the appointment and compensation of directors) to outsiders.¹⁶³ Those opposed to the “American-style” board defend the existing statutory auditor system¹⁶⁴ and are concerned with extending the same benefits to corporations that continue using the previously existing form of corporate governance. It is also quite possible that Japanese corporate governance

160. See Homu Sho Minjikyoku Sanjikanshitsu, *Shohoto no Ichibu wo Kaisei suru Horitsuan Yōkō Chukan Shian no Kaisetsu* [Councillors’ Office, Civil Bureau, Ministry of Justice, Commentary on the Outline of Interim Draft of Bill to Amend a Portion of the Commercial Code, etc.] (Apr. 18, 2001), reprinted in 1206 JURISTO 184, 195 (2001).

161. Accordingly, the Overhaul sets forth one new corporate governance structure that may be adopted by corporations. Companies are also free to retain their current structure. There appears to be fairly widespread agreement that corporations should be allowed some flexibility in choosing the most appropriate form of corporate governance. Under this enabling approach, the role of corporate law would be to provide an appropriate “menu” of legitimate alternatives that each corporation could adapt to its own circumstances and needs.

162. The commentary to the Overhaul bill notes that there was an opinion that all large corporations should be required to adopt the new “American-style” system, but that this question was left for further study.

163. For example, one early survey of one thousand Japanese companies conducted by the Japan Auditors Association found that over half of the companies had determined to maintain the current statutory auditor system, while only four had decided to switch to the “American-style” system. *Beikokukei Keiei Keitai Kano ni: Sangyokai, Donyu ni Shincho* [American-style Management System is made Possible: Industry is Cautious about its Introduction], *NIHON KEIZAI SHINBUN*, May 23, 2002, at 4.

164. The main argument of the system’s defenders is that since there is no widely accepted “best” system of corporate governance, the main issue is one of transparency and disclosure, i.e., to better define and disclose governance institutions and their functions, for example, the identities and roles of statutory auditors and any outside directors, in each corporation. See, e.g., Panel Discussion, *supra* note 20, at 17 (Speaker: Kanda). Conversely, one interviewee stressed that given the general lack of corporate disclosure in Japan, as a practical matter, it would be difficult for outsiders to obtain ongoing access to the necessary information in order to act as an effective check on management. Interview with Kuniyuki Suda, Statutory Auditor, Tokyo Marine & Fire Co., Ltd., in Tokyo, Japan (June 10, 2002). In his view statutory auditors are provided sufficient tools under the Commercial Code to act as an effective check on management, but whether those powers are in fact exercised so as to provide an effective audit function depends on the internal environment of each company. *Id.*

will become bifurcated, with a sophisticated minority of public companies adopting the new committee system in order to attract foreign investors, while the majority of companies retain the existing statutory auditor system.¹⁶⁵

V. Reconsidering the Importance of Law in Japanese Corporate Governance

The legal issues and role of the legal system represented by the Daiwa Bank Case necessitate the reexamination of our views of the role of law in Japan, particularly with respect to corporate governance. The Daiwa Bank Case and its aftermath, which highlight extensive consideration in Japan of the merits of “American-style” corporate governance, also provide a basis for considering the question of the convergence of corporate governance systems.

A. Implications of the Daiwa Bank Case

The Daiwa Bank Case and its aftermath highlight numerous issues relating to the role of law and corporate governance practices which are not addressed by the internal monitoring model of Japanese corporate governance. The Daiwa Bank Case makes clear that the board of directors must take seriously the supervisory function assigned to it in Japan’s Commercial Code. In terms of legal doctrine, directors not only have a duty of oversight, they are now obligated to take board action to establish overall policies for internal controls and compliance with law, and to oversee the creation and implementation of the various components of overall policies. This emphasis on the board of directors providing an independent check on management and taking positive action to assume the lead in formulating and implementing policies goes well beyond what has generally been viewed as the role of the board of directors under Japanese corporate governance.

