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SUBSTANCE OVERLOAD: A COMPARATIVE EXAMINATION OF JAPANESE CORPORATE GOVERNANCE LAW THROUGH THE LENS OF THE DAIWA BANK CASE

A. Reid Monroe-Sheridan[†]

Abstract: Japanese corporate governance law is facing a period of remarkable change. In light of Prime Minister Shinzo Abe's push for corporate governance reforms and the explosive news of Olympus Corporation's \$1.7 billion accounting scandal in 2011, academics and practitioners alike are devoting renewed attention to the rules that govern Japan's boardrooms. This increased focus brings to the fore two key questions about Japan's modern corporate governance principles: how have they evolved and how are they applied in practice? To answer these questions, this article revisits the Daiwa Bank case, one of Japan's most stunning business scandals. This international criminal conspiracy resulted in one of the world's largest banks being banned from operating in the United States and gave rise to a seminal Japanese judicial opinion that found a single bank director personally liable to his employer for over \$500 million. By examining the law and legacy of the Daiwa Bank scandal and subsequent developments in Japanese statutory and case law, both on their own terms and in light of their analogues in Delaware, this article seeks to shed light on and critically evaluate the evolution and application of certain major Japanese corporate governance principles.

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I. INTRODUCTION

Recently, Japanese Prime Minister Shinzo Abe has been locked in a battle with Japan's powerful business interests over key corporate governance reforms, including measures to increase the participation of outside directors on the boards of public companies.¹ After an arduous fight, the Japanese Diet passed certain reforms in June of 2014, with implementation to take place within eighteen months.² In part a response to the explosive news of Olympus Corporation's \$1.7 billion accounting scandal in 2011,³ Prime Minister Abe's insistence on corporate governance reforms as a critical component of his package of economic policies⁴ has brought renewed attention to corporate governance from Japanese law firm practitioners and in-house legal departments alike.⁵ Recent rulings by the Supreme Court of Japan⁶ and the Fukuoka High Court⁷ have added fuel to the fire, with the Fukuoka High Court in particular appearing to expand the scope of corporate directors' fiduciary duty of oversight beyond what many had anticipated.⁸

With corporate governance in the spotlight and significant reforms coming into effect in short order, the origin and practical effect of the

¹ See *Kaishahō No Ichibu Wo Kaisei Suru Hōritsuan Nado No Kokkaiteishutsu To Gaiyō* [*The Proposal of the Bill to Amend a Portion of the Company Law and a Summary Thereof*], 2017 SHŌJI HŌMU 4, 5 (Dec. 1, 2013); Ritsuko Ando, *Japan PM to Urge Company Boards to Open Up in Governance Push as Resolve Tested*, REUTERS (May 14, 2014), <http://uk.reuters.com/article/2014/05/14/uk-japan-governance-shareholders-idUKKBN0DU1Z820140514>.

² *Kaishahō No Ichibu Wo Kaisei Suru Hōritsuan* [The Bill to Amend a Portion of the Company Law], Law No. 90 of 2014 (Japan), available at http://www.moj.go.jp/MINJI/minji07_00151.html (last visited Aug. 31, 2014).

³ Hiroko Tabuchi, *Arrests in Olympus Scandal Point to Widening Inquiry into a Cover-Up*, N.Y. TIMES, Feb. 17, 2012, at B3.

⁴ *Corporate Governance in Japan: A Revolution in the Making*, THE ECONOMIST (May 3, 2014), <http://www.economist.com/news/business/21601557-long-last-japanese-firms-seem-be-coming-under-proper-outside-scrutiny-revolution>.

⁵ See, e.g., Mitsuru Chino, *Gurōbaru Jidai No Kigyōnai Hōmubu Ni Okeru Yakuwari To Kadai* [*The Role of, and Issues Facing, Internal Corporate Legal Departments in the Global Age*], 2025 SHŌJI HŌMU 26, 28–32 (Feb. 25, 2014) (discussing the important role of internal corporate legal departments in facilitating sound corporate governance and compliance); *Kaishahō Kaiseihōan To Shagaitorishimariyaku Ni Kakaru Jitsumutaiō* [*Practical Responses to the Bill to Amend the Company Law and Outside Directorships*], 2023 SHŌJI HŌMU 35 (Feb. 5, 2014).

⁶ Saikō Saibansho [Sup. Ct.] July 15, 2010, 2091 HANREI JIHŌ [HANJI] 90, 93 (Japan) (suggesting that the Supreme Court of Japan has adopted dual substantive and procedural inquiries in applying the business judgment rule; this is addressed in more detail in Part III.D of this article).

⁷ Kōtō Saibansho [Fukuoka High Ct.] Apr. 13, 2012, 1399 KIN'YŪ SHŌJI HANREI [KINYŪ HANREI] 24 (Japan) (affirming a Fukuoka District Court decision that appears to expand directors' fiduciary duty of oversight to include oversight of wholly owned subsidiaries; this is addressed in more detail in Part III.B.3 of this article).

⁸ Yasushi Ito, *Fukuoka Uoichiba Kabunushi Daihyō Soshō Jiken No Kento* [*An Examination of the Fukuoka Fish Market Shareholder Derivative Suit*], 2034 SHŌJI HŌMU 4, 14 (June 6, 2014).

existing rules (and, by extension, their influence going forward in light of these reforms) is ripe for examination. How do Japanese courts apply these legal concepts and what is their practical effect? Although Japanese courts have provided the business and legal communities with relatively limited corporate governance case law, there is one particularly instructive decision—a decision with remarkable origins—that serves as an excellent starting point for this inquiry.

Emerging from one of Japan's most dramatic corporate governance scandals, the Daiwa Bank Case^{9,10} (or "Daiwa" when so indicated by the context) is a seminal and groundbreaking legal opinion that continues to exert remarkable influence on the governance of some of the world's largest corporations.¹¹ A corporate law decision from the Osaka District Court, this case touched on a variety of crucial corporate governance issues that had been largely unexplored by Japanese courts at the time the opinion was published. With a sprawling and at times muddled analysis of the bank's shocking international criminal conspiracy and its implications for corporate shareholders, the Osaka District Court put forth an influential statement of several key principles of Japanese corporate law. The decision also provided a far-reaching and occasionally unsettling illustration of how Japanese courts may seek to apply those principles to the actions of corporate managers.

This article focuses on a selection of these important corporate governance principles that are influential in Japan today and either originated in or were significantly shaped by the Daiwa Bank Case. Revisiting this turning point in the evolution of these legal concepts provides an opportunity to examine the jurisprudential logic and circumstances that helped form several core tenets of corporate governance in the world's third-largest economy. This article will also compare certain portions of the Daiwa Bank Case to key Delaware case law,¹² allowing a more thorough

⁹ Chihō Saibansho [Osaka Dist. Ct.], Sept. 20, 2000, 1721 HANREI JIHŌ [HANJI] 30, 36 (Japan) [hereinafter "Daiwa Bank Case"].

¹⁰ Japanese judicial opinions typically use certain stock pseudonyms for the parties involved and are cited without reference to the party names. This article follows those conventions.

¹¹ For example, Toyota, Softbank and Mitsubishi UFJ Financial Group, all Japanese companies, have market capitalizations exceeding ¥8,000,000,000,000 (roughly \$80 billion). Toyota's market capitalization was in excess of \$200 billion as of this writing. *Jika Sōgaku Rankingu* [Market Capitalization Ranking], NIHON KEIZAI SHINBUN, INC. http://www.nikkei.com/markets/ranking/stock/cap_high.aspx (last visited Sept. 1, 2014).

¹² Due to the large number of major corporations incorporated in Delaware and the media and academic attention devoted to Delaware corporate law decisions, the state plays a uniquely important role in U.S. corporate governance jurisprudence. See, e.g., STEPHEN BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY* 121-22 (2008) (The role Delaware plays in business judgment jurisprudence is

critique of not only the Daiwa court's reasoning and conclusions, but also the current state of several major Japanese corporate governance principles.

Part II of this article examines the factual background of the Daiwa Bank Case. Part III provides analysis of the case and subsequent legal developments in Japan along with a comparison to Delaware law. Specifically, Part III covers five major issues raised by the Daiwa Bank Case: (1) the duty of directors to establish an internal control system, (2) the scope and application of the business judgment rule, (3) limitations on director liability enacted after the Daiwa Bank Case, (4) the causal relationship necessary for a finding of director liability, and (5) the acceptance of plea bargains as evidence of corporate criminality. Part IV concludes.

II. THE EXTRAORDINARY STORY OF THE DAIWA BANK SCANDAL

On November 2, 1995, U.S. bank regulators ordered The Daiwa Bank, Ltd. ("Daiwa" or "Daiwa Bank") to close its operations in the United States within three months, and a federal grand jury indicted Daiwa on twenty-four criminal charges in connection with the bank's concealment of \$1.1 billion in trading losses.¹³ Daiwa was charged with, among other crimes, conspiracy, mail and wire fraud, obstructing an examination of a financial institution, falsification of bank records and failure to disclose federal crimes.¹⁴ Masahiro Tsuda, formerly the general manager of Daiwa's New York branch, was indicted for conspiring to deceive regulators.¹⁵ Daiwa faced fines under the Federal Sentencing Guidelines of over \$1.3 billion,¹⁶ and eventually entered into a plea agreement under which it paid \$340 million, at the time "the largest criminal fine levied on a financial institution in U.S. history."¹⁷

After shouldering the enormous fine, staggering trading losses, and \$10 million in related attorneys' fees—all underscored by a plea bargain admitting executive malfeasance at the bank—Daiwa soon found itself

"pervasive" and Delaware chancellors "sit at 'the center of the corporate law universe.'" (quoting D. Gordon Smith, *Chancellor Allen and the Fundamental Question*, 21 SEATTLE U. L. REV. 577, 578 (1998)).

¹³ Peter Truell, *A Japanese Bank is Indicted in U.S. and also Barred*, N.Y. TIMES (Nov. 3, 1995), <http://www.nytimes.com/1995/11/03/business/a-japanese-bank-is-indicted-in-us-and-also-barred.html>.

¹⁴ See *Criminal Complaint & Indictment Against Daiwa Bank*, THE LECTRIC LAW LIBRARY, (Nov. 2, 1995), <http://www.lectlaw.com/files/cas60.htm>.

¹⁵ Truell, *supra* note 13.

¹⁶ *Id.*; *Press Release Announcing Criminal Indictment of Daiwa Bank*, THE LECTRIC LAW LIBRARY, (Nov. 2, 1995), <http://www.lectlaw.com/files/cur45.htm>.

¹⁷ Bruce Aronson, *Reconsidering the Importance of Law in Japanese Corporate Governance: Evidence from the Daiwa Bank Shareholder Derivative Case*, 36 CORNELL INT'L L.J. 11, 20 (2003).

facing shareholder derivative suits in Japan.¹⁸ These suits were consolidated before the Osaka District Court, which handed down a lengthy ruling against a number of Daiwa's directors on September 20, 2000.¹⁹

Ultimately, the Daiwa Bank Case brought to the fore many novel and underdeveloped issues of Japanese corporate law, including most saliently the fiduciary duty of directors to establish an internal control system, the scope of the business judgment rule, and the scope and causal grounding of corporate director liability. However, to fully appreciate the court's treatment of these issues, it is necessary to first understand the extraordinary facts underlying the Daiwa Bank decision—how did the nineteenth largest bank in the world find itself banned from the United States and subject to such colossal fines?²⁰

A. *The Factual Background of the Daiwa Bank Case*

The origins of the scandal date back to February of 1984, when Daiwa gave its New York branch permission to trade U.S. Treasury bonds within a \$3 million limit.²¹ Toshihide Iguchi,²² who at the time managed securities and custodial services in the New York branch, was put in charge of the trading.²³ Iguchi was a fairly successful trader until June of that year, when he lost approximately \$200,000 in a single trade.²⁴ Rather than report the loss, Iguchi decided that he would recoup the loss through off-the-books²⁵ trading of Treasuries.²⁶ Unfortunately for Iguchi, this off-the-books trading only led to further losses, which he then tried to recoup through even more off-the-books trading.²⁷ One can guess what happened next. Eleven years later, Iguchi was sitting on \$1.1 billion of off-the-books trading losses.²⁸

¹⁸ The Daiwa Bank Case, *supra* note 9, at 9 (the fees were paid to the law firms Debevoise & Plimpton and Morivillo, Abramowitz, Grand, Iason & Silberberg).

¹⁹ *Id.* at 7.

²⁰ Truell, *supra* note 13.

²¹ The Daiwa Bank Case, *supra* note 9, at 8.

²² As is common in Japanese judicial opinions, the Osaka District Court refers to Iguchi by a pseudonym. *See id.* Iguchi grew up in Japan and moved to the United States when he was 20. He graduated from Southwest Missouri State University in 1975 and worked first at a car dealership before joining Daiwa's depository department in 1976. *An Unusual Path to Big-Time Trading*, N.Y. TIMES (Sept. 27, 1995), <http://www.nytimes.com/1995/09/27/business/an-unusual-path-to-big-time-trading.html>.

²³ The Daiwa Bank Case, *supra* note 9, at 8.

²⁴ *Id.*

²⁵ In other words, Iguchi was buying and selling Treasury bonds without properly recording the purchases and sales as required in the books and records of Daiwa's New York office. *Criminal Complaint & Indictment Against Daiwa Bank*, *supra* note 14.

²⁶ The Daiwa Bank Case, *supra* note 9, at 8.

