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Shareholders' Action and Director's Responsibility in Japan

Mitsuru Misawa*

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Abstract

The New York Daiwa Bank scandal in 1995, which involved Daiwa Bank's concealment of the \$1.1 billion in losses from the illegal funding of U.S. Treasury bonds, resulted in the most severe economic penalties ever imposed by the United States on Japan. These penalties included the termination of Daiwa Bank's U.S. operations and a substantiated international distrust of Japanese financial institutions, including their closely aligned governmental regulators, the Ministry of Finance.

In September 2000, a Japanese court handed down a decision in this shareholders' representative action that ordered the defendants, twelve

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directors of Daiwa Bank, to pay bank damages totaling \$775 million (approximately 82.9 billion yen). These damages ranged from \$530 million (approximately 56.7 billion yen) to \$70 million (approximately 7.5 billion yen) per person, and shocked the international society because of the costly size of the penalties. The award raised many basic legal and economic issues regarding the shareholders' representative action system in Japan, which was first introduced to Japan by the U.S. in 1950. Due to the importance of the Japanese economy in a global sense, the system's behavior is expected to have a tremendous effect on the international economic society. International communities are watching closely whether the administrative, legal, and legislative arms of the Japanese government as well as the private sectors can respond to the enrichment and improvement of the shareholders' action system enforcing responsibilities of directors.

The recent court decision regarding the shareholders' action was quite meaningful in examining the duties assumed by the directors of a financial institution, which require them to establish an internal control system for controlling risks and adhering to laws and regulations, differences in the duties of care among the directors, and the objects of the responsibilities, as well as the scope of damages.

Also, the court decision sounded a very important alarm about how Japanese corporations are managed. The background that allowed Japanese companies to be run loosely seemed to be the fact that the supervising authorities and the legal system failed to rigorously pursue the lack of risk management and the concealment of responsibilities.

The present case served to reveal the fact that it is extremely dangerous for Japanese financial institutions to try to operate overseas without mending their looseness in risk management and their sloppiness in legal compliance. Japanese financial supervising authorities must accept this new mind set. Another such an incident could invite international mistrust in the Japanese society itself. The current status of the legal and organizational systems of the Japanese financial supervising authorities is not up to the level of handling international financial businesses.

This lack of sternness in the law enforcement system has created sloppy risk management and concealing attitudes among Japanese companies, which resulted in the current case when one such Japanese company operated in the U.S. with the same loose attitude. In order to prevent this kind of case, more rigorous attitudes are necessary to ensure that directors are more responsible for their duties. That should give the proper incentive to Japanese companies to establish effective risk management and law-abidance systems. It is notable that shareholders' representative actions have finally started to function as an effective

means of law enforcement in Japan.

In this article, the author compares the differing United States and Japanese reactions to the New York Daiwa Bank scandal on legal, economic, and sociological levels. Based on his analysis, the author concludes that cultural differences between the United States and Japan lie at the heart of the scandalous proportions of the Daiwa Bank incident in New York. Furthermore, the author believes that the Daiwa Bank case offers an important lesson for the U.S. and Japanese companies with international operations: "When in Rome, do as the Romans do."

I. Introduction¹

An incredible incident was disclosed in 1995 at Daiwa Bank's New York branch: one of its employees had been illegally trading U.S. Treasury bonds for over eleven years without detection, causing the bank an accumulated loss of \$1.1 billion. Since then, this incident mushroomed into an international scandal, resulting in civil, criminal, and administrative liabilities in both the United States and Japan. There had never been an economic incident with such a tremendous international impact between Japan and the United States.

The concerns about the incident expressed by the supervising authorities of both countries, as well as by stakeholders, such as corresponding foreign banks and the Bank's stockholders, resulted in specific actions taken to manage the situation in its aftermath.² Those

1. Editor's Note: As a service to our readers, the Editorial Board normally checks cited material for both "Bluebook" form and substance. This article, however, relies extensively on sources available only in Japanese, which were unable to be "source-checked" in the traditional law review sense. The sources have been checked for "Bluebook" form.

2. It was August 8, 1995 when the president, an executive vice president in charge of international operations, and a managing director of Daiwa Bank met with the Director General of the Banking Bureau of MOF at the bank's club to report an illegal incident. In response, the Director General of the Banking Bureau told the representatives of the bank that "it [was] bad timing[.]" as disclosure might trigger instability in financial circles, and kept the secret in his pocket. It waited more than 40 days until September 18, 1995 when the MOF finally notified the U.S. authorities. *MOF's Confusion at its Peak: Distrust of Japan's Financial Administration Heightens Regarding Daiwa Bank Scandal: Disbanding of MOF is Suggested*, SHUKAN TOYO KEIZAI, Dec. 2, 1995, at 16. As an example, a Wall Street Journal article stated:

The real rogue in Japan's [MOF]. In the Daiwa affair and in its handling of Japan's banking crisis, the [MOF] has shown its remarkable overconfidence and its willingness to bamboozle U.S. bank regulators, the Japanese public and even itself. . . . So maybe it wasn't surprising that the [MOF] thought it could flout U.S. banking regulations this summer by failing to report—for six weeks—what it had learned about Daiwa's illegal trades in the U.S. The trades cost Daiwa \$1.1 billion. But they cost the [MOF] its reputation.

John Bussey, *Japan's Bungling Ministry of Finance*, WALL ST. J., Nov. 10, 1995, at A14.

Another example that is causing criticisms against the MOF from this perspective is

actions, in return, caused further questions on both sides of the Pacific. It seems that all these opinions, actions, and questions stem from the differences in Japanese and American social systems and thought patterns.³

Daiwa Bank (hereinafter Daiwa or the Bank) and the Ministry of Finance (hereinafter MOF), the authority within the Japanese government that supervises the Daiwa Bank, did not acknowledge any fault in the matter despite the fact that the incident drew severe criticism internationally and caused Japan to lose credibility in the finance industry.⁴ Why? Is there really a difference in the legal systems of the two countries that makes an act illegal in the United States and legal in Japan? Are there any conceptual differences between the systems of the two countries as to a corporation's responsibility for the disclosure of important information regarding its performance?

In addition, the people of Japan had long accepted the mutually supportive relationship between the Japanese government and Japanese industry—often called the “convoy” system.⁵ The rest of the world, however, had become more suspicious of this relationship.⁶

the “Jusen” problem. Although MOF claims that the interest-free preferential credits of Japanese banks against Specialized Housing Finance Companies (Jusen) is ¥40 trillion, the actual figure is rumored to be ¥70 trillion. The U.S. authorities are irritated that MOF is not disclosing information in a straightforward manner and have the impression that MOF is engaged in a cover up, as in the Daiwa Bank case. See *Nippon Island of Bad Debts*, SHUKAN TOYO KEIZAI, Feb. 24, 1996, at 12-17. For “Jusen,” see Mitsuru Misawa, *Lenders' Liability in the Japanese Financial Market; A case of 'Jusen,' the largest problem loan in Japan, Part I*, 30 MGMT. JAPAN No. 2, 18-28 (Autumn 1997); and Mitsuru Misawa, *Lenders' Liability in the Japanese Financial Market; A case of 'Jusen,' the largest problem loan in Japan, Part II*, 31 MGMT. JAPAN No. 1, 18-28 (Spring 1998).

3. The MOF has tried rebutting this criticism regarding the delayed report on various occasions. While the MOF is trying to convince the world by saying “there is nothing to be concerned about in the financial system,” it has taken actions which indicate that it is deeply concerned by the loss of its credibility. For example, after the announcement of the affair, MOF showed keen interests in how it was perceived by overseas observers as exemplified by the Deputy Vice-Minister holding an explanatory meeting in Washington D.C., and the special press conference held by General Directors of Banking Business and International Finance Bureau with foreign correspondents in Tokyo. See *Outlandishness of Japanese Financial System Revealed: MOF Agonizes as its Rebuttals are Ignored*, NIHON KEIZAI SHIMBUN, Oct 18, 1995, at 3.

4. SHUKAN TOYO KEIZAI, *supra* note 2.

5. The treatment of Japanese banks by MOF is best understood by an analogy to a convoy forming a large group consisting of warships, cruisers, and destroyers to ride out rough seas and opposition.

6. In the Senate Banking Committee's hearing on the Daiwa Bank incident, Mr. Alan Greenspan, Chairman of the Federal Reserve Board (FRB) said about MOF's delay in reporting to the U.S. Authorities that “it is regretful that MOF made this error,” while Chairman of the Banking Committee, Senator D'Amato criticized MOF saying, “MOF, which prevented the speedy report to the U.S. authorities in a collusion with Daiwa, severely damaged the trust between the two governments.” *MOF's Failures are Regrettable*, NIHON KEIZAI SHIMBUN, Nov. 29, 1995, at 2.

Accordingly, the Daiwa incident caused the MOF to lose its credibility as a competent authority in the eyes of international observers.⁷ Is such a relationship unacceptable in international society? Does MOF need an overhaul?

Furthermore, Japan disapproved of retaliatory steps taken by the United States.⁸ For instance, the U.S. Federal Reserve Board (hereinafter FRB) ordered Daiwa Bank to cease its operations in the United States.⁹ Some in Japan considered this action to be too severe.¹⁰ What caused this decision by the FRB? What were the legal grounds for it?

In 1995, Daiwa's stockholders brought a representative action against the Bank regarding this incident.¹¹ A Japanese court made a decision in this shareholder's representative action in September 2000.¹² It ordered the defendants, twelve directors of Daiwa Bank, to pay to the bank damages totaling \$775 million (approximately 82.9 billion yen), which ranged from \$530 million (approximately 56.7 billion yen) to \$70 million (approximately 7.5 billion yen) per person; the amount of the damages shocked international society. The case raised many basic issues regarding the shareholder's representative action system in Japan.¹³ Due to the importance of the Japanese economy to the overall world economy, the Japanese legal system's behavior is expected to have a tremendous effect on the international economic society, with international communities watching closely to see whether the

7. After Japan acknowledged that it had failed to notify American banking authorities for six weeks after it learned of a \$1.1 billion scandal at the Daiwa Bank in New York. Treasury Secretary Robert E. Rubin and his Japanese counterpart, Masayoshi Takemura, talked on October 11, 1995 to air their differences. Rubin's aides said that officials of Japan's MOF characterized the conversation as an apology, but Japanese officials said in Tokyo on October 12 that no apology had been offered. *See Cloistered Japanese Banks*, N.Y. TIMES, Oct. 13, 1995, at A1.

8. The MOF has tried rebutting this criticism regarding the delayed report on various occasions. While MOF is trying to convince the world by saying "there is nothing to be concerned about in the financial system," it has taken actions which indicate that it is deeply concerned by the loss of its credibility. For example, after the announcement of the affair, MOF showed keen interests in how it was perceived by overseas observers as exemplified by the Deputy Vice-Minister holding an explanatory meeting in Washington D.C., and the special press conference held by General Directors of Banking Business and International Finance Bureau with foreign correspondents in Tokyo). *See Outlandishness of Japanese Financial System Revealed: MOF Agonizes as its Rebuttals are Ignored*, NIHON KEIZAI SHIMBUN, Oct. 18, 1995, at 3.