The same can be said with respect to the court’s approach to compliance with the law. At first glance, the results of the Daiwa Bank Case might appear quite harsh for several reasons. First, the extent of individual director’s liability was based on foreign laws not specifically known by the directors. Second, this violation of foreign law resulted in a huge damage award based on U.S. criminal procedures and practice. As noted above, Japan does not have a general doctrine of vicarious liability. Similarly, although it is perhaps unsurprising that administrative guidance was not recognized as an independent defense to an accusation of violation of law, it is striking that the court would not give it any consideration as an extenuating cir-

165. Recent surveys indicate that some thirty Japanese companies have announced their intention to switch to the board committee system. See Mariko Ando, *Japan Firms Boost Corp. Governance*, CBS Market Watch, Mar. 19, 2003. A group of internationally oriented Japanese companies may emerge that view improvements in corporate governance as a plus in attracting shareholders, particularly foreign shareholders. See, e.g., Neil A. Martin, *Shareholder-San: Japanese Insurer Nipponkoa Is a Poster Boy for Western-Style Corporate Governance*, BARRON’S, Feb. 24, 2003, at 30.

cumstance. Indeed, as discussed earlier, the court goes on to castigate the defendants by characterizing the defendants' reliance on administrative guidance as an abandonment of their duties as directors to make independent business judgments in the best interests of the corporation.

On the institutional side, the role of shareholder derivative suits and courts in the Daiwa Bank Case is also striking. An effective shareholder derivative suit system was thought to be inconsistent with traditional Japanese practices, and Japanese businesses were greatly surprised by the increase in derivative suits after 1993. The Daiwa Bank Case itself played an important role in opening up the system by rejecting defendants' demand for security for expenses in a preliminary ruling. The limitations on director liability under the Amendment's codification of the business judgment rule are substantially less than those established under Delaware law following *Van Gorkom*, and shareholder derivative suits could continue to be highly significant. As in *Caremark*, judges sometimes make decisions to change or extend existing law in light of changing legal and social conditions. The Daiwa Bank court's choosing such a path indicates an educational role in mandating change in corporate governance practices which challenges the image of Japanese courts and judges as being both cautious and supportive of business.

In terms of corporate governance practices, one is struck both by the enhanced prospective role of lawyers and by the vigorous debate on corporate governance issues. In the fact pattern of the Daiwa Bank Case lawyers are noticeable chiefly by their absence—in keeping, perhaps, with traditional corporate practices in Japan, but leading to disastrous results for several of the defendants in the court's decision. Although it remains to be seen whether the Daiwa Bank Case will become a “full employment law for lawyers” it appears that the court's decision will provide a boost to the underlying trend of lawyers participating more actively in the formulation of corporate policies and board decisions.

Meanwhile, responses to the Daiwa Bank Case included an explosion in demand for D&O insurance and legislation to limit directors' liability. There is active and well-informed debate in Japan concerning the optimal form(s) of corporate governance. However, rather than mandatory government-imposed rules which might elicit compliance in form only, the approach under the post-Daiwa Bank Overhaul is that legal rules should both be flexible and correspond to the realities of adopting improved corporate government practices.

The Daiwa Bank court's finding of directors' liability has already resulted in serious consideration being given, perhaps for the first time, to the standard of liability for directors. Despite the controversy surrounding the Daiwa Bank Case, the fundamental matters discussed by the court, including a directors' duty for internal controls and compliance policies, are here to stay. Further, the restrictions on derivative suits in the Amendment represent exactly the kind of discussion about directors' duties and business judgments with which American lawyers would feel quite famil-

iar—they seem out of place under the prevalent view of corporate governance in Japan which emphasizes informality over the rule of law.