²⁷ *Id.*

²⁸ *Id.*

Iguchi benefitted from loose oversight and an institutional position that allowed him to falsify trading records and have trade confirmations sent directly to him rather than to Daiwa's New York branch back office.²⁹ He also made unauthorized sales of customers' Treasury bonds, held in custody by Daiwa, in order to conceal the losses generated by his own trading.³⁰ The counterparties with whom Iguchi traded were apparently content to let his unusual market activity pass without asking questions. The New York branch under Iguchi, according to one Lehman Brothers trader, was a "hot, hot account and was handled with kid gloves."³¹ Traders at another firm noted the size of Iguchi's trades and took to calling him "Big Foot."³²

On July 18, 1995,³³ Iguchi sent a thirty-page confession to the president of Daiwa.³⁴ Daiwa's president did not immediately report these losses. Instead, according to the Daiwa opinion, the president formulated a plan under which he would enlist Iguchi's help in determining the full scope of the losses, keep a tight lid on the scandal, and disclose the loss promptly to the Japanese Ministry of Finance but not to U.S. authorities.³⁵ Under the plan, Daiwa would address the loss in September of 1995, when it would write off the losses all at once in its midterm settlement of accounts.³⁶

Unfortunately for Daiwa, avoiding disclosure to the U.S. authorities necessitated the forgery of numerous custodial receipts and transfer notes as well as the filing of a fraudulent call report³⁷ with the Federal Reserve Board ("F.R.B.").³⁸ Certain senior managers at Daiwa instructed Iguchi to continue

²⁹ Shinsaku Iwahara, *Daiwa Ginkō Daihyō Soshō Jiken Isshin Hanketsu To Daihyō Soshō Seido Kaisei Mondai (Jō)* [The Daiwa Bank Derivative Suit Trial Court Opinion and Issues of Reform of the Derivative Suit System (Part I)], 1576 SHŌJI HŌMU 4, 5 (Nov. 5, 2000); Mitsuru Misawa, *Daiwa Bank Scandal in New York: Its Causes, Significance, and Lessons in the International Society*, 29 VAND. J. TRANSNAT'L L. 1023, 1027-28 (1996); see also The Daiwa Bank Case, *supra* note 9, at 10-11.

³⁰ Shinsaku Iwahara, *supra* note 29, at 5.

³¹ Saul Hansell, *Futures Trades Could Explain Daiwa Mystery*, N.Y. TIMES (Oct. 5, 1995), <http://www.nytimes.com/1995/10/05/business/futures-trades-could-explain-daiwa-mystery.html>.

³² *An Unusual Path to Big-Time Trading*, *supra* note 22.

³³ Daiwa's president received the letter on July 24, 1995. The Daiwa Bank Case, *supra* note 9, at 9, 40.

³⁴ Truell, *supra* note 13; Sheryl WuDunn, *Japanese Delayed Letting U.S. Know of Big Bank Loss*, N.Y. TIMES (Oct. 10, 1995), <http://www.nytimes.com/1995/10/10/us/japanese-delayed-letting-us-know-of-big-bank-loss.html>.

³⁵ The Daiwa Bank Case, *supra* note 9, at 40.

³⁶ *Id.*

³⁷ *Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks*, BOARD OF GOVERNORS OF THE FED. RESERVE SYS. (Sept. 30, 2014), <http://www.federalreserve.gov/econresdata/releases/assetliab/current.htm>.

³⁸ The Daiwa Bank Case, *supra* note 9, at 40; *Criminal Complaint & Indictment Against Daiwa Bank*, *supra* note 14 (this complaint alleges that Daiwa falsely claimed that it held \$600 million in Treasury bills that it had in fact already sold); Peter Truell, *Court Papers Link 2 Daiwa Executives With Errant Trader*, N.Y. TIMES (Oct. 20, 1995), <http://www.nytimes.com/1995/10/20/business/international-business-court-papers-link-2-daiwa-executives-with-errant-trader.html>.

his off-the-books trading for the time being in order to cover interest payments on the securities he had already sold without authorization.³⁹ The Ministry of Finance, meanwhile, reportedly “demanded that Daiwa Bank maintain tight control over information regarding the incident and hurry to elucidate the situation” and told Daiwa that this was the “worst possible time to disclose the unauthorized trades and sales” publicly.^{40, 41} Japan “had just experienced its first bank run in decades,” and the Ministry was no doubt motivated by increasing global scrutiny of the Japanese financial sector.⁴²

Beginning in 1992, the Federal Reserve Bank of New York had on several occasions voiced its concerns to Daiwa executives that oversight and internal controls in their New York branch were inadequate.⁴³ By 1993, the president of the F.R.B. had expressed suspicions about Iguchi’s trading specifically but received assurances from Daiwa’s management that the trading would be stopped and oversight in the New York branch strengthened.⁴⁴

Daiwa finally disclosed the full extent of its losses to the F.R.B. in mid-September of 1995.⁴⁵ It took less than a month and a half for the United States Attorney’s Office to persuade a grand jury to indict the bank.⁴⁶ The bank then held a board meeting in February of 1996 at which the board of directors voted unanimously to enter into a plea agreement.⁴⁷ Ultimately, Daiwa pleaded guilty to sixteen of the twenty-four criminal charges and paid a \$340 million fine.⁴⁸ Iguchi agreed to a plea bargain under which he was sentenced to four years in prison and fined \$2 million, and Tsuda, the former manager of the New York branch, pleaded guilty and was sentenced to two months in prison and fined \$100,000.⁴⁹

³⁹ *Criminal Complaint & Indictment Against Daiwa Bank*, *supra* note 14; Sheryl WuDunn, *Daiwa Concedes It Told Trader To Keep Dealing*, N.Y. TIMES (Oct. 21, 1995), <http://www.nytimes.com/1995/10/21/business/international-business-daiwa-concedes-it-told-trader-to-keep-dealing.html>.

⁴⁰ The Daiwa Bank Case, *supra* note 9, at 41.

⁴¹ All quotations cited to Japanese sources are this author’s own translations unless otherwise noted.

⁴² Sheryl WuDunn, *Daiwa Affair Turns Up Heat on Japan’s Finance Ministry*, N.Y. TIMES (Oct. 26, 1995), <http://www.nytimes.com/1995/10/26/business/daiwa-affair-turns-up-heat-on-japan-s-finance-ministry.html>.

⁴³ Peter Truell, *Fed Missed Big Opportunity on Daiwa, Ex-Officials Say*, N.Y. TIMES (Oct. 19, 1995), <http://www.nytimes.com/1995/10/19/business/international-business-fed-missed-big-opportunity-on-daiwa-ex-officials-say.html>.

⁴⁴ *Id.*

⁴⁵ *Criminal Complaint & Indictment Against Daiwa Bank*, *supra* note 14.

⁴⁶ Truell, *supra* note 13; *Criminal Complaint & Indictment Against Daiwa Bank*, *supra* note 14.

⁴⁷ The Daiwa Bank Case, *supra* note 9, at 9.

⁴⁸ *Id.*

⁴⁹ *Id.* at 9-10.

B. Revenge of the Shareholders: Derivative Suits Filed in Japan

The fallout from the scandal was hardly confined to the United States. Across the Pacific, Japanese shareholders of Daiwa filed two derivative suits against current and former directors of the bank. In the first suit (the “First Case”),⁵⁰ the shareholders alleged that the directors had breached their fiduciary duties of care and loyalty to the company by failing to establish an adequate internal control system.⁵¹ In the second suit (the “Second Case”), they alleged that the directors had breached their duties of care and loyalty by violating the laws of the United States while doing business there, or by failing to prevent such violations.⁵² Plaintiffs in the First Case sought \$1.1 billion in damages (the total loss from Iguchi’s trades) from the directors, and plaintiffs in the Second Case sought \$350 million in damages (the \$340 million fine Daiwa paid under its plea bargain plus the \$10 million in lawyers’ fees Daiwa incurred in connection with the criminal suit).⁵³ The two cases were consolidated before the Osaka District Court, which ultimately handed down a judgment in the plaintiffs’ favor. The court found that different directors in both the First Case and the Second Case had breached their fiduciary duties to Daiwa and consequently owed a total of \$775 million in damages, with one director in particular personally liable to Daiwa for \$530 million.⁵⁴

The opinion sent shockwaves rippling through the Japanese business and legal communities and quickly established itself as one of the most important corporate governance decisions in Japan due to several factors: the case involved an extraordinary set of facts, one of Japan’s powerful financial institutions, eye-popping liability, and a number of important legal questions that had been seldom addressed (or were unaddressed entirely) by Japanese courts.⁵⁵ The Daiwa Bank Case also helped trigger Japanese corporate law reforms such as limitations on directors’ liability for harm to

⁵⁰ This nomenclature is originally Professor Bruce Aronson’s. See Aronson, *supra* note 17, at 26.

⁵¹ The Daiwa Bank Case, *supra* note 9, at 7-8.

⁵² *Id.* at 12.

⁵³ See *id.* at 7.

⁵⁴ See *id.* (amounts have been approximately converted from Japanese yen into U.S. dollars for convenience).

⁵⁵ The most significant of these issues are: (1) to what extent directors are obligated to create an internal control system, (2) whether the duty of directors to obey the law applies to the laws of foreign countries, (3) whether directors stationed in the company headquarters are responsible for monitoring employees in foreign offices, and (4) to what extent directors can be held liable for corporate losses. See *id.* at 5 (HANREI JIHŌ’s introduction to the Daiwa Bank Case).

their employer-corporation.⁵⁶ Bruce Aronson has noted the similarities between the Daiwa Bank Case and the watershed Delaware cases *Van Gorkom*⁵⁷ and *Caremark*.⁵⁸ These three cases all surprised many in the relevant business and legal communities, involved remarkable amounts of potential liability, and sparked discussion of significant reforms.⁵⁹ Although the Daiwa Bank plaintiffs settled the case after the Osaka District Court ruling⁶⁰—thus precluding input on the Daiwa opinion from a higher court in Japan—its impact has extended far beyond mere persuasive influence on subsequent case law. Indeed, the Daiwa Bank Case continues to be cited today in Japanese corporate law discussions of a director’s duty to establish an internal control system,⁶¹ an area of increasing importance for international corporate law practitioners in Japan.⁶²

Despite the Daiwa Bank Case’s important role in Japanese corporate law and the considerable attention the scandal received from the Japanese and American press, American legal scholars have written little about the Daiwa Bank Case, its legacy, and what it reveals about Japanese corporate law.⁶³ The lack of attention from American legal scholars is surprising in light of the fact that Japan is the United States’ fourth largest trading partner and commands over \$100 billion of foreign direct investment annually from

⁵⁶ See *Kigyō Tōchi Ni Kansuru Shōhō Kaiseihō No Jitsumu No Eikyō* [The Practical Effects of the Commercial Code Reform on Corporate Governance], 1617 SHŌJI HŌMU 8, 12, 17 (2002) (roundtable discussion with Eimei Kubori, Hideki Kanda, and Yoshiaki Miyasako).

⁵⁷ See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

⁵⁸ See *In re Caremark Int’l Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

⁵⁹ See Aronson, *supra* note 17, at 12-13.

⁶⁰ See *id.* at 26.

⁶¹ See, e.g., Motokazu Endō, *Kansa Ni Okeru Fuesei Risuku Taiō Kijun Ga Torishimariyaku Ni Oyoboshieru Eikyō (Jō)* [The Potential Effect of Risk Management Auditing Standards on Corporate Directors (Part I)], 2024 SHŌJI HŌMU 22, 24 (2014) (citing the Daiwa Bank Case in explaining the premises on which the duty to establish an internal control system is based).

⁶² Marubeni and Bridgestone are two examples of major Japanese corporations that have recently found themselves on the wrong side of U.S. anti-bribery enforcement. See *infra* Part III.D.3. High-profile cases like these are a likely contributor to additional practitioner focus on this area. See, e.g., Mitsuru Misawa, *supra* note 5, at 28 (addressing the U.S. Foreign Corrupt Practices Act and other bribery regulations as the second major topic after antitrust law).

⁶³ Bruce Aronson is the only legal scholar with a U.S. Juris Doctor who has published articles focusing chiefly on the Daiwa opinion. He has published two articles about the case. See generally Aronson, *supra* note 17; Bruce Aronson, *Learning from Comparative Law in Teaching U.S. Corporate Law: Director’s Liability in Japan and the U.S.*, 22 PENN ST. INT’L L. REV. 213 (2003). Mitsuru Misawa, who holds an LL.M. from Harvard Law School but received his LL.B. from the University of Tokyo, has also written about The Daiwa Bank Case in English. See generally Mitsuru Misawa, *supra* note 29; Mitsuru Misawa, *A Comparative Study of US and Japanese Directors’ Duty of Disclosure*, 123 BANKING L.J. 39 (2006); Mitsuru Misawa, *Bank Directors’ Decisions on Bad Loans: A Comparative Study of U.S. and Japanese Standards of Required Care*, 122 BANKING L.J. 429 (2005); Mitsuru Misawa, *Shareholders’ Action and Director’s Responsibility in Japan*, 24 PENN ST. INT’L L. REV. 1 (2005).

the United States, giving Japanese corporate behavior the potential to significantly impact U.S. businesses and the U.S. economy.⁶⁴

III. ANALYSIS OF THE DAIWA BANK CASE AND RELATED CORPORATE GOVERNANCE LAW

A. *An Introduction to Fiduciary Duties in Japan*

1. *The Duties of Care and Loyalty*

The plaintiffs' claims in the Daiwa Bank Case were rooted in allegations that the directors breached their fiduciary duties to the bank. Although the fiduciary duties of directors in Japan are similar to their Delaware equivalents, they are not identical, and some background on Japanese fiduciary duties is helpful in understanding the Daiwa opinion.

As under Delaware law, the fiduciary duties of loyalty and due care for corporate directors in Japan find their theoretical grounding in the position of corporate directors and executives as delegees of authority ultimately resting with the shareholders who own the corporation.⁶⁵ Civil Code Article 644 provides that delegees owe a duty to "fulfill delegated obligations with the due care of a good manager."⁶⁶ In Japan, and in the Daiwa Bank Case specifically, the duty of care is referred to as the "duty of care as a good manager" (*zenkanchūgimu*).⁶⁷ Furthermore, the obligations that spring from the duty of care vary according to the business type, scale, scope, and complexity of the relevant company.⁶⁸ Company Law Article 355 codifies the duty of loyalty, providing that "directors must obey the laws, the articles of incorporation, and the decisions made at shareholder meetings, and must execute those duties with loyalty to the joint-stock corporation."⁶⁹ Structurally, some Japanese legal scholars consider the duty of loyalty to be a subordinate and necessary element of the duty of care, such

⁶⁴ *Japan*, OFF. OF THE U.S. TRADE REPRESENTATIVE (Apr. 29, 2014), <http://www.ustr.gov/countries-regions/japan-korea-apec/japan> (citing the trade figure for 2013 and the foreign direct investment figure for 2012, each being the latest year from which data was available at the time of this writing).

⁶⁵ Takurō Yamaguchi, *Torishimariyaku No Zenkanchūgimu Chūjitsugimu: Keiei Handan No Gensoku Nado (Jō) [Directors' Duties of Care and Loyalty: The Business Judgment Rule, Etc. (Part I)]*, 1837 SHŌJI HOMU 32, 32 (2008) (citing Kaishahō [Kaishahō] [Company Law], Law No. 109 of 2006, art. 330 (Japan)).