9. Osaka District Court, Sept. 20, 2000, Shoji Homu, No. 1573, at 4-51 [hereinafter Court Decision]. (All the parts of the court judgment cited in this article are translated to English by the author.)

10. *U.S. Intensifies Criticism Against MOF: MOF Should Not Discuss Its Role*, SHUKAN TOYO KEIZAI, Dec. 2, 1995, at 22 [hereinafter *U.S. Intensifies Criticism*].

11. Kaisha ni Taisuru Sekinin (Responsibilities to Company), Commercial Code Law No. 48 of 1899, art 266-1-5 [hereinafter Kaisha ni Taisuru Senkini].

12. *Court Decision*, *supra* note 9, at 7.

13. *Id.*

administrative, legal and legislative arms of the Japanese government can respond to the enrichment and improvement of the system.¹⁴

The shareholder's derivative action system originally was introduced under the influence of the U.S. system as a part of the revision of the Commercial Code¹⁵ in 1950 but it took a long time to implement because its characteristics were rather exotic to the Japanese culture. The future of the shareholder's derivative action system, including the adequacy of the recent court decision on the Daiwa Bank, also was being discussed thoroughly by the international community.¹⁶

The case involved a locally hired employee of the New York branch of a Japanese bank, a Japanese American, and attracted a lot of international media attention, due to its international nature.¹⁷ More specifically, the related shareholders' representative action was drawing the attention of U.S. corporations (more particularly U.S. banks) operating in Japan, as the case was indicative of a potential risk. It was assumed that there were many U.S. international lawyers who were sought out for advice concerning the responsibilities of directors in Japan.¹⁸ The intention of this article is to clarify for these attorneys and the rest of the legal community the problems that are caused by the differences between Japan and the U.S.

The recent court decision was meaningful in examining the duties assumed by directors of financial institutions which required them to establish an internal control system for controlling risks and abiding by laws and regulations, deciphering the differences in the duties of care among the directors, interpreting the meaning of the "laws" in Section 1-5, Article 266 of the Commercial Code, and the objects of the responsibilities in said section as well as the scope of its damages.¹⁹

There is still room for doubt in this court decision as to whether sufficient examination has been made as to the judgment on identifying specific negligence. The instant case presents legislative questions such

14. *Id.* at 35.

15. Commercial Code Law No. 48 of 1899.

16. Hiroshi Okuda, Chairman of Japan Business Federation, is reported to have commented concerning this court decision that "I believe it is better if people refrain from filing shareholder's representative actions." *NIHON KEIZAI SHIMBUN*, Sept. 21, 2000, at 3. Reporting the court decision, newspapers generally pointed out the problem of secretive atmosphere of the Japanese financial communities and their lack of responsibilities through their editorials and objected the modification of the law claiming that the revision is intended to make the law ineffectual using this court decision as a reason. *Asahi Shimbun*, Sept. 21, 2000, at 2.

17. *See infra* notes 7, 8, 242, and 244.

18. *Id.*

19. *See* Kimura Toshio, *Management Responsibility in the Daiwa Bank Case* (in Japanese), *JAPAN BUSINESS NEWS*, at http://www.japan-bus.pwc.com/insol/business/bushot_pse2001.html.

as whether it is reasonable to order a director to pay the full amount of damages when the damages amount to an enormous sum, or possible to set an upper limit to damages, or even to pardon the responsibility of the defendant. In Part I, the article will outline the case, examine these various issues, and study the meaning of the present case, simultaneously examining the goals for which the shareholder's representative action system should aim. In order to do so, the article will also study various cases of shareholder's representative action in Japan, which preceded the present case to clarify the importance of the present case. The article will also discuss the basic issues between the financial institutions and the financial administration of the government concerning international financial business, issues which became evident by the instant case.

This case contains a broad range of complex issues, encompassing the government and business circles of Japan and the U.S. Therefore, the method of analysis for these issues requires an extensive multi-disciplinary approach based on jurisprudential, economical, sociological, and international comparative studies. This article seeks to provide such a multi-disciplinary analysis.

In Part II, this article discusses past suits and the subsequent standards of directors' liability and applies this standard to the Daiwa Bank suit. Part III of this article reviews the factual background of the Daiwa Bank case. Part IV, reviews the court decision of the recent Daiwa Bank shareholder's suit. Part V, examines the legal actions taken against the Daiwa Bank by the United States and suggests that such actions fall within the general trend of increased supervision by U.S. authorities over foreign banks. Part VI explains and reviews the meanings and issues of derivative action against Daiwa Bank. Part VII compares and contrasts the duty of disclosure under United States and Japanese law. It also discusses the reporting responsibilities of the MOF. Part VIII of this article points out the other effects of the court decision on the shareholder's derivative action.

Finally, the article concludes that both autonomous responsibility principles and free market doctrine are necessary to further Japanese banking in the international market and that further improvement of the relations between the United States and Japan requires a consensus regarding international business. This article further concludes that the Daiwa Bank court decision on the shareholder's derivative action should be considered an alarm, warning against the way Japanese corporations are managed. The case points out the background that allowed Japanese companies to be run loosely seems to be in the fact that the supervising authorities and the legal system failed to rigorously pursue the looseness

of risk management and concealing of responsibilities.²⁰

II. Stockholder's Derivative Suits in Japan

The stockholders' representative action is a rather new form of litigation introduced in the United States in 1950, which has not functioned properly in Japan.²¹ While the number of stockholders' representative actions is increasing and several judgments have been made in cases where the directors' responsibilities were at issue, it is too early to say that the system operating such actions has been well established. The Daiwa Bank case drew much attention from international business circles due to the size of the claim, and will be a leading case in the future. However, examination of a few other typical cases is proper and appears below.

A. Case A: *Mitsui Mining Co., Ltd.*

In a stockholders' representative action, the directors of Mitsui Mining Co., Ltd.²² were sued for damages caused by having to coerce its wholly owned subsidiary into purchasing its stock at a high price and then selling the stock to the Mitsui Group at a lower price. The suit alleges that this action violated the rule prohibiting the acquisition of a company's own stock. The Supreme Court, finding that the acquisition of the stock of their own company was a violation of the Commercial Code,²³ rendered a guilty verdict against the directors.²⁴ Although this representative action requested the payment of ¥100 billion (approximately \$1 billion), the Supreme Court supported the judgment of the Second Tokyo High Court that found ¥3.5 billion (approximately

20. This article is a continuation of an older article, Mitsuru Misawa, *Daiwa Bank Scandal in New York—It's Causes, Significance, and Lessons in the International Society*, 29 VAND J. TRANSNAT'L L. 1023 (1996). For the various development of this case since its disclosure in September 1995 to November 1996, please read that article.

21. In order to make this system function properly, a revision of the Commercial Code was enacted in October 1993 containing: (1) a reduction of the petition fee and (2) allowing plaintiff stockholders to petition for recovery of litigation expenses from the company if the plaintiffs win. *Amendments to the Commercial Code*, June 14, 1993, No. 62.

22. A mining concern listed on the Tokyo Stock Exchange.

23. According to the Commercial Code at that time, a company was prohibited from acquiring its own stocks. *Jiko Kabushiki no Shutoku* [Acquisition of Own Stock] art. 210. Also, a subsidiary is prohibited from acquiring the stocks of its parent company. The rule recognizes the oneness of the parent company and a subsidiary and applies the rule to the transaction between the two. *Jiko Kabushiki no Shutoku* [Acquisition of Own Stock] art. 211-2. However, a company is allowed to acquire its own stocks by the revision of the Treasury Shares portion of the Commercial Code in 2001.

24. *Ariyoshi v. Mitsui Mining Co.*, 1400, 1st Small Court. 1989, (Sup. Ct., Sept. 9, 1993).

\$350 million) in damages.²⁵

B. Case B: Hazama Gumi Ltd.

In a representative action requesting damages from a director of Hazama-gumi Ltd.,²⁶ for a bribe paid to the mayor of Sanwamachi, Ibaragi-ken by the company, the Tokyo District Court rendered a guilty verdict in December 1994.²⁷ The verdict against the directors ordered them to pay ¥14 million (approximately \$140,000) in damages, a sum equal to the amount of the bribery.²⁸ In delivering the verdict, the Tokyo District Court ruled that: (1) using as a means of business a crime of a highly unsocial nature, such as bribery, should not be tolerated; and (2) bribery cannot be justified as a means of business simply because it brings a profit to the company, it is difficult to get an order without it (as competitors do the same), or it is customary in the industry.²⁹ The defendants did not appeal the case.

C. Case C: Nomura Securities

Before loss compensation procedures became illegal by the Revision of 1991 of the Securities and Exchange Law,³⁰ Nomura Securities³¹ compensated such losses.³² In a representative action seeking damages against the directors, the Tokyo High Court supported the decision of the first trial by the Tokyo District Court, which did not hold the directors liable and rejected the claim by the plaintiff.³³ While it found that loss compensation is an unfair trading method in violation of the Antimonopoly Law,³⁴ it also decided that the Antimonopoly Law may conflict with the rules that apply the Commercial Code with regard to damage caused by a violation of the directors.³⁵ The reason for this is

25. Tokyo District Court, May 29, 1986, Harei Jihyo, No. 1194 at 33; Shoji Homu, No. 1078 at 43; and Tokyo High Court, July 3, 1988, Shoji Homu, No. 1188 at 36.

26. A general construction company listed at Tokyo Stock Exchange.

27. Matsumaru v. Otsu, Tokyo District Court, Dec. 22, 1994, Civil Sec. No. 8, 1993 (wa) No. 18447.

28. No. 153 Diet Record (Justice Committee, No. 13), Nov. 27, 2001 (in Japanese), at http://www.shugiin.go.jp/itdb_kaigiroku.nsf/html/kaigiroku/000415320011127013.htm.

29. *Id.*

30. Commercial Code Law No. 25 of 1948.

31. A securities broker listed at Tokyo Stock Exchange.

32. See Mitsuru Misawa, *Loss Compensation in the Japanese Securities Market: Causes, Significance, and Search for a Remedy*, 25 VAND. J. TRANSNAT'L L. 37-58 (1992) (discussing loss compensation).

33. Ikenaga v. Tabuchi, Tokyo High Court, Sept. 26, 1995, 16th Civil Dept., 1993 (ne) No. 3778 [hereinafter Ikenaga].

34. Commercial Code Law No. 54 of 1947, art. 19.

35. Kaisha ni Taisuru, *supra* note 11, at art. 266-1-5.

that the party that receives the loss is not the company, but the competitor.³⁶ The decision also stated that the loss compensation was within the normal boundaries of the management's judgment, and neither the violation of the duty of due care nor the violation of the duty of loyalty to the company were found.³⁷ Thus, the directors were not liable.