The far-reaching impact of the Daiwa Bank Case was partly due to underlying trends involving the role of law in Japanese corporate governance during the 1990s. The increase in derivative suits and the first plaintiffs' victories provided a base for the development of both legal doctrine and the derivative suit system. Following the collapse of the bubble economy, corporations were already gradually reforming corporate governance practices and relying more on outside counsel. Most listed companies had already begun to obtain limited amounts of D&O insurance coverage. Industry groups had already proposed legislation codifying the business judgment rule and limiting directors' liability. The Daiwa Bank Case greatly accelerated and broadened these underlying trends.

The above discussion points to a need to rethink the generally accepted internal monitoring model of Japanese corporate governance. The Daiwa Bank Case highlights the progress of ongoing changes in Japan, which indicate the increasing importance of formal legal checks and balances, more of an independent function for the board of directors, an increased emphasis on "American-style" internal controls and compliance with law in Japanese corporations, as well as a greater external check on management activities by means of shareholders' suits. While it is unlikely that Japan will—or would want to—look like American society, it does appear that the dominant view of Japanese corporate governance fails to account for the dynamic changes occurring in Japan.

B. Convergence Theory and the Traditional Borrowing Process

The discussion of the landmark Daiwa Bank Case and its aftermath, together with the broader fundamental debate on corporate governance, raises issues concerning Japanese corporate governance and convergence theory. Views on convergence theory were a contributing factor in the formulation of the widely accepted internal monitoring model of Japanese corporate governance. This is also particularly relevant in light of the Japanese penchant for studying American and other foreign legal systems, and the numerous references in this Article to the Japanese consideration or adoption of "American-style" corporate governance practices.

The convergence debate is not only of great intellectual interest. It also potentially has enormous practical significance for transitional economies that are engaged in formulating and constructing their legal and economic institutions. However, there are a number of reservations concerning how far convergence theory advances our understanding of the relationship between legal systems and economic development, particularly when one turns to the evaluation of governance institutions in specific national systems.

First, comparisons of corporate governance systems tend to be influenced by underlying assumptions or value judgments concerning which is the "best" or "model" system. Views on which system is the proper "model" may change over time depending on the economic performance and per-

ceived "success" of various countries.¹⁶⁶ Proponents of the "law matters" theory try to overcome such potential biases by offering comparative empirical evidence to demonstrate that a strong "rule of law," particularly protection for minority shareholders, correlates with strong and efficient capital markets. However, even in the United States, where there are fewer and more certain variables, there is no clear evidence linking corporate governance with economic performance.¹⁶⁷ International comparisons which necessitate relying on even cruder variables and assumptions would seem even more difficult.

A second reservation is the tendency to oversimplify governance systems into static "idealized" models, such as the "Anglo-Saxon" model and the "European/Japanese" model, which can readily be used to make broad international comparisons. However, the United States has experienced significant changes during the 1980s and 1990s in the direction of greater emphasis on shareholder sovereignty and transparent markets.¹⁶⁸ Perceptions also change. For example, it is also clear in the post-Enron era that some of the changes in the United States during the 1990s which were designed to promote the maximization of shareholder wealth, such as the great increase in the award of stock options to management, have had the perverse effect of disaligning management's interests from those of shareholders. Conversely, significant changes have occurred in Japan, including a substantial dismantling of the cross-shareholding structure which was thought to support the internal monitoring model of Japanese corporate governance, seemingly without affecting the "classification" of Japan under the broad scheme employed by proponents of convergence theory.

166. Organizations like the OECD, which seek to improve corporate governance by promulgating common principles with broad applicability, explicitly deny that there is any single "best" system or set of practices. It also appears that international lending organizations like the IMF, given weaker economic performance in the United States and a vocal reaction from their critics, have begun to retreat from their strong advocacy of U.S.-style corporate governance through the "rule of law," which was prevalent in the 1990s.