⁶⁶ MINPŌ [MINPŌ] [CIV. C.] art. 644 (Japan).

⁶⁷ The Daiwa Bank Case, *supra* note 9, at 35.

⁶⁸ Takurō Yamaguchi, *supra* note 65, at 32.

⁶⁹ Kaishahō [Kaishahō] [Company Law], Law No. 109 of 2006, art. 355. *See also* Takurō Yamaguchi, *supra* note 65, at 32.

that any violation of the duty of loyalty automatically results in a violation of the duty of care.⁷⁰

When a director, auditor, accountant, or executive breaches his or her fiduciary duties resulting in a loss to the company, he or she is liable to the company for that loss under Company Law Article 423.⁷¹ In a case of alleged director negligence, a finding of director liability requires the following four elements: (1) the director was negligent, (2) the company suffered damages, (3) there was a causal relationship between the director's negligence and the damages suffered, and (4) there is cause to fault the director for the negligence.⁷² To enforce the director's liability to the corporation, a shareholder may bring a derivative suit on behalf of the corporation under Company Law Article 847. This allows shareholders who have held stock in the company for six months or more to exercise this right by executing a demand on the company to pursue the lawsuit.⁷³ Article 847 further provides that if the company fails to pursue the action within sixty days, the shareholder may commence the derivative suit independently.⁷⁴

2. *The Duty to Establish an Internal Control System*

In Japan, it is now recognized that a director has a duty to monitor her corporate employer as well as establish and maintain an internal control

⁷⁰ See, e.g., Takurō Yamaguchi, *supra* note 65, at 32. This issue is not fully settled. For example, in a 2013 opinion, the Osaka District Court explained that directors are obligated to establish an internal control system as part of their duty of care and then concluded without elucidation that a failure to establish an adequate internal control system is a violation of the duty of care and the duty of loyalty. Osaka Chihō Saibansho [Osaka Dist. Ct.] Dec. 26, 2013, 1435 Kinyū Shōji Hanrei [Kinyū Hanrei] 42, 61 (Japan).

In partial contrast to Japanese law, Delaware law generally defines the duty of care and the duty of loyalty as discrete fiduciary obligations, although Delaware courts concede some overlap. See, e.g., *Chen v. Howard-Anderson*, 87 A.3d 648, 692 (Del. Ch. 2014) (“It is not clear at this stage whether the disclosure violations in the Proxy Statement resulted from a breach of the duty of loyalty or the duty of care.”); *TVI Corp. v. Gallagher*, C.A. No. 7798–VCP, 2013 WL 5809271, at *13 (Del. Ch. 2013) (“[T]he core of Plaintiffs’ allegations are that the Defendants made decisions that were self-interested and motivated by bad faith. Such claims, however, invoke the duty of loyalty, not the duty of care.”) (emphasis added). But see *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 746 n.402 (Del. Ch. 2005) (“The phrasing is natural because, at its core, the duty of loyalty is just a bet that some situations are likely to lead to careless or imprudent transactions for the corporation, which is to say that the duty of care is a motivating concern for the duty of loyalty. Here again the duties overlap.”) (quoting Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 Duke L. J. 1, 43 (2005)).

⁷¹ Kaishahō [Kaishahō] [Company Law], Law No. 109 of 2006, art. 423, para. 1 (Japan). See also Takurō Yamaguchi, *supra* note 65, at 34.

⁷² Takurō Yamaguchi, *supra* note 65, at 34. It is, admittedly, difficult to imagine a situation where a finding of negligence is appropriate but where there is not “cause to fault” the director for negligence.

⁷³ *Id.*; Kaishahō [Kaishahō] [Company Law], Law No. 109 of 2006, art. 423, para. 1 (Japan).

⁷⁴ Kaishahō [Kaishahō] [Company Law], Law No. 109 of 2006, art. 423, para. 3 (Japan).

system.⁷⁵ However, it is still not fully settled how exactly the business judgment rule applies to the standards established by the internal control system and to what extent directors enjoy a right of reliance in ensuring the efficacy of the system.⁷⁶ During the time period when Iguchi was making unauthorized trades at Daiwa, legal scholars in Japan already recognized that directors owe a duty to monitor, but the legal basis for the duty was still the subject of debate at that point.⁷⁷

3. *The Business Judgment Rule*

As in Delaware, the business judgment rule in Japan applies to directors' business decisions in their capacity as corporate managers, offering protection against a claim that a director violated her fiduciary duties. The rule "provides that corporate officers should be afforded wide discretion in their business judgments" and will not breach their duties of care or loyalty "absent decisions that are unreasonable under the circumstances and at the time they were made."⁷⁸ One legal scholar's formulation of the Japanese rule, which appears to be generally consistent with the Osaka District Court's application in Daiwa, is that the rule limits a court's inquiry to: (1) whether the director was erroneously inattentive with regard to the facts upon which the director based her business decision, and (2) whether the director's choice of behavior based on those facts was "extremely unreasonable" (*ichijirushiku fugōri*).⁷⁹ This formulation is, at least in theory, designed to allow directors to approach business decisions aggressively, a claim that this article will address in Part III.D.1.⁸⁰ A knowing violation of law does not fall within the scope of business decisions protected by the business judgment rule, although the bounds of this exception were still in debate at the time Daiwa was decided.⁸¹

⁷⁵ KENJIRŌ EGASHIRA, *KABUSHIKIGAISHAHŌ* [THE LAW OF STOCK CORPORATIONS] 371 (2d ed. 2008).

⁷⁶ For a recent example of the ongoing debate about the scope of the duty to monitor and the court's deference, or lack thereof, to directors' business judgments and reliance on others, see Yasushi Ito, *supra* note 8, at 12–15.

⁷⁷ KAZUTERU KAMI, *TORISHIMARIYAKU NO KENGEN TO SEKININ* [THE RIGHTS AND RESPONSIBILITIES OF DIRECTORS] 70 (Chuō Keizaisha ed., 1994).

⁷⁸ HATSURU MORITA, *Wagakoku Ni Keieihandan Gensoku Wa Sonzai Shite Ita No Ka* [Did the Business Judgment Rule Ever Exist in Japan?], 1858 SHŌJI HŌMU 4, 4 (2009).

⁷⁹ TAKURŌ YAMAGUCHI, *supra* note 65, at 40 n.9 (alternatively formulated as "obviously unreasonable" (*akiraka ni fugōri*)).

⁸⁰ *Id.* at 35.

⁸¹ *Id.* at 36 (citing Kazushi Yoshihara, *Torishimariyaku No Keiei Handan To Kabunushi Daihyō Soshō* [Shareholder Representative Suits and the Business Judgment Rule for Directors], in *KABUNUSHI*

Additionally, at the time of the Daiwa verdict, Commercial Code Article 266⁸² required that directors obey the “laws and regulations” (*hōrei*) as part of their duty of care, an obligation which the Daiwa Court used as a basis for stripping business judgment protection⁸³ and finding director liability.⁸⁴ However, it was an open question whether “laws and regulations” included the laws and regulations of foreign countries in addition to those of Japan.⁸⁵ At the time—and afterwards—there was considerable debate about whether a duty to obey the laws of foreign countries is in fact a component obligation of the duty of loyalty.⁸⁶

B. *The Duty to Establish an Internal Control System*

1. *The Daiwa Court’s Ruling on the Duty of Directors to Establish an Internal Control System*

At least as important as any other aspect of the Daiwa opinion is that Daiwa was the first case to find directors liable for a failure to institute an effective internal control system to monitor legal compliance.⁸⁷ The plaintiffs alleged that although Daiwa had implemented some internal controls in its New York office, the system suffered from such egregious deficiencies that the directors’ failure to improve it amounted to a breach of the directors’ fiduciary duties.⁸⁸ The defendant directors, for their part, alleged that the system in place went above and beyond the industry standard at the time and that it was ineffective only because the measures Iguchi took to conceal his losses were exceptionally devious.⁸⁹ The directors further claimed that “[e]stablishing an internal control system that can withstand even an unusually clever scheme to conceal improper activity is

DAIHYŌ SOSHŌ TAIKEI [A SURVEY OF SHAREHOLDER DERIVATIVE SUITS] 52 (Mitsuo Kondō ed., 1996); see also the Daiwa Bank Case, *supra* note 9, at 5.

⁸² SHŌHŌ (COMM. C.) art. 266, para. 1, no. 5 (Japan) (repealed 2005). It has since been replaced by Company Law Article 355.

⁸³ The Daiwa Bank Case, *supra* note 9, at 41-42.

⁸⁴ Shinsaku Iwahara, *supra* note 29, at 11; see also the Daiwa Bank Case, *supra* note 9, at 32-33.

⁸⁵ Shinsaku Iwahara, *supra* note 29, at 4 n.1.

⁸⁶ See, e.g., *The Practical Effects of the Commercial Code Reform on Corporate Governance*, *supra* note 56, at 19 (Professors Kanda and Miyasako discuss the problematic nature of defining the scope of Commercial Code art. 266 to include foreign laws, with Professor Miyasako noting that even after the Daiwa Bank Case, he interprets the conventional wisdom to be that art. 266 refers only to domestic laws). This debate seems to have subsided. See, e.g., KENJIRŌ EGASHIRA, *supra* note 75, at 427 (simply stating that directors must obey “all the laws” including laws for the public benefit).

⁸⁷ Shinsaku Iwahara, *supra* note 29, at 11 (noting that the Daiwa Bank Case was a “watershed” (*kakkiteki*) opinion with regard to the duty to implement an internal control system).

⁸⁸ The Daiwa Bank Case, *supra* note 9, at 10-12.

⁸⁹ *Id.* at 12-13.

beyond the scope of the duty of care required by law of directors and auditors.”⁹⁰

Ultimately, the court held that directors did indeed have a duty to establish an internal control system:

[The] internal control system must accurately assess, for example, credit risks, market risks, liquidity risks, administrative risks, and systemic risks[,] . . . control these risks adequately . . . [and] must be responsive to the scope of the company’s business, any unique qualities of that business, and similar issues [D]irectors, in their capacity as members of the board of directors, and in their capacity as representative directors or as directors who manage business operations, owe a duty to the company to establish an internal control system [B]ecause statutory auditors . . . are responsible for monitoring the company’s operations, they are responsible for monitoring whether directors are maintaining the internal control system.⁹¹

The court further explained that this obligation was part of the directors’ duties under Commercial Code Article 266, para 1, no. 5.⁹²

From a practical standpoint, the scope and nature of the duty to establish an internal control system is inextricably tied to the depth of review that courts will apply when a plaintiff later challenges the system’s adequacy. Accordingly, in order to fully appraise the duty created by the court it is necessary to understand the specifics of the court’s review and analysis of the internal control system. This is easier said than done, as the Daiwa court’s analysis is abstruse and inconsistent. The greatest challenge to a coherent understanding is that it is not clear what standard of review the court employed. The court noted that it should evaluate the risk management system according to the standards in existence during the time in question, that the “specifics of the risk management system are a matter of business judgment” and that directors “are afforded wide discretion in such matters.”⁹³ However, the court then went on to substantively analyze whether each of the alleged deficiencies in the internal control system reflected inadequate implementation of risk management procedures.⁹⁴ It is

⁹⁰ *Id.* at 13.

⁹¹ *Id.* at 32-33.

⁹² Shinsaku Iwahara, *supra* note 29, at 11; the Daiwa Bank Case, *supra* note 9, at 32-33.

⁹³ The Daiwa Bank Case, *supra* note 9, at 33.

⁹⁴ *Id.* at 33-37.

unclear whether the court applied the business judgment rule here, especially when this portion of the opinion is contrasted with the court's later analysis of the directors' violations of U.S. law.⁹⁵

In its opinion, the court first articulated several specific risks that an internal control system must address, but did not clarify whether this analysis reflected current industry practices or practices in effect during the period of Iguchi's unauthorized trading.^{96, 97} The court then abruptly moved on to address the plaintiffs' allegations of inadequacy with regard to the risk management system.⁹⁸ Throughout its analysis, the court judged that certain elements of the system were "inadequate."⁹⁹ The court at no point elucidated what standard it was employing to evaluate the internal control system, but it concluded that the method for confirming the balance of Treasury bonds in the New York office was "egregiously inappropriate" and ultimately found one director liable on that basis.¹⁰⁰

In light of this analysis, one can deduce that if deference to directors' business judgments offers any protection against a deep substantive review of the internal control system, that protection vanishes when the measures in place are "egregiously inappropriate" or possibly at a lower threshold. In short, in evaluating what it describes as "business judgments" with respect to the internal control system in the First Case, the court addressed the plaintiffs' allegations by probing into the various component elements of those business judgments without articulating a standard of review (though

⁹⁵ The court's analysis of Daiwa's violations of U.S. law includes a section explicitly titled "The Business Judgment Rule," which explains the basis for the rule and why the rule does not apply in this case; an analogous section is conspicuously absent from the court's analysis of the internal control system. Yet, as noted earlier, the court did state explicitly that the particulars of the internal control system are a "matter of business judgment" (*keiei handan no mondati*). *Id.* at 41 (marking the start of the court's business judgment analysis for the decision to violate U.S. law); *id.* at 33 (describing the internal control system as a matter of "business judgment"). This vague reference to "business judgment" without an explicit application of the business judgment rule has even appeared in a more recent decision from the Supreme Court of Japan. Saikō Saibansho [Sup. Ct.] July 15, 2010, 2091 HANREI JIHŌ [HANJI] 90, 93 (Japan).

⁹⁶ The court stated in part that (1) trading in securities creates a risk that traders may abuse their authority, seek to conceal their losses, and then increase those losses in a failed attempt at concealment; and (2) the custody business entails the risk that the custodian will sell the assets in custody without permission. The court then stated that a company must develop an effective internal control system in order to minimize these risks. These criteria highlighted by the court are remarkably similar to the precise actions that Daiwa Bank failed to prevent, making the potential influence of hindsight hard to ignore. The Daiwa Bank Case, *supra* note 9, at 33.

⁹⁷ It seems likely, furthermore, that the court's analysis was not consistent with industry standards at the time. Shinsaku Iwahara, *supra* note 29, at 12.

⁹⁸ The Daiwa Bank Case, *supra* note 9, at 33-34.

⁹⁹ *Id.* at 35.

¹⁰⁰ *Id.* *Ichijirushiku tekisetsusa wo kaite ita*, in the original Japanese, is here translated as "egregiously inappropriate."

at times mentioning “adequacy”). The court then reviewed its own adequacy inquiry for any elements of the business judgments that were “egregiously inappropriate.” There does not appear to be a threshold procedural inquiry that could foreclose substantive review.