D. Standard of Directors' Liability

The facts of these three example representative actions are completely different. By comparing these three decisions, however, one can deduce the following standard of directors' liability.

First, as the decision of the Tokyo District Court stated in Nomura Securities: (1) the management judgment of a corporation is a comprehensive one requiring a professional, predictive, policy-making judgment capability for analyzing unpredictable, fluid, and complex factors, so that it tends to be broad and complex; and (2) a court should examine the actual management judgment of the directors itself from the standpoint of whether there were any careless mistakes in examining the facts that were used as premises, and whether the decision-making process based on the facts was not illogical.³⁸ In essence, it seems that the court is trying to honor the business judgment of directors as much as possible.

The court, however, considered that directors might be subject to liability in certain situations. First, even if an act may be viewed as indispensable for business reasons, the director who committed the act may still be punished if it is an illegal act for which a person can be sent to jail.³⁹ In the above three cases, bribery can be a criminal offense punishable by up to three years of imprisonment under a Criminal Code,⁴⁰ and acquisition of one's own company stock can be a criminal offense punishable by up to five years of imprisonment under the Commercial Code.⁴¹ On the other hand, loss compensation conducted before 1991 is not a criminal offense punishable by imprisonment, and no penalty rules are applicable to violations of the Antimonopoly Law.⁴²

Second, assuming that an act is not a criminal offense, directors will not be punished simply because they caused a loss to the company, if

36. See Misawa, *supra* note 32.

37. Tokyo District Court, Dec. 22, 1994, Civil Sec. No. 8., 1993 (wa) No. 18447.

38. *Id.*

39. *Id.*

40. Zouwai, Assen Zouwai (Bribery, Mediating Bribery), Commercial Code Law No. 45 of 1907, art. 198.

41. Kaisha Zaisan wo Ayauku suru Tsumi (Crime to Risk Company's Assets), Commercial Code Law No. 54 of 1947, art. 489-2.

42. See Misawa, *supra* note 32 (discussing the illegality of loss compensation).

other directors in the same industry could have made the same mistake.⁴³

Third, a director who performs a certain prohibited act or fails to supervise another such a director, a director or auditor who attended the board of directors meeting where the execution plan for such an act was adopted, or an auditor who attended the auditors meeting which examined such a plan, may be liable.⁴⁴

E. Application of Old Standards to the Daiwa Bank Case

These principles should be applied when reviewing the Daiwa Bank case. In light of the first principle, if the court in New York decides that the action of the directors stationed at the New York Branch at the time of the incident is a criminal offense punishable by imprisonment then the same directors will be held liable in the representative action in Japan as well. According to the third principle, not only the directors who actually performed the actions, but also the directors who failed to monitor the directors who performed the actions, as well as the directors and auditors who attended the board meeting at which the action was approved, face liability.

If such action is not a criminal offense punishable by imprisonment, it should then be examined through the second principle.⁴⁵ In other words, if the action of the director that caused a loss to the company is the type of action that would have been performed by many directors in the same industry, the director is not liable.⁴⁶ The question is whether the action performed by the directors stationed at the New York Branch can be considered to be the kind of action that would have been performed by many directors in the same industry. The answer to that question is no; the present case is a very unusual case in view of the common sense of the particular industry. Therefore, it is likely that the directors will be held liable, even if the action does not constitute a criminal offense punishable by imprisonment.

In addition, in the Daiwa Bank case, responsibilities of the directors will be evaluated from new perspectives. For example, is it reasonable to impose supervisory liability on the directors, who resided in Japan at the time, when the incident occurred in New York? The general sentiment of Japanese managers is that "directors who reside in Japan cannot be held responsible for an incident that happened at a place so far away."⁴⁷

43. Tokyo District Court, *supra* note 37.

44. Misawa *supra* note 32.

45. See e.g., Mitsuo Kondo and Toshiaki Hasegawa, et. al., *Various Issues of Shareholder's Suit in Japan*, YOBOU JIHYO, Summer 2001, at 26-35.

46. *Id.*

47. *Id.*

Even though it happened on foreign soil, it may still be reasonable for the stockholders to hold the directors who resided in Japan responsible for a breach of supervisory duty because of the extensive length of time—eleven years—that they remained unaware of what was happening.

The Japanese should welcome the opportunity brought by the judgment in the present case to think about the responsibilities of directors in the expanding international environment and to clarify these standards of responsibilities.

III. Factual Background of the *Daiwa Bank* Case in New York

Daiwa Bank⁴⁸ disclosed on September 26, 1995, that a Bank Vice-President Toshihide Iguchi,⁴⁹ who was in charge of securities trading and control at its New York Branch, had been selling securities that the Bank had in its custody to cover up the loss created by his own unauthorized, unlisted trading of U.S. Treasury bonds.⁵⁰ His trading caused Gush's bank to lose a total of approximately \$1.1 billion (approximately ¥110 billion).⁵¹ Iguchi's cover up consisted of the concealment of transaction certificates.⁵² The amount of Daiwa's loss is among the highest in the history of similar known cases.⁵³

Although the loss in this case was caused by the criminal conduct of an individual, the multiple review of transaction, one of the basic rules for all financial institutions did not work in this case. It is astonishing that this illegal trading remained undetected for eleven years.⁵⁴ Thus, it is important to see how it was concealed.⁵⁵

When a bank trades U.S. Treasury Bonds, securities companies—the bank's counterpart in the transactions—normally send transaction

48. Daiwa Bank was the 17th largest bank in 1995 in the world with about \$318 billion in assets and more than 9,000 employees. The corporation stock was listed in the Tokyo Stock Exchange. Established in 1918 its main office was located at 2-1 Bingo-Machi, 2-Chome, Chuo-ku, Osaka-shi, Osaka Japan. TOKYO KEIZAI JAPAN COMPANY HANDBOOK 1100 (1996).

49. On September 26, 1995, the Federal Bureau of Investigations (FBI) arrested Toshihide Iguchi (age 44), a former employee of Daiwa Bank's New York Branch. See *Daiwa Bank's Huge Loss, 30,000 Unauthorized Transactions: FBI Announces Arrest of Daiwa Bank's Former Employee*, NIHON KEIZAI SHIMBUN, Sept. 27, 1995, at 1.

50. Court Decision, *supra* note 9, at 5.

51. *Id.*

52. See Yoshiyuki Watanabe, *Daiwa Bank Conceals Wrongdoings*, BUNGEI SHUNJU, Dec. 1995, at 94-104 (outlining details of the concealment by Daiwa Bank).

53. Misawa, *supra* note 20.

54. The incident became known to the management of the bank through Iguchi's confession letter dated July 24, 1995 and addressed to the president. For details of the confession letter, see *Exclusive Publication of Defendant Toshihide Iguchi's Confession*, BUNGEI SHUNJU, Jan. 1996, 112-31.

55. *Id.*

confirmation statements to the transaction control section of the bank.⁵⁶ Iguchi, however, instructed the securities companies to send those statements directly to him.⁵⁷ He also hid the true securities balance statements sent from custodial banks, which held the traded Treasury bonds and delivered forged statements to the custodial control section of the Bank.⁵⁸

How could this happen? First, Iguchi was in charge of both securities trading and securities control. Second, he held these positions in the section that traded Treasury bonds for eleven years. It is quite unusual, even among Japanese banks, for an employee to remain essentially in one position for such a long period. Third, although it is customary for bank employees in the United States and Europe to take a long vacation once a year while another employee handles his or her job.⁵⁹ Iguchi never took any long vacations during the eleven-year period. Finally, with regard to market risk management, it is customary for Japanese banks to set up a trading limit for each trader.⁶⁰ In this case, however, the Bank failed to detect the loss, which substantially exceeded the capacity of its New York Branch.⁶¹ While it is granted that the loss was covered up by unlisted or out-of-books transactions, the management's responsibility for the lack of more effective and stringent control is indisputable.

In 1995, certain stockholders⁶² brought suit in the District Court of Osaka claiming \$1.1 billion (¥110 billion) in damages, caused by the loss at the New York Branch of Daiwa Bank, against 49 defendants, including the former chairman of the board, former officers, and the current president and officers of the Bank.⁶³ The Bank's stockholders originally requested that Daiwa Bank's auditor initiate an action against the management of the Bank within thirty days, but the auditor refused to do so.⁶⁴ As a result, those stockholders decided to sue the Bank's directors themselves in accordance with the Commercial Code.⁶⁵

In this shareholder's representative action, plaintiffs P_1 and P_2 as well as a participant S claimed the defendants D_1 through D_{16} , D_{28} through D_{30} , and D_{32} through D_{49} , all of whom were directors or auditors

56. Court Decision, *supra* note 9, at 5.

57. *Id.*

58. *Id.*

59. Tokyo District Court, *supra* note 25.

60. Court Decision, *supra* note 9, at 8.

61. *Id.*

62. Two individual stockholders and one corporation stockholder.

63. *Stockholders Representative Action to be Filed Tomorrow Asking 1.1 Billion Dollars in Damages*, NIHON KEIZAI SHIMBUN, Nov. 26, 1995, at 30.

64. Court Decision, *supra* note 9, at 8.

65. Kaisha ni Taisuru Senkini, *supra* note 11, arts. 267, 275-74.

of Daiwa Bank, should pay damages in a sum of \$1.1 billion, claiming that those defendants caused a loss of \$1.1 billion to Daiwa Bank, wherein the representative directors and the directors who served as the New York branch managers during the period relevant to the case for failing to perform their duties of care and loyalty as good managers by failing to establish a control system for preventing misconducts of employees and minimizing damages that can be caused by such misconducts ("internal control system").⁶⁶ In addition, the other directors and auditors failed to perform their duties of care and loyalty for checking to see if said representative directors, and said directors who served as the New York branch managers established the internal control system, and thus failed to prevent the present case.⁶⁷ This is "case A." The court granted only a portion of the damages for D₂ for case A.⁶⁸

After the case was disclosed to the public, Daiwa Bank became the target of a criminal prosecution,⁶⁹ primarily on the grounds that it failed to report to the Federal Government the incurred loss of approximately \$1.1 billion related to the case.⁷⁰ They ended up admitting guilt for 16 counts and paid the penalty of \$340 million.⁷¹ In a shareholder's representative action, P₁, P₂, and S claimed that the defendants D₁ through D₃₂ violated their duty of care and loyalty as directors or auditors of the bank, causing a loss of \$340 million in penalties plus a lawyer's fee of \$10 million, for a total of \$350 million and that D₁ through D₃₂ should pay the damages.⁷² This is "case B."