167. For a broad review of the existing empirical studies in the United States, see Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAWYER 921 (1999). With respect to these U.S. studies, one commentator notes that "the variables become so numerous as to make the subject impossible to study." Hamilton, *supra* note 8, at 365. Hamilton further notes that "studies limited to the impact of corporate governance changes on increases in shareholder wealth involve significant problems and assumptions. To broaden the study further is simply impractical." *Id.* Although the empirical studies by La Porta et al. seek to measure much broader matters, it seems that the same concerns would be applicable. Evaluation of the empirical studies also depends on how narrowly and literally one views the findings; the authors of the studies seem more aware of their limitations than some others who cite the studies. See La Porta et al., *supra* note 17.

168. Some would say that the theory of shareholder sovereignty in the United States has become a reality only during this recent period. This, again, constitutes an idealized view of American corporate governance. See *supra* note 7 and accompanying text (as noted in the Introduction, this applies only to large public corporations). Even for large corporations, there is still considerable debate about the reality. See generally Hamilton, *supra* note 8. In addition, the corporate laws of some states specifically authorize directors to consider the interests of constituencies other than shareholders. See *id.* at n.38.

Third, there may be alternative explanations for recent global developments. There is little doubt that the general goal of maximizing shareholder wealth has become more widely accepted,¹⁶⁹ and in a broad sense all developed countries and many transitional economies appear to be moving in a similar direction as the importance of direct finance, as represented by the equity and debt markets, has increased significantly relative to indirect forms of corporate finance. However, this could simply be the result of parallel changes initiated in response to the same postindustrial phenomena, such as deregulation, globalization, and technological development, rather than convergence. In addition, many countries outside the United States place a greater emphasis on the social role of corporations, as corporate governance systems are not solely a matter of law and economics.¹⁷⁰ Corporate governance systems have broad social implications and any country contemplating change would obviously work to adapt principles or models that conform to its local institutions and value systems.¹⁷¹

A consideration of Japan helps to illustrate the discussion above. U.S. practices have undoubtedly significantly influenced recent Japanese thinking concerning corporate governance. Yet, the Japanese are still cautious; they regard the argument that the form of corporate governance relates to business performance or has other economic benefits as unproven. They also doubt both the existence of any particular optimal form of corporate governance and the wisdom of legally imposing a particular set of practices on Japanese corporations. Despite widespread acknowledgement of the necessity for change, some Japanese still believe that the emphasis should instead be on greater transparency and disclosure regardless of the particular institutional arrangements relating to corporate governance. In this light, it may be useful to view forms of corporate governance on a continuum, with the Japanese recognizing the desirability of placing greater emphasis on shareholder primacy within the context of their legal structure and governance institutions.

In turn, this suggests that the traditional borrowing process is relevant to convergence theory. The current situation in Japan suggests that changes in many areas may be occurring simultaneously in response to changed economic circumstances and the dismal failure of Japan's economic and other policies in the 1990s. It also suggests that behind the debate on "convergence" may lay a fairly traditional pattern of borrowing, whereby Japan, for example, may look to a country with prior experiences in a particular problem area, such as the United States, with the purpose of

169. Although, perhaps, not to the extent argued by its most enthusiastic proponents. See Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

170. In many countries outside the United States, such as Japan, Dodd is still discussed on a relatively equal footing with Berle-Means. See, e.g., AKIRA MORITA, KAISHAHO NO KISEI KANWA TO KŌPORŌTO GABANNASU [Enabling Corporate Code and Corporate Governance] 23-43 (2000) (distinguishing Berle's focus on shareholders from Dodd's focus on society).

171. A number of thoughtful commentators on convergence theory have raised this point. See generally Gilson, *supra* note 17 and accompanying text.

finding useful approaches or concepts and adapting them to fit its own needs.¹⁷²

The Daiwa Bank Case and its aftermath provide a good illustration of this process. A new director's duty of oversight for internal controls and compliance with law was formulated within the Japanese courts' existing framework of examining liability based primarily on a director's supervision over a particular business department. Additionally, new legislation codifies the "American-style" business judgment rule, while monitoring management by strengthening the German-inspired institution of independently functioning statutory auditors that has no U.S. counterpart. Other legislation enables, but does not require, Japanese corporations to adopt a "U.S.-style" governance system featuring independent directors and board committees.