Given the court’s sprawling and deep analysis, the duty of directors to establish an internal control system would appear to encompass more than a simple reporting and control structure. Rather, directors appear to be obligated as part of their fiduciary duties to establish a complex and sophisticated network of controls, perhaps even beyond industry standards.¹⁰¹ In evaluating this approach, Delaware case law provides a helpful point of reference.¹⁰²

2. *A Comparison with Delaware Law*

In this area, the Daiwa case is most clearly comparable to the seminal Delaware internal control system case, *In re Caremark International Inc. Derivative Litigation*.¹⁰³ There are, however, key differences between the standards articulated by the Daiwa and *Caremark* courts with regard to what will fulfill the internal control system requirement. Most notably, while the Daiwa standard involves an exacting evaluation of the substance of the internal control system, the *Caremark* standard provides that “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”¹⁰⁴ The *Caremark* approach is easy to reconcile with the policy considerations behind the business judgment rule,¹⁰⁵ as it is designed to “mak[e] board service by qualified persons more likely,” and “act as a stimulus to good faith performance of duty by such directors.”¹⁰⁶

The starkly different degrees of analysis to which the Daiwa court and the *Caremark* court subjected their defendants’ respective internal control systems reflect the different approaches of the Daiwa and *Caremark* courts

¹⁰¹ See *supra* note 96 and accompanying text.

¹⁰² Delaware jurisprudence is a useful point of comparison due to the high level of sophistication and wide influence of Delaware corporate law decisions. See *generally supra* note 12.

¹⁰³ *In re Caremark Int’l Inc. Derivative Litigation*, 698 A.2d 959, 970 (Del. Ch. 1996); Aronson, *supra* note 17, at 34-36 (drawing the connection to *Caremark* and providing substantial comparative analysis).

¹⁰⁴ *Caremark*, 698 A.2d at 971.

¹⁰⁵ For more detail on the business judgment rule, see *infra* Part III.C-D.

¹⁰⁶ *Caremark*, 698 A.2d at 971 (italics omitted).

with regard to the business judgment rule.¹⁰⁷ Whereas the *Caremark* court eschewed substantive analysis of business decisions,¹⁰⁸ the Daiwa court engaged in such analysis without reservation; whereas the *Caremark* court required virtual absence of an internal control system for a finding of liability,¹⁰⁹ the Daiwa court found a director liable for hundreds of millions of dollars despite the undeniable existence of a functional, if inadequate, internal control system within Daiwa Bank.

The Daiwa opinion illustrates the perils of a rule that requires courts to wade into the substance of the internal control system. Not only did the Daiwa court apply its internal control review standards in an apparently retroactive manner, the criteria espoused by the court also put an enormous burden on defendant directors who wish to argue, as part of their defense, that their internal controls were consistent with industry standards. Such directors confront the unenviable task of persuading another industry player to expose itself to criticism or perhaps even liability by testifying that its internal control system was comparable to the defendant directors' allegedly inadequate system.¹¹⁰

In 2006, the Delaware Supreme Court scrutinized the *Caremark* standards in *Stone v. Ritter*, another landmark case.¹¹¹ Aside from endorsing the standard of director liability articulated in *Caremark*, the court underscored the extreme difficulty of establishing director liability for a failure to monitor.¹¹² The court noted:

[I]mposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations . . . [P]laintiffs' complaint seeks to equate a bad outcome with bad faith . . . [but] [i]n the absence of red flags, good faith in the context of oversight must be measured by directors' actions "to assure a reasonable information and reporting system exists" and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome.¹¹³

¹⁰⁷ As discussed in *supra* Part III.B.1, it is not entirely clear if the court's analysis of the internal control system reflects an application of the Japanese business judgment rule. See *infra* Part III.D for further comparative analysis of the business judgment rule.

¹⁰⁸ *Caremark*, 698 A.2d at 971.

¹⁰⁹ *Id.*

¹¹⁰ *The Practical Effects of the Commercial Code Reform on Corporate Governance*, *supra* note 56, at 17.

¹¹¹ *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006).

¹¹² *Id.* at 373.

¹¹³ *Id.* (quoting *In re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959, 971 (Del. Ch. 1996)).

Delaware courts thus consider director decisions with regard to the structure of an internal control system to be no less deserving of business judgment protection than other types of business decisions.¹¹⁴ Furthermore, the Delaware rule is not necessarily a total bar to director liability in circumstances such as the Daiwa Bank Case; *Stone v. Ritter* leaves open the possibility that “‘red flags’ can be pled with sufficient particularity” to suggest director malfeasance sufficient for at least excusal of the demand requirement, and some non-Delaware courts have applied the *Caremark* standard this way.¹¹⁵

The Daiwa plaintiffs might have explored this red flags argument. Although Daiwa Bank had passed various inspections and examinations at the hands of several regulatory entities without incident, other red flags were nonetheless present. For example, in 1988, the Ministry of Finance informed Daiwa Bank that its “Treasury bond trading volume [wa]s unusually high” and that it should “reduce trading volume.”¹¹⁶ Mail from securities firms also continued to arrive at the bank’s downtown custody office due to Iguchi’s continued trading in that office even after Daiwa formally ceased all securities trading in the custody office.¹¹⁷ Furthermore, Daiwa’s New York branch at one point transferred Treasury bond traders from its downtown to its midtown office in order to avoid the exposure of unauthorized, continued trading at the downtown office during an investigation by the F.R.B.¹¹⁸ Finally, in 1993, Daiwa Bank’s Americas Strategy Office informed the bank’s New York branch manager that the trading of Treasury bonds in the downtown custody office was illegal, and a Japanese governmental inspector also warned the manager that Iguchi should not be responsible for both the custodial business and the trading of Treasury bonds.¹¹⁹

The Daiwa Bank Case serves as a useful example of the advantages of the Delaware formulation of the duty to monitor. The plaintiffs in the Daiwa

¹¹⁴ *Id.* Although the good faith analysis is technically not an application of the business judgment rule per se, *Stone v. Ritter* sets forth an extremely deferential standard that is highly protective of directors’ business judgments. See *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006).

¹¹⁵ Paul L. Lee, *Risk Management and the Role of the Board of Directors: Regulatory Expectations and Shareholder Actions*, 125 *BANKING L.J.* 679 (2008). See, e.g., *Rich ex rel. Fuqi Intern., Inc. v. Yu Kwai Chong*, 66 A.3d 963, 977 (Del. 2013) (Addressing a derivative claim in the corporate oversight context: “[W]here the plaintiff by particularized pleading has raised a reasonable doubt that the board’s actions are in compliance with its fiduciary duties, Rule 23.1 [of the Delaware Chancery Court Rules, requiring that plaintiffs allege with particularity the efforts made to obtain the desired action from the corporate directors,] is satisfied and the plaintiff may proceed derivatively.”).

¹¹⁶ The Daiwa Bank Case, *supra* note 9, at 11.

¹¹⁷ *Id.* at 10-11.

¹¹⁸ *Id.* at 11.

¹¹⁹ *Id.* Daiwa also received warnings from the Bank of New York. See *supra* Part II.A.

Bank Case had a colorable and perhaps compelling argument that sufficient red flags existed, at least with respect to certain directors, for failure to improve the internal control system to amount to a conscious disregard of the duty to monitor. In analyzing such a claim, the Daiwa court might have been able both to avoid second-guessing directors' business decisions and to incentivize diligent responses on the part of directors to warnings that arise through the internal control system. However, given that directors are able to assume that delegees responsible for implementing and maintaining particular aspects of the internal control system are acting in good faith, it is unlikely that any red-flag-based claims in the Daiwa case would have implicated all of the defendant directors who were implicated by the plaintiffs' allegations of substantive deficiencies in the internal control system.¹²⁰ Yet the Daiwa court only found one director ultimately liable for damages in the First Case, so the plaintiffs might well have achieved the same outcome under this alternative theory of liability. With this duty now being applied to a potentially broader scope than in the past,¹²¹ Japanese courts should consider the potential benefits of a Delaware-style analysis.

3. *Subsequent Developments in Japanese Law*

Legal reforms in Japan subsequent to the Daiwa Bank Case have fleshed out the Daiwa court's partially inchoate standards. The Japanese duty to establish an internal control system, which was not codified when the Daiwa opinion was released,¹²² now appears in Company Law Article 362, para. 4, no. 6, which requires, among other things, that directors establish a means for insuring that the directors' duties and the company's business are executed in accordance with applicable laws and with the company's articles of incorporation.¹²³ Company Law Enforcement Regulation No. 100, para. 1 also provides some particular, if vague, internal control requirements for joint stock corporations. For example, a company must establish a system for maintaining and managing information related to directors' execution of their duties, and must implement a system for managing the risk of loss to the corporation.¹²⁴

¹²⁰ The plaintiffs brought suit against a total of 38 directors and statutory auditors in the First Case. The Daiwa Bank Case, *supra* note 9, at 10.

¹²¹ See *infra* Part III.B.3.

¹²² The duty was first codified in 2002, in SHŌHŌTOKUREIHŌ [COMMERCIAL CODE SPECIAL STATUTES] art. 21-7, para. 1, no. 2 (Japan). See KENJIRŌ EGASHIRA, *supra* note 75, at 371 n. 4.

¹²³ YOSHINORI TSUCHIDA, NAIBUTŌSEI NO JITSUMU [INTERNAL CONTROL SYSTEMS IN PRACTICE] 3, 6 (2d ed. 2007).

¹²⁴ *Id.* at 3.

Subsequent legal reforms also require that directors, upon establishing an internal control system, publish a summary of the system in the corporation's business report.¹²⁵ In the report, directors must include an auditors' evaluation of their internal control system, including its adequacy or lack thereof, and an explanation of the reasons for any inadequacy.¹²⁶ Financial Products Trading Law Article 24-4, para. 4, no. 1 provides further evaluation and reporting requirements for listed companies.¹²⁷ As articulated in the Daiwa Bank Case, directors also owe to the company a duty to supervise other corporate actors' fulfillment of their duties.¹²⁸

Given that internal control systems are subjected to increased extrajudicial scrutiny under the subsequent codification of internal control rules, one might think that Japanese courts would be free to take a more hands-off approach when inquiring into the adequacy of a corporation's internal control system, but the legacy of Daiwa lives on. The Fukuoka District Court, in a surprising 2011 ruling that was subsequently affirmed by the Fukuoka High Court, held that directors violated their duty to monitor for reasons that included their failure to detect fraudulent business practices at a subsidiary.¹²⁹ Although the prevailing wisdom among Japanese legal scholars at the time was that directors have a duty to understand the business of their employer-company's subsidiaries in light of the fact that the subsidiaries' equity is an asset of the parent company, the traditional view in Japan was that directors do not have a duty to specifically monitor compliance at these subsidiaries.¹³⁰ Accordingly, the Fukuoka rulings represent an unexpected and potentially substantial expansion of the scope with which Japanese courts may apply the standards originating in Daiwa.

Lastly, following post-Daiwa reforms to Japan's Company Law, an important similarity with Delaware has emerged with respect to limitations on liability. Under Delaware law, directors' monitoring duty is a component of the duty of good faith, which is a subordinate element of the duty of

¹²⁵ *Id.* at 7.

¹²⁶ *Id.*

¹²⁷ KENJIRŌ EGASHIRA, *supra* note 75, at 371 n.4.

¹²⁸ The Daiwa court held that directors are generally allowed to delegate specific monitoring tasks and assume that the delegees are executing their duties in good faith absent extraordinary circumstances indicating otherwise. This ability to delegate, however, does not relieve directors of their duty to monitor. The Daiwa Bank Case, *supra* note 9, at 38. Although this, and the principle that directors must establish an internal control system, are now commonly accepted, the Daiwa Bank Case remains one of the leading cases on this point. See KENJIRŌ EGASHIRA, *supra* note 75, at 430 (the first relevant citation is to The Daiwa Bank Case).

¹²⁹ Judgment of Jan. 26, 2011, Fukuoka Chihō Saibansho [Fukuoka Dist. Ct.], Jan. 26, 2011, 1367 KINYŪ SHŌJI HANREI [KINYŪ HANREI] 41, 62-63 (Japan), *aff'd* by Fukuoka Kōtō Saibansho [Fukuoka High Ct.] Apr. 13, 2013, 1399 KINYŪ SHŌJI HANREI [KINYŪ HANREI] 24, 31 (Japan).

¹³⁰ Yasushi Ito, *supra* note 8, at 13-14.

loyalty, and in Delaware director liability cannot be reduced or eliminated for violations of the duty of loyalty.¹³¹ In Japan, limitations on director liability extend only to findings of simple negligence, so, as in Delaware, director liability is probably unlimited for a sustained and repeated failure to respond to significant red flags.¹³²

C. *The Role of the Business Judgment Rule in the Daiwa Bank Case*

1. *The Business Judgment Rule in Relation to the Internal Control System (The First Case)*

As described in Part III.B.1 above, the Daiwa court's analysis of the internal control system appears to reflect an application of the business judgment rule, but this is not perfectly clear. Because the concerns that animate the business judgment rule are generally applicable to a judicial analysis of the specifics of a company's internal control system,¹³³ this article will also address the Daiwa court's internal control analysis from a business judgment rule perspective. While analysis in Part III.B focuses on the duty to establish an internal control system and the scope of that duty, the analysis in Part III.D focuses specifically on the business judgment rule, both as applied in the Daiwa Bank Case and generally. Admittedly, these concepts are not perfectly separable given that the nature of the duty to establish an internal control system is defined in part by the level of business judgment protection courts will afford directors in fulfilling that duty.¹³⁴ However, bifurcating the analysis is useful as the business judgment rule is an important concept that merits discussion in its own right. Accordingly, Part III.D.1 addresses the court's business judgment analysis with respect to both the First Case and the Second Case.

¹³¹ Rebecca Walker, *The Importance of Board Oversight of a Company's Compliance Program: The Implications of Stone v. Ritter*, 1731 PLI/CORP 559, 566 (2009).

¹³² KIICHI GOTŌ, SHINKAISHAHŌ [THE NEW COMPANY LAW] 304 (2008). See *infra* Part III.E for a discussion on Japanese limits on director liability.

¹³³ Delaware courts' approach to internal control system analysis is designed to "mak[e] board service by qualified persons more likely," and "act as a stimulus to good faith performance of duty by such directors." *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996); see also *supra* Part III.B.2.