The plaintiffs claimed that, of the counts to which the defendants admitted guilt, counts 14 through 20 directly were related to the fact that the representative directors and the directors who served as the New York branch managers during the concerned period failed to fulfill their duty of care and loyalty for establishing an internal control system, while other directors and auditors failed to check if the internal control system was established by the representative directors and the directors who served as the New York branch managers.⁷³ Thus, all of them prevented the non-party Iguchi from making false statements in various documents that constituted those counts.⁷⁴ Counts 1 through 7, 23 and 24 were related to the performance of the directors, who served as the New York branch managers during the concerned period, and who performed in

66. Court Decision, *supra* note 9, at 8.

67. *Id.* at 5.

68. *Id.* at 47.

69. *Id.* at 6.

70. *Id.* at 5.

71. Court Decision, *supra* note 9, at 8.

72. *Id.*

73. *Id.* at 10.

74. *Id.*

breach of the U.S. law and violated of their duties of care and loyalty as a good manager. These counts also related to the fact that other directors' and auditors' failure to check if the representative directors and the directors who served as the New York branch managers were observing the pertinent U.S. laws. This was the violation of their duties of care and loyalty. The failure eventually led to the parties being unable to prevent the accused wrong-doing.⁷⁵ The court provided a decision allowing only a part of the claims against the defendants D₁ through D₄, D₆ through D₁₀, and D₂₇ as to case B.⁷⁶

IV. The Court Decision for the Daiwa Bank Shareholders' Suit in 2002

First, looking into the facts of the case admitted into the court for the decision, it is noted that on July 18, 1995, Iguchi sent a letter confessing his unauthorized dealings to a defendant D₁, the president of Daiwa Bank, and D₁ received it on July 24.⁷⁷ Upon receiving it, D₁ immediately disclosed the letter to a defendant D₂ (vice president),⁷⁸ a defendant D₃ (vice president),⁷⁹ a defendant D₄ (the chairman of the board and a former president),⁸⁰ a defendant D₅ (director in charge of general affairs and human resources),⁸¹ a defendant D₆ (director and the international department manager as well as a former New York branch manager),⁸² and a defendant D₇ (director in charge of planning, accounting and securities departments).⁸³ Incidentally, Daiwa Bank issued 50 million shares of preferred stocks on July 27, 1995 without publicly disclosing the incident.⁸⁴

Meanwhile, D₁ instructed D₂, D₆, and D₃, who was the New York branch manager at that time, to investigate the incident secretly.⁸⁵ While they came to realize the facts of the matter, D₁ instructed those investigators to keep it secret.⁸⁶ Accordingly, on July 31, a defendant D₈ filed a false call report to the U.S. Treasury Department, reporting that the Treasury bills (T-bills) sold without authorization existed as a property of the New York branch of the Bank.⁸⁷ D₆ either instructed or

75. Court Decision, *supra* note 9, at 8.

76. *Id.*

77. *Id.* at 30.

78. *Id.*

79. *Id.*

80. Court Decision, *supra* note 9, at 8.

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

85. Court Decision, *supra* note 9, at 8.

86. *Id.*

87. *Id.*

knew about this report, and both D₁ and D₂ acknowledged it, at least after the fact.⁸⁸

On August 8, 1995, D₁, D₂, D₆, D₉, and D₁₀ met with the Director-General of the Banking Bureau and the Director of the Commercial Banks Division of the Ministry of Finance to report the outline of the case and their plan on how to handle the matter, asking the Ministry's opinions on how the case should be disclosed to the public.⁸⁹ The Director-General of the Banking Bureau stated that the coming September would be the worst time to disclose it considering the financial situation of Japan and requested that bank representatives hold the information in tight security to prevent any leakage.⁹⁰

In late August 1995, in consideration of an opinion from the department in charge of the U.S. operation that there were strict regulations in the U.S.,⁹¹ D₁ instructed D₆ to consult with a U.S. lawyer about the specific regulations of related U.S. laws.⁹² In accordance with the instruction, D₆ reported to D₁, D₂, D₇, D₉, and D₁₀ that Daiwa Bank legally was obligated to report the case to the Federal Reserve Board (FRB) and the State of New York Banking Department.⁹³ Upon receiving this report, D₁ decided to report the matter to the FRB in mid-September and reported that decision to the Director of the Commercial Banks Division of the Ministry of Finance.⁹⁴ On September 18, D₂ reported the case to the Vice Chairman of the FRB and the Superintendent of Banks of the New York Banking Department.⁹⁵

D₁ disclosed the matter at the board meeting held on September 25 1995, at which time all 13 defendants, D₁₄ through D₂₆ (directors), came to know about the case for the first time.⁹⁶ Three defendants D₁₁ through D₁₃ (representative directors) learned about the case in a management meeting held on September 7.⁹⁷ On September 26, a disclosure of the case was made also to three defendants D₂₈ through D₃₀ (standing auditors) as well as to two defendants D₃₁ and D₃₂ (non-standing auditors or outside auditors), whereupon D₁ attended a news conference to disclose the matter, essentially making a public announcement of the case on the same day.⁹⁸

88. *Id.*

89. *Id.* at 31.

90. Court Decision, *supra* note 9 at 31.

91. *Id.* at 32.

92. *Id.*

93. *Id.* at 33-34.

94. *Id.*

95. Court Decision, *supra* note 9 at 33-34.

96. *Id.* at 8.

97. *Id.*

98. *Id.*

Based upon these facts, the claims were partially granted by the court and the results were as follows:

A. Issue 1 (Whether Nonfeasance Existed Regarding Duties of Establishing an Internal Control System)

According to the Commercial Code,⁹⁹ decisions are made by the board of directors and are required for performing important business of a corporation.¹⁰⁰ The outline of the internal control system¹⁰¹ that touches on the basics of corporate management,¹⁰² needs to be determined by the board of directors and representative directors, as well as the director who was in charge of a concerned business unit and had the duty to lay out a risk management system based on the provided outline.¹⁰³

The abovementioned constitutes the contents of the duties of care and loyalty for directors as good managers. Auditors, on the other hand, have a duty to monitor, to check whether the directors were operating conscientiously and refurbishing the risk management system as needed.¹⁰⁴

However, the contents of the risk management system to be installed became enriched as knowledge was gained from various cases and accidents and research on risk management advanced.¹⁰⁵ Therefore, it was not appropriate to use the current level of the risk management system required at this point as the judgment standard for the present case.¹⁰⁶ Moreover, it was a matter of judgment by management to decide what kind of risk management system refurbishing should be made so that there was wide latitude of decision making ability provided to directors who were essentially corporation management specialists.¹⁰⁷

Directors have duties to establish a law abiding system in order to prevent employees from engaging in illegal conduct while doing their jobs, which also constitutes their duties of care and loyalty as directors.¹⁰⁸ Refurbishment of a system for controlling operation risks also means refurbishing of a law-abiding system.¹⁰⁹

The procedures for checking the storage balance of T-bills adopted

99. Commercial Code Law No. 54 of 1947, art. 260-2.

100. Court Decision, *supra* note 9, at 36-41.

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.*

105. Court Decision, *supra* note 9, at 36-41.

106. *Id.*

107. *Id.*

108. *Id.*

109. *Id.*

by the headquarters of Daiwa Bank (inspection department),¹¹⁰ the New York Branch, and the accounting auditor employed by the bank were extremely inadequate.¹¹¹ To check the balance, it was mandatory to use a method appropriate for the nature of securities in storage; in other words, it was necessary to check actual securities.¹¹²

An in-shop inspection was conducted using the inspection department's standards, which were based on the inspection rule prepared by the inspection department and approved by the director in charge of the inspection department.¹¹³ Since the on-site inspection was executed strictly in accordance with the above-mentioned inspection rule, the director in charge of the inspection department was then responsible for negligence in performing his job as an employee/director because the method of checking the storage balance of T-bills was still deemed inadequate.¹¹⁴ Moreover, since the in-shop inspection and the audit performed by the person in charge of internal auditing were conducted under the supervision of the New York branch manager, the director who happened to be the branch manager at that period was also negligent in his job performance.¹¹⁵ Consequently, the three defendants D₂, D₆, and D₈ who served as New York managers at different, but inclusive points in time pertinent to the case, were also negligent.¹¹⁶

In a large, dynamic corporation such as Daiwa Bank, the president or vice presidents were allowed to delegate some of their jobs to directors.¹¹⁷ In doing so, the presidents and vice presidents were generally relieved of supervisory responsibilities, with the exception of special circumstances.¹¹⁸ There were no claims made in the action as to such special circumstances.¹¹⁹

Directors who were not involved in the chain of command within the inspection department or the New York branch (including the representative directors) have the responsibility of monitoring whether the risk management system was properly established.^{FN} However, it was unreasonable to claim that the risk management system was not outlined properly, nor was its specific structure clear, which made it difficult to blame those directors for being negligent in their monitoring of proper inspection methods.

110. Court Decision, *supra* note 9, at 36-41.

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. Court Decision, *supra* note 9, at 36-41.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

The auditors, irrespective of whether they were standing or non-standing, internal or external, except those auditors who actually attended the check by the accounting auditors, are assumed to have been unaware of any problems associated with the method of checking the balance, clearing them of any liability.

The defendant D₃₃, who visited the New York branch for inspection in September 1993, should have found that the method used by the accounting auditors to confirm the storage balance of T-bills was inappropriate, yet failed to acknowledge and correct it. This failure to act made the defendant liable.¹²⁰

B. Issue 2 (Whether Nonfeasance Existed Regarding Duties Concerning the Violations of US Laws)

The Commercial Code obligates directors of corporations, as a basis of corporation management, to abide by applicable laws, laws not only of Japan but also of foreign countries, if a corporation operates overseas.¹²¹ Abiding by laws of foreign countries is indeed within the jurisdiction of a director's duty as a good manager.

The FRB required New York branches of foreign banks to report to the United States Secret Service when they had any doubts about potential criminal activities of their employees and if the suspect matters required immediate action.¹²² Such reports of suspect matters could be done via emergency telephone calls, followed by written reports submitted within 30 days of the initial report.¹²³ In violation of this obligation, D₁, who was the representative director of Daiwa Bank, caused others to call the FRB to report the fraudulent contents and entries on the books and records of its New York branch,¹²⁴ while concealing the facts from the U.S. authorities and failing to file the criminal report within the period required by the law.¹²⁵

It was quite unconceivable that the defendants of the case B were unaware of the unlawfulness of intentionally calling to report fraudulent contents to the FRB. It was not difficult to assume that they at least knew the generalities of the U.S. laws and regulations concerning those reports and filings. It also was quite reasonable to conclude that they intended deceitfully represent themselves to the FRB.

The act of D₆ (New York branch manager) was a violation of the

120. Court Decision, *supra* note 9, at 36-41.

121. Commercial Code Law No. 54 of 1947, art. 266-1-5.

122. Court Decision, *supra* note 9, at 41-47.

123. 12 C.F.R. § 208.20 (1996).