Despite the substantial and growing literature on convergence theory, this Article's examination of Japanese efforts to close the gap between the theory and practice of corporate law highlights the difficulties inherent in analyzing governance-related institutions in a rapidly changing environment in a way that lends itself to meaningful comparisons with other systems. The Japanese example suggests caution in applying convergence theory so that it serves in aiding analysis of governance systems, rather than unintentionally hindering our ability to analyze and appreciate ongoing changes within them.

Conclusion

The role of law in Japan, which was largely overlooked in the traditional view of Japanese society, is in the process of assuming far greater importance due to significant changes in Japan. A crisis may be necessary for drastic change, and Japan now has one. It has become the conventional wisdom in Japan that the country is now undergoing its third great modernizing transformation, following those of the Meiji restoration in the 19th century and the immediate post-World War II era. It may be that the ultimate extent of such change—including both the role of law generally and reliance on the newly emerging forms of corporate governance in particular—will not be fully tested until Japan experiences a sustained economic recovery. However, as measured by the rulings in the Daiwa Bank Case and its aftermath, the ferment in Japanese corporate governance is real and is likely to continue.

At this stage, the degree of "real change" in Japan remains open to question. All the debate over appropriate forms of corporate governance

172. Although this borrowing process has a long history, discussion of legal "transplants" is also encumbered with its own intellectual baggage, including the underlying assumption that certain advanced societies act as "donors" in providing laws to be transplanted to "recipient" societies. For a discussion of this point in relation to Japan, see, for example, ERIC A. FELDMAN, *THE RITUAL OF RIGHTS IN JAPAN* 145-48 (2000). In fact, in recent years Japan, which has typically been viewed as a recipient nation, has embarked on an ambitious donor program by providing technical legal assistance to a number of transitional economies in Southeast and Central Asia.

has not produced a widely accepted new model of corporate governance. Nevertheless, the change is real; it would surely be difficult today to find a Japanese executive who felt comfortable focusing only on informal relationships with his main bank, *keiretsu*, and government ministry, while ignoring the formal legal duties of board members, derivative suits, D&O insurance, lawyers, and compliance with law.

The five-year history of the Daiwa Bank Case (from criminal prosecution in the United States to liability in a shareholder derivative suit in Japan) itself provides a roadmap for the significant changes occurring in Japan. The dramatic beginnings of the case in New York first highlighted the importance of internal controls and compliance with law for Japanese banks and regulators. These represented new issues, such as policies and procedures to prevent and detect employee wrongdoing and to ensure compliance with laws, which were not adequately addressed by prior Japanese practices. Within five years these new concepts were sufficiently accepted in Japan to the point that the Daiwa Bank court enunciated them as legal duties and found liability of several directors for violating them. In hindsight, the Daiwa Bank Case will perhaps provide a milestone or dividing line demarcating the “traditional” behavior of the bank in this case and an increased emphasis on law in Japanese corporate governance as exemplified by the court’s emphasis on the legal duties of directors. The case and its aftermath dramatically highlight an underlying trend of the increasing role of the formal legal system in corporate governance and, in turn, both reinforce and expand such a trend.

The Daiwa Bank Case also provides evidence of a shareholder derivative system functioning to a surprising degree like the U.S. system during the transformation of the American corporate governance model during the 1980s. The derivative lawsuit system, specifically the potential for “big” cases to be transmitted through and amplified by the formal legal system and exert an impact on corporate practices, is arguably the least likely element of the U.S. transformation to appear in Japan under current theory. We must reconsider theories of comparative corporate law in order to account for changes occurring in Japanese corporate governance and the new importance of law in Japan.