¹³⁴ See *supra* Part III.B.1.

2. *The Business Judgment Rule in Relation to Corporate Criminality (The Second Case)*

The Osaka District Court's analysis of the Daiwa directors' violations of U.S. law was groundbreaking.¹³⁵ In determining the scope of "laws and regulations" with which directors must comply, the court states with little analysis that directors' duty to obey the laws extends to the laws of foreign countries because "[o]beying the laws is the very basis of corporate management" and that "Commercial Code Article 266, para. 1, no. 5 not only requires compliance with the laws of Japan, but also requires compliance with the laws of any country into which the company expands its business."¹³⁶ The defendant directors argued that the business judgment rule should apply to their actions and that these were difficult business decisions made in a good faith attempt to deal with a massive scandal at a time of great uncertainty in the banking industry.¹³⁷ In response, the court explored the possibility of providing business judgment rule protection to the directors' actions.¹³⁸

D. *The Substance of the Daiwa Court's Business Judgment Rule Analysis*

1. *Analysis and Comparison to Delaware Law*

The Daiwa court's business judgment rule analysis in the Second Case is simpler and easier to address than in the First Case. In the Second Case, before the court explicated the business judgment rule, it moved through each group of directors and analyzed whether those directors breached their fiduciary duties in connection with the bank's actions that led to its indictment.¹³⁹ Here, the court's analysis becomes notably muddled. While it would seem simple enough to at least argue that some of the defendant directors were engaged in a criminal conspiracy to commit some of the illegal acts for which Daiwa was indicted, and thus ineligible for business judgment rule protection, the court brushed past this line of reasoning. It ultimately found that several directors breached their fiduciary duties by, if

¹³⁵ Shinsaku Iwahara, *Daiwa Ginkō Daihyō Soshō Jiken Isshin Hanketsu To Daihyō Soshō Seido Kaisei Mondai (Ka)* [*The Daiwa Bank Derivative Suit Trial Court Opinion and Issues of Reform of the Derivative Suit System (Part II)*], 1577 SHŌJI HŌMU 4, 4 (Nov. 15, 2000).

¹³⁶ The Daiwa Bank Case, *supra* note 9, at 39. This unprecedented holding is discussed in greater detail at *infra* Part III.D.3.

¹³⁷ The Daiwa Bank Case, *supra* note 9, at 41-42.

¹³⁸ *Id.*

¹³⁹ *Id.* at 40-41.

not ordering illegal activities themselves, then “at the very least” failing to prevent those illegal activities.¹⁴⁰ This is extraordinary because, although illegal activities are not afforded business judgment protection,¹⁴¹ the court did not clarify what specific illegal activities took place in order to justify stripping business judgment protection from certain directors.¹⁴²

One can easily conceive of at least a minimally credible explanation of why a bank director might make a good faith judgment that later turned out to allow or even facilitate illegal activity on the part of other bank managers or employees.¹⁴³ However, the Daiwa court did not appear to consider this possibility. Instead, the court simplistically explained that the business judgment “discretion accorded to directors does not extend to decisions to violate laws, and it is not for directors to decide whether to obey laws, including the laws of foreign countries” without explicating how precisely these directors had violated the law.¹⁴⁴ The absence of a thorough justification for stripping business judgment protection from the directors who were not criminally charged may reflect the unusual circumstances of the case; it is certainly possible that the Daiwa court was uncomfortable concluding that these individual directors had violated U.S. law without some kind of a U.S. court decision to substantiate such an interpretation. Nonetheless, omitting a necessary step of the liability analysis further confuses the issue of when business judgment protection should apply.

By comparison, it is not clear that Delaware’s business judgment rule classifies all director decisions to take illegal corporate action as breaches of the duty of care, especially in cases where the director is not aware that the action is illegal.¹⁴⁵ Accordingly, it is hard to imagine that mere failure to prevent illegal activities “at the very least” would be sufficient grounds for stripping business judgment rule protection and finding director liability

¹⁴⁰ *Id.*

¹⁴¹ The majority view in Japan appears to be that the business judgment rule does not apply even to inadvertent, non-negligent violations of law, but if a director can show a lack of both knowledge and negligence, she can nonetheless avoid liability. KENJIRO EGASHIRA, *KABUSHIKIGAISHAHO TAIKEI* [SERIES ON THE LAW OF STOCK CORPORATIONS] 316 (1st ed. 2013).

¹⁴² Furthermore, in stating its decision, the court did not explicitly reference any failure-to-monitor standard other than asserting that certain directors should have been able to prevent the illegal activity. Accordingly, it is not entirely clear if a business decision related to monitoring or simply a lack of action is what the court deemed to be a breach of fiduciary duty. This makes analysis from a business judgment standpoint somewhat difficult. *The Daiwa Bank Case*, *supra* note 9, at 40-41.

¹⁴³ For example, the director may have believed that the behavior was not in fact illegal and even received advice from a lawyer to that effect. Alternatively, the director may have believed that the actions necessary to ensure prevention of the illegal activity were beyond her individual authority and extraordinarily costly while the risks involved were exceedingly low.

¹⁴⁴ *The Daiwa Bank Case*, *supra* note 9, at 42.

¹⁴⁵ See, e.g., Thomas A. Uebler, *Shareholder Police Power: Shareholders’ Ability to Hold Directors Accountable for Intentional Violations of Law*, 33 DEL. J. OF CORP. L. 199, 206-07, 213-14.

under the Delaware standard.¹⁴⁶ Indeed, the standard set by the Daiwa court would significantly impair the efficacy of the business judgment rule, especially in situations where the illegal nature of the corporate action is unclear and the directors have acted in good faith.

Compared to the Second Case, the business judgment analysis in the First Case is more complicated and confused. Most notably, the court's approach to the plaintiffs' allegations is deeply substantive and in that sense remarkably different from business judgment analysis under Delaware law. Under Delaware law, the business judgment rule is:

[A] presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company The burden is on the party challenging the decision to establish facts rebutting the presumption

[T]o invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. While the Delaware cases use a variety of terms to describe the applicable standard of care . . . under the business judgment rule director liability is predicated upon concepts of gross negligence.¹⁴⁷

In contrast to the Delaware rule, in addressing the plaintiffs' argument that the directors failed to implement an effective internal control system, the Osaka District Court found, for example, that the defendants' failure to implement a system of surprise inspections was "not necessarily an inadequate inspection method when examined from a risk-management perspective."¹⁴⁸ This kind of inquiry into whether the particulars of the

¹⁴⁶ The standard in Delaware seems to require at least some measure of scienter. *See, e.g.*, *Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch. 2007) ("*Caremark* itself encouraged directors to act with reasonable diligence, but plainly held that director liability for failure to monitor required a finding that the directors acted with the state of mind traditionally used to define the mindset of a disloyal director—bad faith—because their indolence was so persistent that it could not be ascribed to anything other than a knowing decision not to even try to make sure the corporation's officers had developed and were implementing a prudent approach to ensuring law compliance.").

¹⁴⁷ *Aronson v. Lewis*, 473 A. 2d 805, 812 (Del. 1984).

¹⁴⁸ The Daiwa Bank Case, *supra* note 9, at 35.

business decision do or do not measure up to the court's standards of "adequacy" is exactly the type of analysis that the Delaware business judgment rule appears designed to obviate. Application of the Delaware business judgment rule would require that the court stop its inquiry immediately upon finding a "rational business purpose" for the directors' actions, absent certain other special circumstances, such as self-dealing.¹⁴⁹ In *Daiwa*, the defendants argued that providing prior notice of inspections was a measure designed to speed up the inspection process, which, disingenuous or not, surely amounts to a rational business purpose.¹⁵⁰ Had these allegations been made before a Delaware court, the liability analysis would almost certainly have stopped there if it were not already foreclosed by *Caremark*.¹⁵¹

Although the *Daiwa* court's analysis of the bank's internal control system differs starkly from an application of the Delaware business judgment rule, that does not mean that the analysis is necessarily faulty under Japanese law. At the time of the *Daiwa* case, there was not a clear-cut distinction between substantive and procedural business judgment analysis as there exists in Delaware.¹⁵² In his writing on *Daiwa*, Professor Aronson takes a generally positive view of the court's internal control analysis, describing it as a new duty of oversight "formulated within the Japanese courts' existing framework of examining liability based primarily on a director's supervision over a particular business department."¹⁵³ Professor Aronson does criticize the court's business judgment analysis but does not do so harshly.

Nonetheless, the logical underpinnings of the Japanese business judgment rule are generally analogous to those articulated by Delaware courts.^{154, 155} Furthermore, the reasons that Delaware courts refuse to engage

¹⁴⁹ The Delaware business judgment rule "posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be 'attributed to any rational business purpose.'" *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)). The *Daiwa* court's analysis of the various elements of the internal control system for adequacy and efficacy reaches much deeper into the realm of director discretion than would a mere search for a "rational business purpose."

¹⁵⁰ The *Daiwa* Bank Case, *supra* note 9, at 12-13.

¹⁵¹ *Caremark* is discussed in greater detail in *supra* Part III.B.2.

¹⁵² See KAZUSHI YOSHIHARA ET AL., *KAISHAHŌ* [CORPORATE LAW] 163, 164 (2d ed. 2001) (roughly contemporaneous with the *Daiwa* decision) (describing the business judgment rule as a tool with which to determine whether directors had acted negligently in violation of Commercial Code Article 266).

¹⁵³ Aronson, *supra* note 17, at 59. Professor Aronson does note in a different article that hindsight bias presents a significant problem in the *Daiwa* case. See Aronson, *supra* note 63, at 237.

¹⁵⁴ See KENJIRŌ EGASHIRA, *supra* note 75, at 428 n.3 (noting that the Japanese business judgment rule is designed to prevent directors from avoiding risk when doing so does not work to maximize shareholder wealth and to avoid retroactively evaluating directors' decisions in a way that will make them risk-averse);

in substantive analysis of directors' business judgments apply just as well to corporate directors in Japan as they do to those in the United States. Most salient are courts' "institutional incompetence . . . to pass upon the wisdom of business decisions," the risk of incentivizing directors to become excessively risk-averse, and the risk of deterring promising candidates for directorship from service.¹⁵⁶ Problems of hindsight bias also may skew courts' concepts of what risks were or were not foreseeable.¹⁵⁷

In the context of Daiwa, Professor Aronson has suggested that "traditional views hostile to public disclosure of confidential corporate processes" and "the absence of an effective litigation discovery system" may make it difficult for plaintiffs to obtain "sufficient information on the decision-making process."¹⁵⁸ Professor Aronson argues that these concerns may justify an inquiry into the substance of directors' business decisions.¹⁵⁹ While this analysis may accurately pinpoint the motivation behind the substantive component of Japanese business judgment analysis, the lack of an effective discovery system and lack of corporate disclosure are more likely to exacerbate rather than legitimate the shortcomings of substantive business judgment inquiries. Plaintiffs, rarely able to obtain evidence relating to the process of a business judgment, must logically focus their claims on substantive flaws in the judgment. Information related to the substance and results of business judgments is much more likely to be obtainable through news sources or other public records compared to information relating to the decision-making process itself. The Daiwa case itself provides a fine example; many of the plaintiffs' allegations concerned the substantive elements of the internal control system but none of their allegations focused on the process of decision-making that shaped the

see GARY LOCKWOOD, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES, AND LIABILITIES § 2:12 (2014) (stating, among other reasons, that the business judgment rule "serves to give managers sufficient latitude in decision-making to avoid the overly conservative management that would be the likely result of excessive exposure to liability").

¹⁵⁵ This claim is not entirely without controversy. See Hatsuru Morita, *Wagakoku Ni Keieihandan Gensoku Wa Sonzai Shite Ita No Ka* [Did the Business Judgment Rule Ever Exist in Japan?], 1858 SHŌJI HŌMU 4 (Feb. 25, 2009) (arguing that the Japanese business judgment rule does not appear to be grounded in the current contractual theory animating the Delaware rule but nonetheless agreeing that it arises from a delegation of authority).

¹⁵⁶ LOCKWOOD, *supra* note 154, at nn.18-20 (citing *Freedman v. Restaurant Associates Industries, Inc.*, 1987 WL 14323, *8 (Del. Ch. 1987) (unreported)); John C. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 26 (Oct. 1986) (noting that outside directors are likely to be risk-averse because they face substantial liability but have a relatively small stake in the corporation); see also *Smith v. Brown-Borhek Co.*, 200 A.2d 398, 401 (Pa. 1964)).

¹⁵⁷ Aronson, *supra* note 63, at 237.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

contours of the internal control system.¹⁶⁰ Thus, the Osaka District Court's only means of providing relief in the First Case necessitated a substantive analysis of the directors' decisions. The Daiwa Bank Case represents an example in which substantive review is not only permitted but instead becomes, in a judicial system with ineffective discovery and lack of corporate disclosure, a virtual prerequisite to granting relief.

Despite the Daiwa court's apparent difficulty in granting relief to the First Case plaintiffs without a substantive inquiry, common fears about substantive business judgment review appear well-founded when stacked side-by-side with the Daiwa court's internal control system analysis. Notably, the Daiwa court "focuse[d] narrowly on a detailed aspect of internal controls that arguably may not have been considered significant under the prevailing standards during that period."¹⁶¹ The defendant directors argued that, "although the particular New York branch had been audited by an external auditor, inspected by both the Japanese and U.S. banking supervisory authorities, and had been subjected to internal auditing by the bank's internal American auditor," none of these entities indicated any deficiency in the method of confirming the balance of custodial securities.¹⁶² The Daiwa court brushed aside these arguments, noting that it lacked enough evidence to conclude that the sundry examinations and investigations proved that Daiwa's internal control system was adequate, and that whether Daiwa Bank's practices were standard for the industry at the time was not dispositive as to whether the internal control system was flawed.¹⁶³

The fundamental problem is not that the court necessarily reached an incorrect result. Instead, the issue is that systemic pressures on the plaintiffs to make allegations rooted in the substance of business judgments effectively precluded any finding of liability based on the directors' decision-making processes. As a result, even if the directors' decisions to ignore warnings relating to the internal control system would have amounted procedurally to a breach of the duty of care or good faith, the Daiwa court had no basis for finding liability on those grounds. It is certainly conceivable that Daiwa Bank's internal control system had major flaws, perhaps even flaws so significant that failure to remedy them amounted to a breach of the duty of care on the part of the directors. Indeed, other

¹⁶⁰ The Daiwa Bank Case, *supra* note 9, at 10-11 (The closest the Plaintiffs come to making a process-based claim is noting that Daiwa ignored a warning from the Ministry of Finance that it should reduce trading volume in its overseas securities finance division.).