124. Court Decision, *supra* note 9, at 41-47.

125. *Id.*

United States Code and was considered to be a violation of the director's duty of care as a good manager.¹²⁶

D₂ (general manager of the American operations department at the main office) did not commit the acts in question, but he could have prevented them from being executed.¹²⁷ Therefore, he was considered to have violated the director's duties of care and loyalty as a good manager.¹²⁸

D₄, upon hearing about the report from D₁, should have urged the representative directors to file the report to the U.S. authorities. He also could have prevented the call to report the fraudulent contents. Therefore, he also was considered to have violated the director's duties of care and loyalty as a good manager.

D₁ (representative director & president), D₂ (representative director & vice president in charge of international operations), and D₃ (representative director & general manager of the international department) failed to report to the U.S. authorities while knowing about the unauthorized transactions.¹²⁹ As to the filing of the call report of the fraudulent contents, it can only be assumed that they either gave explicit instructions or approved for the fraudulent call, but it is surely known that they failed to prevent it, thus constituting violations of supervising duties as the superiors in the chain of command. This kind of conduct clearly was a violation of the United States Code¹³⁰ and is considered a violation of the director's duties of care and loyalty as a good manager.

D₃ (representative director & vice president), D₉ (representative director), D₅ (representative director), and D₇ (representative director) failed to report to the US authorities while they were aware of the unauthorized transactions.¹³¹ They could have prevented such an act.¹³² Therefore, they were considered to have violated the directors' duties of care and loyalty as good managers.¹³³

D₁₀ and D₂₇ were aware of the unauthorized trading of this case, and they should have urged the representative directors to report to the US authorities.¹³⁴ Therefore, they were considered to have violated the directors' duties of care and loyalty as good managers.¹³⁵

D₈ (New York branch manager) failed to report to the U.S.

126. *Id.*

127. *Id.*

128. *Id.*

129. Court Decision, *supra* note 9, at 41-47.

130. *Id.*

131. *Id.*

132. *Id.*

133. *Id.*

134. Court Decision, *supra* note 9, at 41-47.

135. *Id.*

authorities despite having full knowledge of the unauthorized trading of this case.¹³⁶ He also committed the crimes of filing a call report of fraudulent contents to the FBI and made false entries into the books and records of the New York branch, both of which were violations of the United States Code.¹³⁷ He was then considered to have violated the director's duties of care and loyalty as a good manager.¹³⁸

The three defendants, D₁₁ through D₁₃, came to know about the unauthorized dealings after the fact and circumstances have not proven that they could have previously known the facts of the crime.¹³⁹ Therefore, they could not be accused of any violations of the directors' duties of care and loyalty as good managers.¹⁴⁰

The thirteen director defendants, D₁₄ through D₂₆, came to know about the unauthorized dealings after the fact—on the day before the case was made public—and the five auditors-defendants, D₂₈ through D₃₂, received the report about the case on the day everything was made public.¹⁴¹ All those defendants who were informed of the case after the fact could not be held liable for any violations of the directors' duties of care and loyalty as good managers.¹⁴²

A director generally was given a wide range of discretionary power in executing his/her job.¹⁴³ Therefore, in order to bring up a charge against a director challenging past business decisions as being made in violation of his/her duties of care and loyalty, the challenger must bring proof of a material and negligent error as the basis of the director's decision.¹⁴⁴ However, the discretionary power of a director did not go beyond the boundary of applicable laws and a director was not given the authority to judge whether or not his/her business decisions violated laws, in particular, laws of foreign countries.¹⁴⁵

The defendants of the case B claimed that there were no expectation probabilities for reporting unauthorized dealings with the U.S. authorities against the wish or suggestion of the Ministry of Finance (MOF).¹⁴⁶ However, no evidence was filed with the court to prove that the MOF instructed or ordered D₁, et al. not to report the matter to the U.S.

136. *Id.*

137. *Id.*

138. *Id.*

139. Court Decision, *supra* note 9, at 41-47.

140. *Id.*

141. *Id.*

142. *Id.*

143. *Id.*

144. Court Decision, *supra* note 9, at 41-47.

145. *Id.*

146. *Id.*

authorities.¹⁴⁷

The defendants of case B claim that they were not aware of the rules and regulations of the United States involving banks, but the claim could not be justified.¹⁴⁸ If it is assumed that they were not fully aware of the details of the relevant rules and regulations of the United States, they should have immediately investigated and studied the appropriate rules and regulations of the United States no matter how rare and unusual the case. As managers of a corporation conducting business in the United States, this was critical. Instead, they failed to take any action until such time that they received a suggestion from the department in charge of the particular operation.¹⁴⁹ The investigation was obviously too late and inexcusable; an inevitable circumstance that stems from ignorance of the rules and regulations.

As can be seen from the above, D₁, et al. made an extremely unreasonable and inappropriate business decision as the business managers, overlooking the severe condition Daiwa Bank was facing. It then is reasonable to say that they violated the directors' duties of care and loyalty as good managers.

C. *Issue 3 (Existence and Scope of Damage)*

1. Case A

(1) D₂

The defendant was not responsible for the damages that were already incurred when he arrived in New York as the branch manager.¹⁵⁰ Therefore, he is liable for repaying the damages, which are conservatively estimated to be approximately \$570 million of the total damages of approximately \$1.1 billion.¹⁵¹

(2) D₆, D₇

It was unclear if the damages occurred after either of them assumed the position of the branch manager, and no evidence had been filed to the court to prove that the damages were incurred because either of them neglected their duties.

147. *Id.*

148. *Id.*

149. Court Decision, *supra* note 9, at 41-47.

150. *Id.* at 47-49.

151. *Id.*

(3) D₂₃

It was unclear if the damages occurred after he conducted a survey of the branch, and no evidence had been filed to the court to prove that the damages occurred because he neglected his duties.

2. Case B

The defendants of the case B claimed that the plaintiffs' claimed that the defendants of the case B were negligent in the establishment of a risk management system had no causal relation with the result that Daiwa Bank, a corporation, paid a penalty.¹⁵²

However, if the New York branch had adopted an appropriate inspection method,¹⁵³ Iguchi's act that corresponded to the counts 14 through 20 could have been prevented,¹⁵⁴ and resultantly Daiwa Bank could not have been punished with the penalty, so that it was reasonable to assume a legal causal relation.¹⁵⁵

(1) D₄, D₁, D₈, D₇

Since the guilty pleas of this case, which were the causes of the penalty that consisted of sixteen counts (and the defendants D₄ et al. were liable only for seven of them),¹⁵⁶ it was not reasonable to ask D₄ et al. to be responsible for repaying the damages equivalent to the sum of the penalty and the legal fee.¹⁵⁷ It was more reasonable to make a proportionate distribution of causal relation based on their individual contribution to the case.¹⁵⁸

It was reasonable to have each of the defendants bear the payment responsibility up to the limitation of \$105 million, which was the most conservative estimate, i.e., 30% of said sum of the penalty and the lawyer's fee, \$350 million.¹⁵⁹

(2) D₂, D₆

Based on the same reasoning, these defendants were liable to pay up to the limitation of \$204 million, which was the most conservative

152. *Id.*

153. *Id.*

154. Court Decision, *supra* note 9, at 41-47.

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

159. Court Decision, *supra* note 9, at 41-47.

estimate, i.e., seventy percent of \$350 million.¹⁶⁰

(3) D₉, D₁₀, D₂₇

Based on the same reasoning, these defendants were liable to pay up to the limitation of \$70 million, which was the most conservative estimate, i.e., twenty percent of \$350 million.¹⁶¹

(4) D₈

Based on the same reasoning, the defendant was liable to pay up to the limitation of \$157.5 million, which was the most conservative estimate, i.e., forty-five percent of \$350 million.¹⁶²

V. U.S. Administrative Legal Actions Against Daiwa Bank in 1995

To understand the background of the court decision for this shareholders' derivative suit, it is necessary to review how the U.S. administrative legal actions were made against Daiwa Bank, that took place before this court decision.¹⁶³ On November 2, 1995, the FRB ordered Daiwa Bank to close its branches and terminate all operations in the United States within ninety days.¹⁶⁴ Moreover, for the next three years, Daiwa Bank was obligated to submit a petition in writing if either the Bank or its affiliates wished to reopen operations in the United States.¹⁶⁵ This petition was then subject to the discretionary control of U.S. authorities.¹⁶⁶ In practical terms, this meant that Daiwa Bank had been completely banished from the United States.¹⁶⁷ This action by U.S. authorities was viewed as an "abnormally" severe punishment in Japan.¹⁶⁸ This article next examines whether this Japanese claim had any merit by reviewing the legal grounds of the FRB's action and the judgment that resulted from it.

According to the International Banking Act (IBA),¹⁶⁹ there were two grounds on which FRB could base its decision of the deportation of Daiwa Bank. First, Daiwa Bank did not obey the supervision of

160. *Id.*

161. *Id.*

162. *Id.*

163. Court Decision, *supra* note 9, at 7.

164. Senjin Kishi, *Fault of MOF Which Betrayed World and Japan: Japan Financial Administration. Far Apart From Anglo-Saxon Logic*, *ECONOMIST* (Japan), Dec. 5, 1995, at 40-42.

165. Court Decision, *supra* note 9, at 7.

166. Kishi, *supra* note 164.

167. *U.S. Intensifies Criticism*, *supra* note 10, at 22.

168. *Id.*

169. 12 U.S.C. § 611 (1994).

regulation of the MOF.¹⁷⁰ Since Daiwa Bank had been consulting with the MOF, it was unlikely that this was the reason for the FRB's decision. It is better to assume that the FRB's action was based on the second reason: Daiwa Bank's operations included those that could be considered unsafe and unsound banking practices.¹⁷¹

First, Daiwa Bank violated the law that imposes certain reporting obligations. Daiwa Bank failed to file a criminal referral report within thirty days after the date of detection, the period defined in Regulation H.¹⁷² It seems inconceivable, however, that the FRB decided to expel Daiwa Bank permanently from the U.S. solely on the grounds that the Bank violated this reporting rule. The punishment for a violation of the

170. See §§ 7(e) and 10(b) of the International Banking Act, added in 1991 as amendments.

The Board may order a foreign bank to terminate the activities of such branch, agency, or subsidiary, if the Board finds that—

(A) the foreign bank is not subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country; or

(B)(1) there is reasonable cause to believe that such a foreign bank or any affiliate of such foreign bank, has committed a violation of law or engaged in an unsafe or unsound banking practice in the United States; and as a result of such violation or practice, the continued operation of the foreign bank's branch, agency, or commercial lending company subsidiary in the United States would not be consistent with the public interest or with the purposes of this Act, the Bank Holding Company Act of 1956 or the Federal Deposit Insurance Act.

Id. [hereinafter IBA §§ 7(e) and 10(b)]. See also 12 U.S.C. § 3107(b) (1994).

And in case of termination of a Federal branch of agency:

The Board may transmit to the Comptroller of the Currency a recommendation that the license of any Federal branch or Federal agency of a foreign bank be terminated in accordance with section 4(1) [12 U.S.C. § 3102(I)] if the Board has reasonable cause to believe that such foreign bank or any affiliate of such foreign bank has engaged in conduct for which the activities of any State branch or agency may be terminated.

12 U.S.C. § 2105(e)(5) (1994).

171. *Id.*

172. 12 C.F.R. § 208.20 (1996). *Id.*

A state member bank shall file a criminal referral report . . . in every situation where the State member bank suspects one of its directors, officers, employees, agents, or other institution-affiliated parties of having committed or aided in the commission of a crime. . . . A state member bank shall file the report . . . no later than 30 calendar days after the date of detection of the loss or the known or suspected criminal violation or activity. If no suspect has been identified within 30 calendar days after the date of detection of the loss, or the known, attempted, or suspected criminal violation or activity, reporting may be delayed an additional 30 calendar days or until a suspect has been identified; but in no case shall reporting of known or suspected crimes be delayed more than 60 calendar days after the date of detection of the loss or known, attempted, or suspected criminal violation or activity. When a report requirement is triggered by the identification of a suspect or group of suspects, the reporting period commences with the identification of each suspect or group of suspects.

reporting duty alone should entail, at most, a fine imposed on the Bank or a criminal penalty against the individual(s) involved.¹⁷³

In addition to the reporting rule violation mentioned above, Daiwa Bank committed two additional violations.¹⁷⁴ The Bank had been making false reports to the authorities for the past eleven years in order to conceal the unlawful trading.¹⁷⁵ In addition, it continued to conceal these facts of this situation after management received Iguchi's confession.¹⁷⁶ The Bank conducted a systematic concealment operation regarding the loss generated by Daiwa Bank Trust, the subsidiary of the Daiwa Bank.¹⁷⁷ It is assumed that when the FRB discovered these two violations, in addition to the reporting rule violation, it concluded that the Bank had been conducting an "unsafe and unsound banking practice."¹⁷⁸

As the backdrop of the FRB's decision is the Bank of Credit and Commerce International (BCCI) case.¹⁷⁹ BCCI was notorious for its

173. *Id.*

Any foreign bank or any office or subsidiary of a foreign bank, that—

(A) fails to make, submit, or publish such reports or information as may be required under this Act or under regulations prescribed by the Board or the Comptroller of the Currency pursuant to this Act, within the time period specified by such agency; or

(B) submits or publishes any false or misleading report or information . . . shall be subject to a penalty of not more than \$20,000 for each day during which such failure continues or such false or misleading information is not corrected.

See also 12 U.S.C. § 3110(c) (1994).

Whoever, with the intent to deceive, to gain financially, or to cause financial gain or loss to any person, knowingly violates any provision of this Act or any regulation or order issued by the appropriate Federal banking agency under this Act shall be imprisoned not more than 5 years or fined not more than \$1,000,000 for each day during which a violation continues, or both.

174. Per the complaint of the U.S. prosecution authorities. See *Former N.Y. Branch Manager Claimed Not Guilty: Defendants Lawyers of Daiwa Bank Case Claim Main Case Itself is Illegitimate as Well*, NIHON KEIZAI SHIMBUN, Nov. 22, 1995, at 4 [hereinafter *Former N.Y. Branch Manager*].

175. Court Decision, *supra* note 9, at 7.

176. *Former N.Y. Branch Manager*, *supra* note 174.

177. Court Decision, *supra* note 9, at 7.

178. *Former N.Y. Branch Manager*, *supra* note 174.

179. The BCCI (Bank of Credit and Commerce International) group is a multinational group of financial institutions having 365 offices in sixty-nine countries around the world and was one of the largest Arabian financial institutions. A Pakistani businessman established the BCCI GROUP in 1972 and the largest group stockholders consist of the Emirate of Abu Dhabi and the people related to its government. BCCI Holding, the holding company of the BCCI group, has a token head office in Luxembourg for the purpose of registration and the actual head office in London. See generally *BCCI Case's Full Picture: Other Countries Responses and Developments in Japan*, KINYU HOHMO JUYOU [Financial and Legal Affairs], Nov. 25, 1991 at 4-12 [hereinafter *BCCI Case's Full Picture*].

The BCCI group had been suspected of drug money laundering for some time. *Id.* When its performance deteriorated due to failures of loans without collateral as well as

underground activities, such as drug money laundering, and was called "the world's dirtiest bank."¹⁸⁰ In 1991, British authorities ordered BCCI to stop its operations, which practically forced BCCI into bankruptcy.¹⁸¹ In the United States, authorities found that BCCI was illegally lending to one of the nation's largest banks, Washington, D.C.-based First American Bank.¹⁸² As a result, the United States fined BCCI \$200 million and permanently expelled nine people involved in the case from banking in the U.S.¹⁸³

In contrast to the Daiwa Bank case, however, U.S. authorities did not take expulsion actions were taken against BCCI itself by U.S. authorities. BCCI, however, stopped its operations on its own initiative and retreated from the United States.¹⁸⁴ From the FRB's standpoint, the most serious violation by BCCI was the false report it made to U.S. authorities when it purchased First American Bank.¹⁸⁵ As a result of this incident, a revision of the IBA was introduced in 1991 to enhance the FRB's authority substantially, giving it powers such as canceling licenses and examining all foreign bank branches in the United States.¹⁸⁶

The FRB's order, directed at Daiwa Bank to terminate operations, was the first action of its kind taken by the FRB since the revision of the IBA in 1991.¹⁸⁷ While some people thought that this action was too severe, it was neither unusual nor unduly harsh, if one understood the trend toward increased supervision by U.S. authorities over foreign banks.¹⁸⁸

dealing failures, it covered up its settlements with window dressing. *Id.*

On July 5, 1991, having been convicted of BCCI's long term window dressing settlement practices, Bank of England, in coordination with the financial authorities of the United States (where First American Bank, its subsidiary in a practical sense, exists), ordered BCCI to halt its operation and froze its assets in each country in order to prevent its customers' run on the bank and the insiders from hiding its assets. *Id.*

180. Court Decision, *supra* note 9, at 7.

181. *Id.*

182. *Id.*

183. See *BCCI Case's Full Picture*, *supra* note 179.

184. Court Decision, *supra* note 9, at 7.

185. *Id.*

186. See IBA §§ 7(e) and 10(b), *supra* note 170.

187. Kishi, *supra* note 164; *U.S. Intensifies Criticism*, *supra* note 10.

188. *Id.*

VI. Meanings and Issues of Derivative Action Against Daiwa Bank in 2002

A. Responsibilities of Directors Concerning Violations of US Laws

1. Meaning of "Laws" in Article 266, Section 1-5 of Commercial Code¹⁸⁹

The court's decision to hold Daiwa Bank liable for damages totaling \$350 million, including the penalty and the lawyers' fees, demonstrates that the defendants D₁ et al. were responsible as directors of a corporation operating overseas by setting up branches and liaison offices. As such, the defendants had a have duties of care as good managers to obey the laws of the country where they were operating.¹⁹⁰ As a consequence, this case created a precedent, which now includes foreign "laws" that are applicable to overseas branches within Article 266,

189. Article 266 of the Commercial Code provides:

1. In the following cases, directors who have done any one of the acts mentioned there shall be jointly and severally liable in effecting performance or in damages to the company, in the case of item (1) for the amount which has been distributed or divided legally, in the case of item (2) for the amount of loans not yet repaid, or in the cases of items (3) to (5) inclusive for the amount of any damage caused to the company:

(1) Where they have submitted to a general meeting the proposal for the distribution of profits in contravention of the provision of Article 290 paragraph 1, or they have distributed money in contravention of the provision of Article 293-5 paragraph 3;

(2) Where they have loaned money to another director;

(3) Where they have effected any transaction in contravention of the provision of the Article 264 paragraph 1;

(4) Where they have effected any transaction mentioned in the preceding Article;

(5) Where they have done any act, which violates any law or ordinance or the articles of incorporation.

2. In cases where any act mentioned in the preceding paragraph has been done in accordance with the resolution of the board of directors, the directors who have assented to such resolution shall be deemed to have done such act.

3. The directors who have participated in the resolution mentioned in the preceding paragraph and who have not expressed their dissent in the minutes shall be presumed to have assented to such resolution.

4. The liability if directors mentioned in paragraph 1 cannot be released except by the unanimous consent of all the shareholders.

5. The liability of directors in respect of the transaction mentioned in item (4) of paragraph 1 may be released by majority of two-thirds or more of the votes of the total number of the issued shares, notwithstanding the provisions of the preceding paragraph. In this case, the directors shall show all material facts as to such transaction at a general meeting of shareholders.

190. The present decision by the court indicated 12 U.S.C. § 208.20 as a specific law violated by D₁ et al.

Section 1-5 of the Commercial Law.¹⁹¹

The understanding of the “laws” has a plurality of theories in Japan. The first is a recent decision made by the Supreme Court on a case of the shareholder’s representative action regarding Nomura Securities’ loss compensation, which indicated that the “laws” include all regulations of the Commercial Law and other laws that are to be obeyed by a company in conducting its business using the company as the addressee.¹⁹² Japan considers this decision by the Supreme Court as the majority theory in Japan for the moment. This indicates that the understanding of the “laws” is based on the idea that companies have law-abiding obligations and the directors’ adherence to these laws that specify the company as the addressee in the course of their job executions, belong to their job-related duties for the company.¹⁹³

The second theory only includes within the “laws” the regulations of the Commercial Law (essentially a substantive corporate law) and regulations that cover public policies for corporate directors. Consideration for all other laws suffices if those laws are considered from the standpoint of whether a decision causes any violation of the director’s duty of care.¹⁹⁴

The third theory defines “laws” as those laws that directly or indirectly try to maintain the soundness of the asset of a company.¹⁹⁵ Violations of any other laws matter only from the standpoint of liabilities to damages.¹⁹⁶

Despite the differences between these three theories, they do share a common ground. All three require companies operating overseas, through establishing branches, to abide by the local laws.

2. Principle of Respondent Superior

The question about the present court decision has been questioned because it presumes that the law concerning the defendants’ responsibilities is Article 266, Section 1-5 of the Commercial Code. It is questioned because a common theory in Japan in regard to a shareholder’s representative action is that the entire liability of a director to the company, not just the responsibility according to Article 266 of the

191. Court Decision, *supra* note 9, at 15.

192. Supreme Court decision, July 7, 2000; KINYU/SHOJI HANREI [FINANCIAL/COMMERCIAL PRECEDENCE], 1096, at 3 (2002).

193. Court Decision, *supra* note 9, at 15.

194. Mitsuo Kondo, *Torishimariyaku no Keieiyo no Kashitsu to Kaisha nitaishuru Sekinin* [Directors’ Errors in Management and Their Responsibilities for Company] KINYU FOMU JJO [Financial Legal Situations], 1372, at 10.