¹⁶¹ Aronson, *supra* note 63, at 237.

¹⁶² Mitsuru Misawa, *supra* note 29, at 13.

¹⁶³ The Daiwa Bank Case, *supra* note 9, at 3, 37.

evidence buttresses this argument: as U.S. authorities investigated Iguchi's trades they discovered that Daiwa Bank Trust Company had also engaged in unlisted trading of U.S. Treasury bonds and had concealed \$97 million in losses through a scheme involving a collection of Cayman Islands shell companies.¹⁶⁴ However, process is not a focus of the court's analysis and the lack of discovery surely limited the ability of the First Case plaintiffs to make a compelling case on a procedural basis. The practical result of this system is thus a business judgment rule that is entirely substantive.

The Daiwa opinion demonstrates with remarkable clarity the perils of such a rule. Even the Osaka District Court itself acknowledged that the particular methods of a company's international control system that a board of directors elects to implement or sanction reflect a combination of business judgments that should ordinarily be within directors' discretion.¹⁶⁵ And yet, with the door to process-based remedies closed, the court evaluated the substance of the internal control system, enjoying perfect hindsight, delving deep into the particulars of the control mechanisms, and ultimately finding staggering amounts of liability on the part of one director. This kind of result, only encouraged by the lack of discovery in the Japanese judicial system, is likely to incentivize excessively risk-averse behavior on the part of directors and discourage qualified candidates from becoming directors.¹⁶⁶

2. *Subsequent Developments in Japanese Business Judgment Law*

Japanese scholars are well aware of the concerns that give rise to the Delaware formulation of the business judgment rule,¹⁶⁷ but despite occasional contrary voices,¹⁶⁸ joint procedural and substantive analysis has

¹⁶⁴ Mitsuru Misawa, *supra* note 29, at 1028-29.

¹⁶⁵ The Daiwa Bank Case, *supra* note 9, at 33.

¹⁶⁶ In fact, the legal reforms limiting directors' liability enacted after the Daiwa case were in part a political response to fear of lawsuits on the part of directors. *The Practical Effects of the Commercial Code Reform on Corporate Governance*, *supra* note 56, at 13. See *infra* Part III.E for a discussion of the liability reforms.

¹⁶⁷ See, e.g., TAKESHI KAMEYAMA, *KAISHA KEIEI TO TORISHIMARIYAKU NO SEKININ* [CORPORATE MANAGEMENT AND DIRECTOR LIABILITY], 133-135 (2d ed. 2007) (noting that the business judgment rule allows directors, rather than judges, to make business decisions, that retroactive evaluations of directors' decisions are problematic, and that directors must take risks); Takurō Yamaguchi, *supra* note 65, at 35 (stating that the business judgment rule allows directors to focus on business management without fear of excessive liability).

¹⁶⁸ Yasushi Ito, *Apamanshoppu Kabunushi Daihyō Soshō Jōkoku Shinhanketsu* [Decision on the Apamanshoppu Shareholder Derivative Suit Appeal], 2209 SHŌJI HŌMU 51, 55 (Sept. 15, 2013) (noting that there are Japanese legal scholars who argue that the inquiry into business decisions should be confined entirely to process).

become the business judgment standard for Japanese courts.¹⁶⁹ The widely publicized Daiwa case has likely contributed to this development. Indeed, the basic standards utilized by the Osaka District Court are alive and well today in Japanese corporate law. In decisions issued in 2013, the Tokyo District Court described the business judgment rule as an inquiry into whether the relevant business decision was “egregiously unreasonable,”¹⁷⁰ and the Osaka District Court described the failure to establish an “adequate”¹⁷¹ risk management system as a violation of the duties of care and loyalty.¹⁷² Furthermore, a 2010 decision from the Supreme Court of Japan suggests that the Supreme Court itself approves of an inquiry for business judgments that is both procedural and substantive.¹⁷³ Although this particular holding is not broadly applicable by its terms, at least one Japanese scholar has advocated its widespread adoption by other courts.¹⁷⁴ Interestingly, there has been some disagreement by Japanese courts as to whether “unreasonable” or “egregiously unreasonable” is the proper standard for the process prong of the business judgment analysis, and the Supreme Court’s decision notably applied the “egregiously unreasonable” standard to both process and substance.¹⁷⁵ In 2014, the Tokyo District Court seemed to directly adopt this standard, suggesting that it is likely to appear soon in additional Japanese corporate governance cases.¹⁷⁶

¹⁶⁹ Historically, the majority interpretation of the Japanese business judgment rule has looked for either (1) an unreasonable mistake in the decision-making process, or (2) a decision that is “egregiously unreasonable” (*ichijirishiku fugōri*). Tanaka Wataru, *Keiei Handan To Torishimariyaku No Sekinin—Apamanshoppu HD Kabunushidaihyō Soshō Jiken [Business Judgments and Director Liability—The Apamanshoppu HD Shareholder Derivative Suit]*, 1442 JURISUTO 101, 102-03 (June 2012). This formulation does not seem too far afield from the Daiwa court’s evaluation of the internal control system for “egregiously inadequate” elements, although an “egregiously unreasonable” decision is also perhaps closer in nature to a decision with “no rational business purpose” (the Delaware business judgment standard) than is a decision that merely yields “egregiously inadequate” results. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993). For recent examples of courts applying joint procedural and substantive analysis, see Tōkyō Chihō Saibansho [Tōkyō Dist. Ct.] Sept. 10, 2013, Hei 24 (wa) no. 5142, WLJPCA 09108021, at 6 (Japan); Ōsaka Chihō Saibansho [Ōsaka Dist. Ct.] Dec. 26, 2013, 1435 KINYU SHŌJI HANREI [KINYU HANREI] 42, 61 (Japan).

¹⁷⁰ “Ichijirushiku fugōri,” Tōkyō Chihō Saibansho [Tōkyō Dist. Ct.] Sept. 10, 2013, Hei 24 (wa) no. 5142, WLJPCA 09108021, at 6 (Japan).

¹⁷¹ “Fujūbun Na Risuku Kanri Taisei,” Ōsaka Chihō Saibansho [Ōsaka Dist. Ct.] Dec. 26, 2013, 1435 KINYU SHŌJI HANREI [KINYU HANREI] 42, 61 (Japan).

¹⁷² *Id.*

¹⁷³ Yasushi Ito, *supra* note 168, at 54 (noting that the Supreme Court of Japan’s statement that “to the extent the decision-making process and the decision itself were not egregiously unreasonable, the directors did not violate their duty of care” does not, without more, amount to a clear-cut application of the business judgment rule by the Supreme Court of Japan) (quoting Saikō Saibansho [Sup. Ct.] Jul. 15, 2010, 2091 HANREI JIHŌ [HANJI] 90, 93 (Japan)).

¹⁷⁴ Tanaka Wataru, *supra* note 169, at 104.

¹⁷⁵ *Id.*

¹⁷⁶ Hiroaki Hara, *Kanzen Kogaisha Ni Taisuru Kensetsukikai No Baiyaku To Kinin No Kashitsuke Ni Yoru Daihyō Torishimariyaku No Nimuketaiseikinin [Representative Director Liability for Breach of Duty*

Despite the now-established nature of substantive inquiry as a constituent element of Japanese business judgment analysis, the undesirable consequences of reviewing directors' business decisions in hindsight and applying modern standards retroactively remain an issue.¹⁷⁷ Furthermore, in the years since the Daiwa Bank Case, the causes for concern have increased. Japanese boards of directors remain largely opaque, and progress in introducing outside directors has generally been glacial in pace.¹⁷⁸ Meanwhile, the scope of directors' obligation to establish an internal control system may actually be expanding. For example, in a recent ruling, the Fukuoka High Court found directors liable for breaching their duties of care and loyalty by failing to root out fraudulent business practices at a subsidiary, a decision that runs contrary to legal scholars' conventional, narrower interpretation of the scope of the duty of oversight.¹⁷⁹ Furthermore, the recent Company Law reforms may also marginally expand the scope of directors' oversight duties. Although the reforms may not further expand the conventional interpretation of directors' duty to oversee subsidiaries, they may make it more difficult for courts to take the minority view that fundamentally no duty of subsidiary oversight exists.¹⁸⁰

In light of these factors, a joint procedural and substantive business judgment analysis is likely to keep plaintiffs and, as a result, courts focused on substance while promoting excessive risk-aversion¹⁸¹ and discouraging qualified candidates from serving as outside directors.¹⁸² These troublesome consequences have particular relevance now as they are directly contrary to

Resulting from the Sale of Construction Equipment and Loans to a Wholly Owned Subsidiary], 1456 KINYŪ SHŌJI HANREI (KINYŪ HANREI) 2, 4 (Jan. 1, 2015) (noting the clear influence of the Supreme Court's holding on the Tokyo District Court's analysis in the "G-Trading" case (Judgment of Apr. 10, 2014) (1443 KINYŪ SHŌJI HANREI (KINYŪ HANREI) 22 (June 15, 2014))).

¹⁷⁷ See *supra* Part III.D.1.

¹⁷⁸ See, e.g., Hiroko Tabuchi, *Japanese Shareholders Starting to Show Their Teeth*, N.Y. TIMES, June 28, 2012, at B3 (At Mizuho Holdings, institutional shareholders helped Mizuho "defeat a shareholders' proposal that would have simply required the bank to disclose what kind of training its new directors had received."). Additionally, as of 2012, "[a]bout half of the companies listed on the Tokyo Stock Exchange [did] not have any outside directors on their boards, according to Nomura Securities." *Id.*

¹⁷⁹ Yasushi Ito, *supra* note 8, at 14.

¹⁸⁰ The conventional view is that directors already have some degree of duty to oversee their employer-company's subsidiaries to the extent that the subsidiaries constitute important assets of the parent company. According to Professor Shinsaku Iwahara, the Company Law reforms do not change this duty but simply codify it with increased clarity. Shinsaku Iwahara et al., *Kaiseikaishaō No Igi To Kongo No Kadai (Ka) [The Significance of the Amendments to the Company Law and Ongoing Topics for Discussion]*, 2042 SHŌJI HŌMU 4, 5 (Sept. 5, 2014).

¹⁸¹ KENJIRŌ EGASHIRA, *supra* note 75, at 428 n.3 (noting that disincentivizing managerial risk-taking will not be to shareholders' advantage).

¹⁸² In re Caremark Int'l Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

Prime Minister Abe's push for innovation, independence, and increased transparency.¹⁸³

Admittedly, without reforms, a refusal on the part of Japanese courts to look into the substance of business decisions may pose an insurmountable barrier to plaintiffs seeking director liability in many cases.¹⁸⁴ However, targeted reforms to allow limited discovery and increases in board transparency could allow courts to retain the advantages of the incentive structure provided by a non-substantive business judgment rule while also allowing plaintiffs relief in appropriate circumstances. Until then, Japanese directors can expect to continue to grapple with the prospect of courts retroactively and substantively analyzing their business decisions and plaintiffs who focus on decisional substance rather than procedure as the most likely source of relief.

3. *Directors' Duty to Obey Foreign Laws and Its Relation to the Business Judgment Rule*

The Daiwa case is also seminal in that it represents the first holding by a Japanese court that "laws and regulations" as defined in Commercial Code Article 266¹⁸⁵ include the laws of foreign countries.¹⁸⁶ One criticism of this approach is that it may put corporate directors at the mercy of a plethora of foreign laws and regulations, rules about which even legal experts lack comprehensive knowledge.¹⁸⁷ Today, this concern is far from hypothetical in light of far-reaching foreign laws and regulations such as the U.S. Foreign Corrupt Practices Act¹⁸⁸ and sanctions administered through the U.S. Office of Foreign Assets Control.¹⁸⁹ Running afoul of such rules is a real risk for many Japanese corporations. Marubeni Corporation, for example, entered into a plea agreement with the U.S. Department of Justice in March of 2014 to pay an \$88 million fine in connection with alleged

¹⁸³ *Japanese Prime Minister Shinzo Abe Launched His Third Arrow*, WASH. POST (July 1, 2014), http://www.washingtonpost.com/opinions/japanese-prime-minister-shinzo-abe-launched-his-third-arrow/2014/07/01/3ed5c1ce-015b-11e4-8fd0-3a663dfa68ac_story.html.

¹⁸⁴ See Aronson, *supra* note 63, at 237 (the lack of an effective discovery system may "require" substantive analysis of business decisions).

¹⁸⁵ SHŌHŌ (COMM. C.) art. 266 (Japan) (repealed 2005). It has since been replaced by Company Law, art. 355.

¹⁸⁶ Although groundbreaking, this decision was generally consistent with the logic of relevant precedent. See Shinsaku Iwahara, *supra* note 135, at 4.

¹⁸⁷ See *The Practical Effects of the Commercial Code Reform on Corporate Governance*, *supra* note 56, at 18–19.

¹⁸⁸ Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78dd-1, *et seq.*

¹⁸⁹ See, e.g., *Office of Foreign Assets Control: Sectoral Sanctions Identifications List*, U.S. DEPT OF THE TREASURY. (Sept. 12, 2014), <http://www.treasury.gov/ofac/downloads/ssi/ssi.pdf>.

bribery in Indonesia.¹⁹⁰ The Bank of Tokyo-Mitsubishi UFJ is another example; the bank faced a \$315 million fine as recently as November 2014 for allegedly “misleading [U.S.] regulators regarding its transactions with Iran, Sudan, Myanmar, and other sanctioned entities.”¹⁹¹

Nonetheless, this fiduciary duty to comply with law is only breached by negligent or intentional violations of law, and the Daiwa opinion appears to generally take this approach as well.¹⁹² Before it began its analysis of the directors’ violations of U.S. law, the Daiwa court stated that it must examine whether the directors “effectuated corporate management with the goal of complying with law.”¹⁹³ The court did not clarify exactly what the implications of this standard are (e.g., whether a finding that directors had a good faith intention to comply with law will accord their decision business judgment protection), and there was some debate at the time as to whether a good faith standard or a negligence standard should apply generally,¹⁹⁴ though either one could present a workable solution.¹⁹⁵ The court sidestepped questions of negligence and was perhaps partially justified in doing so as there was little question that certain defendant directors had intentionally violated U.S. law.¹⁹⁶

The Delaware position on unwitting violation of the law may differ from the Japanese standard. Delaware law similarly provides that knowingly causing a corporation to act unlawfully is a violation of the duty

¹⁹⁰ Press Release, U.S. Dep’t of Justice, Marubeni Corp. Agrees to Plead Guilty to Foreign Bribery Charges and to Pay an \$88 Million Fine (Mar. 19, 2014), <http://www.justice.gov/opa/pr/2014/March/14-crm-290.html>; see also Press Release, U.S. Dep’t of Justice, Bridgestone Corporation Agrees to Plead Guilty to Participating in Conspiracies to Rig Bids and Bribe Foreign Government Officials (Sept. 15, 2011), <http://www.justice.gov/opa/pr/2011/September/11-crm-1193.html>.

¹⁹¹ Press Release, New York State Dep’t of Fin. Services, NYDFS Announces Bank Of Tokyo Mitsubishi UFJ To Pay Additional \$315 Million Penalty For Misleading Regulators, Individual Bank Employees Will Resign And Accept Bans (Nov. 18, 2014), <http://www.dfs.ny.gov/about/press2014/pr141181.htm>.

¹⁹² Shinsaku Iwahara, *supra* note 135, at 6.

¹⁹³ “[T]orishimariyaku Jishin Ga Hōreijunshu To Iu Kanten Ni Tatta Kaishakeiei Wo Okonatta No Ka Ina Ka.” The Daiwa Bank Case, *supra* note 9, at 3, 39.

¹⁹⁴ See KAZUSHI YOSHIHARA, *supra* note 152, at 160 (arguing that, because of the practical impossibility of being certain of all applicable laws, the prohibition on director violation of law should be read with an implicit negligence standard).

¹⁹⁵ The court might ask itself whether a reasonable director in the situation presented, attempting to obey all applicable laws, might have taken the same actions as the director in question. This seems compatible with the standard currently in effect, providing for liability in the event of intentional or negligent violations of law. KENJIRŌ EGASHIRA, *supra* note 75, at 428 n.1 (explaining the current standard for liability for violation of law under Company Law Article 355).

¹⁹⁶ For example, they submitted a fraudulent call report to the Federal Reserve Board. See *The Practical Effects of the Commercial Code Reform on Corporate Governance*, *supra* note 56, at 19 (Professor Kubori notes that providing an analogous fraudulent report to the Ministry of Finance in Japan would have been a crime, so it is hard to believe that the directors who were actively involved did not know that they were violating U.S. law.).

of loyalty “even if the fiduciary believes that the illegal activity will result in profits for the entity.”¹⁹⁷ If, however, directors have no knowledge of illegality, and assuming that the business judgment rule would otherwise apply, even illegal acts will receive business judgment protection, at least if made in reliance on the advice of counsel reasonably selected.¹⁹⁸ If reliance on counsel reasonably selected is a prerequisite for business judgment protection of illegal director activity, the Delaware rule may reflect simply the behind-the-scenes operation of a negligence standard largely consistent with the Japanese rule. In other words, a showing of reliance on counsel may simply be a proxy for showing that the decision-making process involved due care, in which case the decision is only accorded business judgment protection after the director is able to demonstrate that the decision-making process was not negligent.¹⁹⁹ This reading of the Delaware rule cannot be compared directly with the Daiwa opinion, because the Daiwa court did not explicitly state whether its refusal to apply the business judgment rule to directors’ illegal activities was due to procedural negligence on the part of the directors, though the court’s analysis implies that it found the directors did not act in good faith.^{200, 201}

As long as some requirement of negligence or intentionality is present, a global application of the duty to obey foreign laws is more sensible from a policy perspective than what was the prevailing wisdom before the Daiwa case—namely that “directors who reside in Japan can not be held responsible for an incident that happened [in] a place so far away [as

¹⁹⁷ *Desimone v. Barrows*, 924 A.2d 908, 934-35 n.89 (Del. Ch. 2007) (quoting *Metro Communication Corp. BVI v. Advanced Mobilecomm Technologies, Inc.*, 854 A.2d 121, 131 (Del. Ch. 2004)).

¹⁹⁸ *Id.* at 935; *Litt v. Wycoff*, No. 19083-NC, 2003 WL 1794724, at *7 n.42 (Del. Ch. 2003) (“There can be no personal liability of a director for losses arising from ‘illegal’ transactions if a director were financially disinterested, acted in good faith, and relied on advice of counsel reasonably selected in authorizing a transaction.”) (quoting *Gagliardi v. Trifoods Int’l, Inc.*, No. 14725, 1996 WL 422330, at *4 n. 2 (Del. Ch. 1996), *published in part*, 683 A.2d 1049, 1051). Delaware courts do not appear to have yet addressed an unintentional violation of law made in the non-oversight context. The Seventh Circuit examined a board’s “failure to act in the face of known egregious violations of law” and noted that in such circumstances the directors may not receive business judgment protection. Alan L. Dye, *Postgraduate Course in Federal Securities Law: Current Developments*, SL020 ALI-ABA 671, 683 (2005) (citing *In re Abbott Laboratories Derivative Shareholders Litigation*, 325 F.3d 795 (7th Cir. 2003)).

¹⁹⁹ This reading represents burden-shifting rather than a standards-based change to the business judgment rule. Under this formulation, upon a showing of illegal director behavior, the directors would bear responsibility for showing that the decision-making process was not negligent.

²⁰⁰ The Daiwa Bank Case, *supra* note 9, at 39 (Because the court examines whether directors acted “with a goal of complying with law,” presumably a finding of liability would indicate a lack of good faith, though the court does not state this explicitly.).

²⁰¹ Although there is not a definitive ruling on this issue, the basic principle under Japanese law seems to be that “unlawful acts” (*hōreihankōi*) do not benefit from business judgment protection. Hatsuru Morita, *supra* note 155, at 8.

New York].²⁰² The idea that it is not within directors' discretion to violate the law logically applies to foreign laws just as much as it does to domestic ones, and the necessity of damages in order to find liability means that directors will not be liable to the corporation for a violation of law which did not cause harm to the corporation.²⁰³ The negligence or bad faith requirement should assuage concerns about holding directors liable for violating laws of which they could not reasonably be aware.²⁰⁴ Additionally, the Daiwa court specified that directors have a duty to obey the laws of foreign countries when the company expands its business into or establishes offices within those countries. However, the court did not state that any and all foreign laws are necessarily within the ambit of Commercial Code Article 266, para. 1, no. 5.²⁰⁵ This leaves open the possibility that a director's failure to obey certain foreign laws may not amount to negligence.²⁰⁶

The Daiwa court's groundbreaking conclusion that directors are bound by Commercial Code Article 266 to obey the laws of foreign countries was thus eminently reasonable and also consistent with precedent.²⁰⁷ Although there are no relevant Delaware cases for comparison,²⁰⁸ the logical underpinnings of both the Japanese and the Delaware duty of directors to obey the law are entirely consistent with a definition that includes foreign laws. Accordingly, the court's reading of the scope of Commercial Code Article 266 is solid from both public policy and analytical standpoints.²⁰⁹

As the stakes for international compliance have increased for Japanese corporations, the standards set by the Osaka District Court in Daiwa have

²⁰² Mitsuru Misawa, *supra* note 29, at 1060-61.

²⁰³ Company Law, art. 423, para 1 states that directors will be liable for damages resulting from a breach of duty and not simply for the breach of duty itself. Kaishahō [Kaishahō] [Company Law], Law No. 109 of 2006, art. 423, para 1 (Japan).

²⁰⁴ Professors Kanda and Miyasako express these worries in *The Practical Effects of the Commercial Code Reform on Corporate Governance*, *supra* note 56, at 18-19.

²⁰⁵ The Daiwa Bank Case, *supra* note 9, at 39.

²⁰⁶ This seems to be consistent with current Japanese law on this topic. See *supra* Part III.D.1.

²⁰⁷ Prior to Daiwa, the most relevant opinion in this area was the Nomura Securities Loss Compensation Case, a Tokyo High Court ruling that held that the phrase "laws and regulations" includes the Commercial Code and all the laws that a company is supposed to obey in conducting its business. Mitsuru Misawa, *Shareholders' Action and Director's Responsibility in Japan*, *supra* note 63, at 29.

²⁰⁸ Having practiced law in the United States and in Japan (as a foreign lawyer), this author's impression is that the distinction between "foreign" and "domestic" corporate law is less meaningful in a country with fifty powerful state legislatures creating a network of rules that corporations must regularly address regardless of their home state of incorporation.

²⁰⁹ Issues of causation and the source of director liability are potentially problematic aspects of this portion of the Daiwa opinion, but those are excluded for the sake of clarity in this analysis of the scope of Commercial Code art. 266, para. 1, no. 5. Shinsaku Iwahara, *supra* note 29, at 4 n.1.

become increasingly important and are even easier to justify from a policy perspective. With a large number of Japanese corporations operating overseas and enmeshed in a thick net of international regulation, competent oversight of compliance with foreign regulations has become a crucial part of many Japanese directors' duties and a focus for legal practitioners.²¹⁰ Household names in Japan like Marubeni and Bridgestone Corporation²¹¹ have found themselves on the receiving end of U.S. Department of Justice prosecution for alleged overseas bribery of government officials, and negligent failure to comply with international law is an entirely foreseeable risk that can result in real damage to shareholder value.

E. Limitations on Director Liability: Japan's Response to the Daiwa Bank Case and a Comparison to Delaware Law

At the time of the Daiwa decision, the court's enormous findings of director liability surely exacerbated the risk of deterring competent candidates for directorship. The astonishing sums involved prompted one Japanese commentator to hyperbolically describe director liability of this magnitude as a human rights issue.²¹² Partially in response to the Daiwa case, the Japanese Diet wasted little time in enacting limitations on directors' liability and allowing corporations to enter into limited liability contracts with directors.²¹³ Outside directors can now enter into contracts to reduce their liability within limits specified by the corporation's articles of incorporation under Company Law Article 427, except in cases of bad faith or gross negligence.²¹⁴ This provision will be expanded to include non-outside directors who are not executive officers by the amendments to the Company Law expected to take effect in 2015.²¹⁵

Company Law Arts. 425 and 426, para. 3 provide the general procedures for relieving a director of liability in a company that has not already amended its articles of incorporation to provide for limited director

²¹⁰ See, e.g., Mitsuru Chino, *supra* note 5, at 29; Kana Morimura, *Beikokuhōjō No Karuteru Jian Ni Okeru Taiō Jitsumu* [A Practical Response to Cartel Issues under U.S. Law], 2036 SHŌJI HŌMU 25 (2014).

²¹¹ Bridgestone Corporation Agrees to Plead Guilty to Participating in Conspiracies to Rig Bids and Bribe Foreign Government Officials, *supra* note 190.

²¹² Literally, an "issue connected to the defense of human rights" (*"jinken wo yōgo suru koto ni mo tsunagaru"*). Tatsuo Uemura, *Torishimariyaku Ga Taikaishasekinin Wo Ou Baai Ni Okeru Songaibaishō No Hani* [The Scope of Damages for Directors Who Are Liable to Their Corporations], 1600 SHŌJI HŌMU 4, 4 (2001).

²¹³ KIICHI GOTŌ, *supra* note 132, at 303.

²¹⁴ *Id.* at 306.

²¹⁵ *The Proposal of the Bill to Amend a Portion of the Company Law and a Summary Thereof*, *supra* note 1, at 6.

liability. The procedure is quite complicated and involves several steps and qualifiers: (1) the finding of liability must not be based on bad faith or gross negligence; (2) the directors must disclose during a shareholder meeting the reasons for limiting liability, the degree to which they wish to limit liability, and similar information, and they must receive consent through a special vote; (3) if the company uses internal auditors, the directors must obtain unanimous consent from the auditors, and if the company instead uses a committee system, the directors must obtain unanimous consent from the audit committee; (4) the directors must consider the particular facts and circumstances resulting in the director liability at issue, and if they determine that limitation of liability is necessary, they then may amend the company's articles of incorporation to state that director liability may be reduced to some specific minimum; and (5) if a director vote rather than a shareholder vote has effectuated the reduction in liability (a resolution to limit director liability can be implemented through either a director vote or a shareholder vote), then directors must give shareholders up to one month to object.²¹⁶ If shareholders holding three percent or more of the shares of the company object, then the director's liability will not be limited.²¹⁷

If the company's articles of incorporation already provide for limitations on director liability, the directors must get unanimous consent of the auditors or the audit committee before voting on a resolution to limit a particular director's liability.²¹⁸ Liability may be limited to, but no lower than, the following amounts: six times the annual compensation for a representative director; four times the annual compensation for a director, and two times the annual compensation for outside directors, auditors, accounting consultants, and account auditors.^{219, 220} The amendments to the Company Law to take effect in 2015 will bring this limit down to two times the annual compensation for non-outside directors who are not executive officers.²²¹

This framework for limiting liability has come under considerable criticism. Because it calculates salaries before tax, its limitation of representative director liability, for example, to six years' salary could in fact amount to ten years' salary after taxes (depending on applicable tax

²¹⁶ KIICHI GOTŌ, *supra* note 132, at 304-05.

²¹⁷ *Id.*

²¹⁸ *Id.* at 305.

²¹⁹ *Id.* at 304.

²²⁰ Stock options are included when the amount of annual salary is calculated. *The Practical Effects of the Commercial Code Reform on Corporate Governance*, *supra* note 56, at 17.

²²¹ *The Proposal of the Bill to Amend a Portion of the Company Law and a Summary Thereof*, *supra* note 1, at 6.

rates).²²² The reduction in the limit for non-outside directors included in the recent amendments to the Company Law was likely in part a reaction to this criticism. Additionally, even though the liability limitations were enacted in part as a response to the Daiwa case, certain Daiwa directors who were found liable in the Second Case were also found to have acted intentionally, which would have pushed their activity beyond the purview of these liability limitations.²²³ Initially, some Japanese scholars feared that subjecting amendments to the articles of incorporation to permit limitations on even outside director liability to shareholder vote would expose companies to reputational harm and shareholder criticism.²²⁴ However, several years later outside director limited liability contracts seemed to be functioning effectively.²²⁵ There also exists debate about whether it would be preferable to permit total elimination of outside director liability²²⁶ as in Delaware.²²⁷ Notably, a company will face a difficult choice if it seeks a limitation on director liability after the commission of questionable director behavior but before a lawsuit has been lodged; seeking after-the-fact limitation of director liability may effectively force the company to admit simple negligence on the part of the director.²²⁸

Delaware, on the other hand, allows corporations to do away with director liability in its entirety absent conflicts of interest, intentional misconduct, or a lack of good faith.²²⁹ This wholesale elimination of director liability in many circumstances is workable partially because of the credible threat that litigation poses in the United States to expose and embarrass directors who do a poor job of fulfilling their duties.²³⁰ Admittedly, an effective discovery system is necessary for threats of this type to be credible, and only in rare cases will plaintiffs in Japan be able to

²²² *The Practical Effects of the Commercial Code Reform on Corporate Governance*, *supra* note 56, at 17.