195. SHIGERU MORIMOTO, KAISHAHO KOGI [CORPORATE LAW] 253 (2nd edition, 2001)

196. *Id.*

Commercial Code, can be the target of a shareholders' action. In case of (employee/director who happened to be the New York branch manager), for example, there can be a view that his responsibility as an employer being the New York branch manager was prosecuted.

In November 1995, D₃, the former New York Branch general manager of Daiwa Bank was arrested and indicted in Federal District Court of the Southern District of New York as being guilty of misprision of felony.¹⁹⁷ Also the allegations were made against the Bank as a corporation of misprision of felony and obstruction of the examination of the financial institution by the authorities.¹⁹⁸

While the prosecutor alleged that Daiwa Bank was liable under *respondeat superior* for the damages its customers and the U.S. financial authorities suffered due to illegal transactions, Daiwa Bank alleged that the case was a personal wrongdoing committed by defendant Iguchi, and that "the bank was a victim and was not responsible for the misconduct."¹⁹⁹

The disparity between Japanese and U.S. laws regarding *respondeat superior*, caused a difference of opinion between U.S. authorities and Daiwa Bank in this case. According to common law principle operating in the United States, an employer was held liable for the conduct of its employee that results in damages to third parties during the course of his or her employment, regardless of whether or not the employer was at fault.²⁰⁰ According to Japanese law, an employer was liable only when the employer was negligent in the selection and supervision of the employee.²⁰¹ However, Japanese law placed more responsibility on the employer in its interpretation of an employee's course of employment.²⁰²

Daiwa Bank agreed in 1996 to plea bargain with the prosecutor to settle the case by admitting some wrongdoing and paying a penalty.²⁰³ It admitted wrongdoings as to sixteen of the allegations. Most notably were the intentional concealment and conspiracy regarding a loss, which were regarded as the center of the accusations.²⁰⁴ Daiwa Bank paid \$350

197. Court Decision, *supra* note 9, at 6.

198. *Former N.Y. Branch Manager*, *supra* note 174, at 4.

199. *See Daiwa Bank Has Employer's Responsibility: Federal Prosecutor's Rebuttal Stresses Legitimacy of Accusation*, NIHON KEIZAI SHIMBUN, Feb. 13, 1996, at 3.

200. Court Decision, *supra* note 9, at 6.

201. *Id.*

202. Japanese Civil Code, Law No. 89 of 1898; Law No. 9 of 1898, art. 715.

203. *See generally Daiwa Bank Seeks Judicial Settlement, Admits Huge Loss and Conspiracy: Federal Prosecutor Charges \$35.6 Billion Penalty for 16 Accounts Including Delayed Report: Affected by MOF's Intention*, NIHON KEIZAI SHIMBUN, Feb. 29, 1996, at 1 (giving the details of the plea bargain agreement) [hereinafter *Daiwa Bank Seeks Judicial Settlement*].

204. Court Decision, *supra* note 9, at 6-7.

million in penalties.²⁰⁵ However, since plea-bargaining does not exist under Japanese law there had been some strong criticism in Japanese economic circles of this mode of settlement by Daiwa Bank, arguing that the bank should have fought to the end to clarify its role in the matter.²⁰⁶

3. Negligence Concerning Recognition of Illegality

D₁ et al. claimed that they were unaware of the contents of the laws and regulations about banks in the U.S.²⁰⁷ However the existence of case law made this argument illogical.²⁰⁸ Therefore, the issue regarding D₁ et al. became whether they were aware of the applicable U.S. laws and regulations and whether there was a negligent act if they were unaware of them.

Ultimately, the court decision rendered it unthinkable that the defendants were unaware of the fact that it is illegal to file a report of fraudulent contents to the FRB.²⁰⁹ However, doubt remained about whether each defendant was aware of the specific law or regulation of the U.S. that prohibited the act. It was possible to assume that the defendants were not so knowledgeable because things they received U.S. legal consultation only after they heard from the department in charge of the U.S. operation. The reality was that many of Japanese financial institutions were unaware of the U.S. laws and the fact that their law-abiding systems were inadequate.²¹⁰ Similarly, some American bankers were only vaguely aware of the banking law requirements, along with their punishments. Thus, it was likely that D₁ et al. were not well aware of the applicable laws and regulations in the U.S.²¹¹

The question then was whether we could conclude that the defendants were aware of the possible violation, or at least they were negligent, if they had some notion that they could be pursued for violation of some laws. If we were to assume a position that the defendants could not be judged as having been negligent unless they were cognizant of violation of specific laws,²¹² it would be necessary to

205. *Id.*

206. *Id.*

207. *Id.* at 42.

208. Misawa, *supra* note 2.

209. Court Decision, *supra* note 9, at 42.

210. See Brian P. Volkman, *The Global Convergence of Bank Regulations and Standards for Compliance*, 115 BANKING L.J. 550, 554 (1998).

211. If Daiwa Bank concealed a fact of unauthorized dealings from the Japanese authorities in charge of overseeing banking activities, the penalties such as \$350 million, or approximately ¥37 billion, which was charged in the U.S. is inconceivable in Japan. If a bank files a fraudulent report to the Financial Reestablishment Commission, the penalty is less than ¥3 million in Japan. Banking Law of Japan, art. 63, § 1.

212. Tokyo High Court Decision, February 23, 1999; see also SHOUJI HOUMU

make a more finite fact recognition of whether they were required to take immediate action (i.e. such as contacting a local U.S. law office even under the circumstance they were facing, or comparing their case with those of American bank managers). It was a case where recognition that their action could be illegal, or at least negligent, was a possibility.

In November 1995, in Federal District Court of the Southern District of New York, Daiwa Bank itself and D₃, the former director and general manager of the New York Branch admitted their guilt regarding a number of the charges and agreed to a plea bargain with the U.S. prosecutor.²¹³ 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.²¹⁴

4. Claim of "Management Decision"

Rather than debate the existence or lack of a malfeasance, the defendants claimed that the "management decision" was correct at the time of the incident.²¹⁵ In other words, the defendants argued whether the response of the directors to the incidents was "extremely unreasonable."

For this point, the present court decision stated a general theory that a director's responsibility was pursuable only when either a material or negligent error existed in the recognition of a fact which became the premise of the director's judgment at the time of taking the particular business measure, or the decision-making processes or its contents were particularly unreasonable or inappropriate, considering the fact that a director was given a wide range of discretionary power in making a management decision.²¹⁶ If this was compared to the leading case of the management decision principle, the general theory of the management decision principle in the verdict of the first hearing in the case of the shareholder's representative action regarding Nomura Securities' loss compensation,²¹⁷ the decision was notable in that it said it was possible to seek the directors' responsibilities not only on the decision-making processes, but also on the contents if they were unreasonable or inappropriate. However, the court found D₁ et al. responsible without applying this principle, noting that the discretionary power given to a

(BUSINESS LAW AFFAIRS) 192, at 164-168 (explaining that it is necessary to prove the recognition or possibility of recognition of specific illegality in order for a director's liability for damages to be established).

213. Court Decision, *supra* note 9, at 6.

214. *Id.* at 17.

215. *Id.* at 45.

216. *Id.*

217. Ikenaga, *supra* note 33.

director was limited to a range that does not violate any laws,²¹⁸ and in particular, that the director was not given any discretionary power to judge if a decision abides by a foreign law or not.²¹⁹

It was true that a sufficient amount of precedence existed to support the ruling that the management decision principle was not applicable to illegal actions out of malice even in the United States where the management decision principle was born. Additionally, there was no argument about it in Japan.²²⁰ It went without saying that a director could not evade responsibility if the director engaged in an action that was knowingly illegal, judging from the notion that the "laws" of Article 266, Section 1-5 included any laws that were applicable to the company.²²¹ Therefore, it would be difficult to apply the management decision principle if there was at least some recognition that the action could be illegal.

However, if D₁ et al. had no notion of illegality, and there was only a possibility of negligence, the management decision principle could be an issue. In that case, a close examination would be required to determine if there were any material and negligent error existed in the recognition of the fact which was the preamble of the judgment by D₁ et al., or if there was any mismatch in the decision making processes and contents. There was a high probability that D₁ et al. at least were cognizant that their action could be illegal.²²²

5. Intervention of MOF (Expectation Probability)

D₁ et al. also claimed that there was no expectation probability for reporting to the US authorities against the MOF's request or suggestion.²²³ In fact, Daiwa Bank seemed to have thought that it was adequate to report the incident to the MOF and simply to obey the guidance of the MOF.²²⁴ The MOF, however, did not tell Daiwa Bank what to do in this case.²²⁵ Thus, Daiwa Bank inadvertently broke the IBA's reporting rule that an incident has to be reported within thirty days after it was discovered.²²⁶

A detailed analysis of the above is provided below, since it contains

218. Court Decision, *supra* note 9, at 45.

219. *Id.*

220. TAKASHI MAEDA, HANSETSU SHOUJI HOUMU (COMMERCIAL LAW) 154, at 28-31.

221. Court Decision, *supra* note 9, at 46.

222. See *Daiwa Bank Seeks Judicial Settlement*, *supra* note 203 (explaining recognition of illegality).

223. Court Decision, *supra* note 9, at 31.

224. *Id.*

225. *Id.*

226. *Id.*

extremely important factors in understanding the background of the present case such as special relations between the government and civilian sectors and the difference of cultures between Japan and U.S.²²⁷

Aside from focusing on the attempts by Daiwa Bank to hide losses, U.S. criticism had also targeted the closed-room administrative practices of the MOF.²²⁸ Such criticism arose from the MOF's failure to notify U.S. financial authorities for six weeks after the MOF received its report from Daiwa Bank.²²⁹ These numerous criticisms suggested that the MOF was really at fault in the matter rather than Daiwa Bank since it failed to follow necessary procedures after receiving the report from the Bank.²³⁰

As mentioned above, Daiwa Bank was "obligated to report to the FRB within 30 days after the criminal case was suspected," according to Regulation H.²³¹ While the MOF's reporting duty does not stem directly from this law, it should have advised Daiwa Bank to report to the FRB.²³² The MOF is accused of being morally responsible for this nonfeasance.²³³ Moreover, even though there was no legal regulation to abide by, the MOF should have inferred from the purpose of the law that they had a responsibility to report this kind of information quickly to the FRB.

As for this implicit responsibility for the nonfeasance of the MOF,²³⁴ there was a strong view among the informed sources in the Japanese financial world that the MOF did not know about this thirty-day disclosure duty under the U.S. IBA.²³⁵ However, the FRB and U.S. prosecutors did not think that this was true.²³⁶ This reporting requirement was created based on the experience of the BCCI affair,

227. See *supra* text accompanying note 8.

228. See *supra* note 6 and accompanying text.

229. See *supra* note 2.

230. *Id.*

231. See *supra* note 173.

232. *Suggestion for Disbanding of MOF Surfaced Abruptly with Daiwa Bank Sandal*, SHUKAN TOYO KEIZAI, Dec. 2, 1995, at 12.