²²³ *Id.*

²²⁴ See, e.g., *id.* at 23; see also Ichirō Kawamoto, *Daiwa Ginkō Kabunushi Daihyōsoshō No Wakai Wo Kataru* [A Discussion on the Daiwa Bank Derivative Suit Settlement], 94 TORHISHIMARIYAKU NO HŌMU 4, 12-13 (2002) (not discussing outside directors specifically, but stating that companies may be effectively admitting director malfeasance if they attempt to vote into effect limitations on director liability).

²²⁵ KIICHI GOTŌ, *supra* note 132, at 306-307.

²²⁶ *The Practical Effects of the Commercial Code Reform on Corporate Governance*, *supra* note 56, at 24.

²²⁷ See Del. Code Ann. tit. 8, § 102(b)(7) (2011).

²²⁸ Ichirō Kawamoto, *supra* note 224, at 12.

²²⁹ Lawrence A. Hamermesh, *Twenty Years After Smith v. Van Gorkom: An Essay on the Limits of Civil Liability of Directors and the Role of Shareholder Inspection Rights*, 45 WASHBURN L.J. 283, 286 (2006).

²³⁰ *Id.* at 290 (noting that some of these cases involve a failure on the part of directors respond to “red flags” in monitoring their corporation).

“piggyback” their claims on discovery conducted as part of a criminal investigation, as did the plaintiffs in Daiwa.²³¹ Without broad powers of discovery and with a liability standard of intentional misconduct or bad faith, potential plaintiffs in Japan would be able to find representation in only the most extraordinary circumstances. Even the Daiwa Bank Case, which involved apparently intentional director misconduct and the largest criminal fine levied on a financial institution in U.S. history, was ultimately litigated not by a large firm but by a small-firm lawyer who found it difficult to eke out a living as the case dragged on.²³²

Accordingly, adoption of Delaware-style rules permitting total elimination of director liability in most cases would not be suitable in Japan’s current litigation and corporate governance environment, even in light of Prime Minister Abe’s recent push for increased transparency. On the other hand, it is hard to believe that current limitations on director liability are sufficient to fully mitigate the risk of deterring qualified candidates who seek to avoid courts second-guessing their business decisions and retroactively applying modern industry standards to evaluate business decisions from years past. Yet there remain other means to that end, such as indemnification, liability insurance for directors, and reform of the Japanese business judgment rule.²³³ Thus, these limitations on director liability appear to be reasonable and apposite in light of Japan’s litigation system and corporate governance landscape.

F. Causation and the Scope of Director Liability

Issues of causation present a major problem in the Daiwa Bank Case. Professor Shinsaku Iwahara convincingly articulates this set of criticisms, noting contradictions in the courts’ reasoning.²³⁴ One issue arises from the fact that the criminal fine levied on Daiwa was part of plea bargain that encompassed certain illegal activity by Iguchi prior to his confession to

²³¹ Aronson, *supra* note 17, at 24.

²³² Ichirō Kawamoto, *supra* note 224, at 7.

²³³ Indemnification and liability insurance in Japan are, unfortunately, beyond the scope of this article.

²³⁴ Most, but not all, of Professor Iwahara’s arguments are addressed here. Iwahara also argues, for example, that damages incurred through a criminal fine ultimately stemming from a failure to monitor may be special damages to which Minpō (Civil Code) art. 416, para. 2 applies rather than standard damages to which Civil Code art. 416, para. 1 applies. A suit for special, rather than standard, damages will saddle plaintiffs with a more exacting foreseeability requirement. A further exploration is beyond the scope of this article. See Shinsaku Iwahara, *supra* note 29, at 9; MINPŌ [MINPŌ] [CIV. C.] art. 416 paras. 1–2 (Japan).

Daiwa's president.²³⁵ Although the court only found one director liable for failing to implement and maintain an internal control system in the First Case, in the Second Case the court found that many directors were nonetheless liable for the criminal fines incurred.²³⁶ In other words, even though in the First Case the court found certain directors not liable for losses incurred by Iguchi's trades, in the Second Case, the court found some of the same directors liable for other consequences of Iguchi's clandestine activity.

Furthermore, Professor Iwahara describes as dubious the court's finding that the criminal penalties of this scale, which ultimately stemmed from directors' failure to adequately maintain an internal control system, were sufficiently foreseeable for a finding of director liability.²³⁷ Iwahara argues that, given that this was a record-breaking fine, the court should have considered that a certain portion of the fine might not have been foreseeable.²³⁸ Iwahara also notes that the true measure of director liability in the Second Case is the degree to which the directors' violations of law increased the fines levied on Daiwa over the fines that would have been levied on Daiwa had Iguchi's activity been the sole violation of law at issue.²³⁹ This would accurately reflect the causal relationship between (1) certain defendant directors' decision to cover up the losses through false reports and (2) the monetary harm suffered by Daiwa as a result of those decisions. Iwahara would still have the plaintiff bear the burden of proof and the requirement of reasonable foreseeability would still apply.²⁴⁰

Among the above criticisms, least convincing is the claim relating to foreseeability of the criminal fine.²⁴¹ Iwahara correctly notes that directors who were not liable for Iguchi's unauthorized trading losses due to a failure to monitor should not be liable for criminal fines incurred as a result of Iguchi's illegal activity.²⁴² Accordingly, the analysis should examine the extent to which the \$340 million fine exceeds the fine that Daiwa would have faced absent the post-confession cover-up in the Second Case.²⁴³ Here,

²³⁵ See *Criminal Complaint & Indictment Against Daiwa Bank*, *supra* note 14; Peter Truell, *Daiwa Bank Admits Guilt In Cover-Up*, N.Y. TIMES (Feb. 29, 1996), <http://www.nytimes.com/1996/02/29/business/daiwa-bank-admits-guilt-in-cover-up.html>.

²³⁶ Shinsaku Iwahara, *supra* note 29, at 8-9.

²³⁷ *Id.* at 9.

²³⁸ *Id.* at 9, 10 n.3 (stating that even though the fine was decided pursuant to the Federal Sentencing Guidelines, the magnitude of the fine was extraordinary).

²³⁹ *Id.* at 9-10.

²⁴⁰ *Id.* at 10.

²⁴¹ Counsel for Daiwa Bank also made this claim, arguing on appeal (before settlement was reached) that "nobody could have foreseen the astronomical criminal fines" levied on Daiwa. Ichirō Kawamoto, *supra* note 224, at 16.

²⁴² Shinsaku Iwahara, *supra* note 29, at 10.

²⁴³ *Id.*

Iwahara leaves open the possibility that the fine may have been unforeseeable even given the management-level criminality in the Second Case.²⁴⁴ However, in this portion of the analysis, certain directors making this claim would find themselves in the unenviable position of arguing that the fine was not a foreseeable consequence of a high-level corporate conspiracy to conceal from the U.S. regulatory authorities \$1.1 billion in losses incurred through off-the-books securities trades—including (at least allegedly) the forgery of custodial receipts, destruction of evidence, and the submission of a fraudulent call report to the F.R.B. claiming \$600 million in phantom assets—even though the Federal Sentencing Guidelines provide for up to \$1.3 billion in fines for such violations of law. That the Daiwa court did not thoroughly explore this line of reasoning does little to undermine the credibility of the court’s decision.

Furthermore, although it is undeniably important to determine what amount of the fine was purely a reflection of Iguchi’s illegal activity, there was a “very good chance” that Daiwa would not have faced any criminal charges had it promptly reported Iguchi’s illegal actions.²⁴⁵ As a result, the decision to engage in a criminal cover-up may in fact have been the proximate cause of the criminal fine in its entirety. Admittedly, the court’s analysis is unequivocally lacking with regard to these issues of foreseeability and causation. However, it is not clear that these analytical lacunae had any effect on the outcome of the case, though the plaintiffs certainly would have faced a higher burden of proof had the court explored these issues.

Professor Iwahara’s most potent arguments—namely that the liability analysis conflates discrete issues and that the court inconsistently found directors simultaneously liable and not liable for what was effectively the same activity—are extremely convincing. Furthermore, Iwahara’s focus on consistency and clarity of analysis in applying complex foreign legal concepts is well placed. Indeed, these are crucially important points for Japanese courts to consider as the web of international regulation in which companies operate becomes increasingly complex and some large Japanese corporations are finding themselves on the wrong end of criminal investigations by the U.S. government.²⁴⁶

²⁴⁴ *Id.*

²⁴⁵ Steven A. Miller, *How Daiwa Self-Destructed*, 113 *BANKING L.J.* 560, 574-75 (1996). Miller is the former Chief of the Banking and Financial Institutions Fraud Unit of the U.S. Attorney’s Office in Chicago. *Id.* at 560 n.a.

²⁴⁶ *See supra* Part III.D.3.

G. *Criminality*

A final point for criticism in the Daiwa opinion is the court's assumption of director criminality as a result of the bank's plea agreement. The court held that the directors' behavior forming the basis for the charges in the indictment was in violation of U.S. law but relied entirely on the plea agreement as proof of violation of U.S. law.²⁴⁷ In this context, issues of criminal culpability, business judgment, and international legal standards all converge.²⁴⁸ In the United States, plea agreements are extremely common and allow defendants to reduce the unpredictability of jury trials.²⁴⁹ Even though a corporation must plead guilty in a plea agreement, the guilty plea may well reflect a business judgment on the part of the directors to reduce corporate risk regardless of whether the corporation has committed clearly criminal acts. These considerations provide a strong argument that plea agreements should not be taken as *per se* evidence of criminality.

Refusing to recognize that directors in this situation may choose to enter into a plea bargain as a matter of business judgment may ultimately create a conflict of interest for certain directors. If a director fears that any plea agreement she causes her corporation to enter into will be taken as *per se* evidence of corporate or director criminality in subsequent lawsuits, she may be incentivized to avoid plea bargaining even when it would be in the best interests of the corporation. The muddled analysis of business judgment illegality under Commercial Code Article 266, para. 1, no. 5 in the Daiwa Bank Case is likely to exacerbate this by lumping in failure to prevent violations of law with actual violations of law and denying business judgment protection to even the directors who were not themselves shown to have violated or caused a violation of law.²⁵⁰

Because Japan does not have a plea bargain system similar to that of the United States, this particular point of the Daiwa Bank Case has not been a major subject of debate.²⁵¹ Nonetheless, as the United States further builds out its anti-bribery and anti-terrorist legal frameworks,²⁵² this issue is likely to resurface in the near future. A standard that recognizes the different plea

²⁴⁷ Mitsuru Misawa, *Shareholders' Action and Director's Responsibility in Japan*, *supra* note 63, at 32 ("The plaintiffs in the stockholders' representative action used this plea bargain as indisputable evidence showing that they had knowledge that their actions constituted a wrongful action.").

²⁴⁸ Ichirō Kawamoto, *supra* note 224, at 17.

²⁴⁹ *Id.*

²⁵⁰ The Daiwa Bank Case, *supra* note 9, 40-41.

²⁵¹ Mitsuru Misawa, *Shareholders' Action and Director's Responsibility in Japan*, *supra* note 63, at 31.

²⁵² *See supra* Part III.D.3.

bargaining procedures and their potential impact on directors' business judgments would be far preferable to the current standard and would allow for a better alignment of incentives to preserve shareholder value.

IV. CONCLUSION

With Japan's current focus on corporate governance reform and the increasing degree to which Japanese corporations find themselves subject to foreign laws, the duties of corporate directors and the related issues raised in the Daiwa Bank Case are assuming even greater importance than in the past. Nonetheless, this article's examination of some of the most influential and groundbreaking judicial analysis underpinning several tenets of modern Japanese corporate governance reveals that these tenets have not always been supported by perspicuous logic and may not be structured to achieve optimal outcomes. The far-reaching influence of Daiwa has been oblique in some respects, particularly because the case was settled before the Osaka High Court could produce a decision on the appeal. Even one of Daiwa Bank's defense lawyers was disappointed that the case settled before a higher court had a chance to rule on some of the more intriguing questions raised by the Osaka District Court opinion.²⁵³ And yet even though the case has continued to be a subject of study for Japanese law students, it remains largely unexamined by American legal scholars, with a few exceptions.²⁵⁴

The case's value stems as much from its analytical shortcomings as from its trailblazing interpretations and analytical successes. Indeed, the court's application of the business judgment rule and its examination of directors' duty to establish an internal control system throw into stark relief the concerns animating the analogous Delaware rules and invite reconsideration of the relevant Japanese ones. Similarly, the court's analysis of causation, scope of liability, and criminality leave much to be desired and may serve as an example of mistakes to avoid in future cases, which are likely to arise sooner rather than later given the international environment in which Japanese companies operate today. On the other hand, the court's interpretation of the scope of "laws and regulations" as it appears in Commercial Code Article 266 and the Japanese Diet's subsequent reforms (both following Daiwa and again in 2014) to allow limitations of director

²⁵³ Ichirō Kawamoto, *supra* note 224, at 16.

²⁵⁴ See note 63. For example, the late Professor Yoshiaki Miyasako's class on corporate management (*kigyō keiei no homu*) at the University of Tokyo Law School spent a week on The Daiwa Bank Case in 2008, when this author was enrolled there.

liability are innovative and workable solutions to new problems confronting Japanese corporate governance in an era of inexorable globalization.

The impact of the Daiwa Bank Case as a milestone of evolving jurisprudence is undeniable, and it holds particular value as a focal point for corporate governance analysis and debate in a country with relatively little relevant case law. The criticism of the Daiwa opinion from both Japanese academics and legal practitioners is evidence of the considerable intellectual resources that the Japanese legal community has devoted to questions of corporate governance, and that devotion encourages optimism in the ongoing process of Japanese corporate law reform, despite dispiriting developments such as the Olympus accounting scandal. In serving as a springboard for discussion and reform of key corporate law principles, the Daiwa Bank Case represents a remarkable success that continues to pay dividends.