233. *Id.*

234. The attitude taken by MOF in this case is a violation of the agreement among the banking supervisory agencies of various national governments established to control international banking transactions. Basle Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments*, July 1992, <http://riskinstitute.ch/139290.htm>.

When BCCI went bankrupt, the Japanese financial institutions experienced a severe blow due to the delay of UK's supervisory authorities. Compared to the U.S. where legal systems such as the International Banking Act of 1978 and the Foreign Bank Supervision Enhancement Act of 1991 are established, Japan is extremely retarded in dealing with foreign banks activities in the nation. See Japanese Banking Act, art. 47.

235. See Court Decision, *supra* note 9, at 10.

236. *Id.*

which shook the world.²³⁷ It was difficult for them to believe that the MOF and Daiwa Bank, which had been operating in the United States for many years, did not have knowledge of the thirty-day disclosure duty. Even if the MOF and the Bank did not have knowledge of the law, it is well-established in both Japan and the United States, that lack of knowledge of the law does not disprove the existence of intent or *mens rea*.²³⁸ Since the FRB's opinion was that the "MOF neither disclosed important information nor honored the reporting duty between the bank supervising authorities of the two countries" and that "[t]his was a breach of faith,"²³⁹ the expulsion of Daiwa Bank should be understood as an indirect warning on the part of the FRB to the MOF.

The characteristics of the response of the MOF to the Daiwa Bank incidents can best be described as obfuscation and delay, which is the traditional technique of the MOF based on their governing principle: "Never let them know; let them rely on us."²⁴⁰ "Obfuscation" and "delay" as well as "secrecy" are the key words often used these days in criticizing the Japanese financial system.²⁴¹ They are analogous to "equivocation" and are taken as a kind of cover-up. All of these words suggest not an attitude of clarifying the problem and solving it, but of an attempt to make the status and magnitude of the problem fuzzier, which is a typical form of "responsibility evasion."²⁴²

This secrecy-prone administrative technique by the MOF had

237. *Id.*

238. "Ignorance of the law excuses no one (*Ignorantia legis neminem excusat*)" is one of the basic principles of the common law in the United States. In other word, everyone must know the ordinary laws of the country in which one lives, and ignorance therefore does not excuse oneself from being charged with either civil or criminal liability. The same principle applies to the citizens of Japan. See Criminal Code, Law No. 45 of 1906, art.38-3.

239. *MOF's Failures are Regrettable*, NIHON KEIZAI SIMBUN, Nov. 29, 1995, at 2.

240. Diet Record No. 153 (Justice Committee), Nov. 28, 2001, at http://www.shugiin.go.jp/itdb_kaigiroku.nsf/html/kaigiroku/000415320011128014.htm.

241. Shigeo Nakao, *Globalization to be Reconsidered*, at <http://koho.osaka-u.ac.jp/vuniv2002/nakao2002/nakao2002-10.html>.

242. Another example that is causing criticisms against the MOF from this perspective is the "Jusen" problem. Although MOF claims that the interest-free preferential credits of Japanese banks against Specialized Housing Finance Companies (Jusen) is ¥40 trillion, the actual figure is rumored to be ¥70 trillion. The U.S. authorities are irritated that MOF is not disclosing information in a straightforward manner and have the impression that MOF is engaged in a cover up, as in the Daiwa Bank case. See *Nippon Island of Bad Debts*, SHUKAN TOYO KEIZAI, Feb. 24, 1996, at 12-17. For "Jusen," see Mitsuru Misawa, *Lenders' Liability in the Japanese Financial Market; A case of 'Jusen,' the largest problem loan in Japan, Part I*, MANAGEMENT JAPAN, Autumn 1997, 18-28; Mitsuru Misawa, *Lenders' Liability in the Japanese Financial Market; A case of 'Jusen,' the largest problem loan in Japan, Part II*, MANAGEMENT JAPAN, Spring 1998, 18-28.

severely damaged the international credibility of Japan.²⁴³ Nevertheless, the MOF insisted that this problem was created by the “difference of culture between Japan and the [United States],”²⁴⁴ and did not accept its fault, which was really the crux of the problem.²⁴⁵ Such denial was similar to the fact that the management of Daiwa Bank did not realize its duty to disclose the important information at the earliest opportunity.

However, a “difference of culture” cannot be used to rationalize negligence with regard to rules and violations. International business is conducted under a certain set of rules and develops when mutual trust deepens as agreements and contracts are exchanged and honored. It became quite clear that there is a marked difference between Japan and the United States in the understanding of this principle. The violation of the reporting duty is a clear violation of a rule. The MOF clearly showed how selfish the Japanese financial system was and how difficult it was for the system to be accepted internationally. In that sense, the “Daiwa Bank problem” was a “Japanese” problem as well.

Of course, it goes without saying that it is essential to have open communication and tight cooperation among countries in order to maintain an international financial system. In an age of progressively globalized finances, where money can be transferred within a split second, mistrust between financial supervisory authorities may lead to a financial crisis. We have to conclude that the MOF’s understanding of this point was too naïve.

The root of this case was the collaboration between the MOF and the Japanese Banking industry regarding the so-called “administrative guidance,” which was indistinct and secretive.²⁴⁶ Such an administrative method delayed healing and worsened the damage. When it became impossible to hold back the information any more, and the truth was finally made public, a huge irrevocable international and domestic loss of trust resulted. Why then did the Japanese financial industry depend on the “administrative guidance” of the secret room? Why did it not want to act and take responsibility for its own acts?

The first reason is that, since the end of World War II, there have not been clear rules established for the financial world in Japan under which it could act on its own operating principles and take responsibility

243. See *supra* note 8.

244. At a press conference held on September 18, 1995 for foreign correspondents in Japan, MOF explained that “the problem resided in the difference of culture.” See *Suggestions of Splitting MOF Surfaced Abruptly with Daiwa Bank Scandal; MOF Campaign of Bureaucracy, Shows Sign of Fatigue*, SHUKAN TOYO KEZAI, Dec. 2, 1995, at 16 [hereinafter *Suggestions of Splitting MOF Surfaced Abruptly*].

245. See *supra* note 7.

246. Seichro Saito, *Daiwa Bank Case and MOF*, available at <http://www.mmjp.or.jp/news>.

for its own activities.²⁴⁷ Rather, it had to adhere to the murky rules of “administrative guidance,” whereby it was required to ask the intentions of the MOF.²⁴⁸ In this case, for example, there was no explicit rule stating that the Bank had to report within a specific number of days after it learned about such an incident. There was simply a guiding principle that it had to be reported as soon as possible.

Secondly, the reason that such a secretive collaboration between the administration and the industry, and its lack of disclosure, lasted so long were the existence of the so-called “convoy system.”²⁴⁹—a concept to approve the government backup system as a desirable matter—and the increase in real-estate and stock prices that continued to rise for years and years due to the continuous expansion of the Japanese economy.²⁵⁰ Under such conditions, it was easier for industry to obey administration policy, as the profit would automatically flow in with the expansion of the Japanese economy.²⁵¹ Even if industry officials made a mistake in managing the Bank, the damage would be healed automatically by the rise of the real-estate and stock market prices if they “kept their mouths shut” and acted in collaboration with the administration.²⁵²

Thirdly, from the international viewpoint, the Japanese financial institutions, despite their limited international experience, had quickly become giants in size during the last ten years, mainly because of a sharp yen appreciation against the U.S. dollar.²⁵³ Their holding increased twofold in terms of the dollar, and the amount of funds they controlled increased sharply.²⁵⁴ Thus, the Japanese financial institutions, big in size, but rather primitive in international etiquette, felt that they had to depend on the administration’s guidance in order to compete amongst the more sophisticated institutions of the world,²⁵⁵ which, in comparison, have survived years of tough competition and merger battles while being responsible for their own acts.²⁵⁶ The MOF’s shallow understanding of what the international financial system should be was the true cause of

247. *Id.*

248. *Id.*

249. *See supra* note 4.

250. *Then Prime Minister Hashimoto’s Report on MOF’s Misadministration to the Diet*, February 5, 1998, <http://www.kantei.go.jp/jp/hasimotosouri/speech/1998/0209soriokura.html>.

251. *Id.*

252. *Id.*

253. *See MOF’s Confusion at its Peak: Distrust of Japan’s Financial Administration Heightens Regarding Daiwa Bank Scandal: Disbanding of MOF is Suggested*, SHUKAN TOYO KEIZAI, Dec 2, 1995, at 16 [hereinafter *MOF’s Confusion at its Peak*].

254. *Id.*

255. *Id.*

256. *See John Bussey, Japan’s Bungling Ministry of Finance*, WALL ST. J., Nov. 10, 1995, at A14.

the joint failure of the MOF, on whom Daiwa Bank relied for guidance, and Daiwa Bank to comply with U.S. law.²⁵⁷

Nonetheless, the court's decision declared that there was no evidence to prove that the MOF instructed or ordered D₁ et al. not to report to the U.S. authorities and that it was inexcusable that they chose not to make any decision on their own, relying solely on the MOF's judgment or support.²⁵⁸

Judging from the contents of their meeting with the Director-General of the Banking Bureau of the MOF, it was unclear whether MOF requested D₁ et al. to delay not only the disclosure timing, but also the report to the U.S. authorities.²⁵⁹ Therefore, in order to deny their responsibilities, it was necessary to prove the specific request of the MOF officers.²⁶⁰ Moreover, even if the MOF's request was made clear, it alone could not deny their responsibilities. Even if they received such a request, their illegal action in view of the U.S. laws would not be tolerated unless they were forced to do so under a certain law.²⁶¹ If ever their responsibilities had to be removed, it had to be proven that a very unusual situation existed where they had no choice but to obey MOF's instruction.

B. Responsibility for Establishing Internal Control System

1. Responsibility of Establishment

The court stated that directors of a corporation were generally responsible for establishing a risk control system and a law-abiding system, an internal control system, and decided that the directors of the case were responsible under Article 266, Section 1-5 because the system was inadequate.²⁶² The court also decided that the auditors were responsible because they failed to monitor the system properly.²⁶³ The decision established precedence, as there had been no prior decision that had made such an explicit statement.

No one could deny that risk management and law-abiding operations were extremely important in present day corporations, particularly financial institutions. In addition, it was no secret that directors were responsible for supervising those operations. However, as

257. *Id.*

258. Court Decision, *supra* note 9, at 31.

259. *Id.*

260. *Id.* at 45.

261. *Id.*

262. Court Decision, *supra* note 9, at 31.

263. *Id.*

the court pointed out, it was impossible for directors to guide and supervise all employees directly in large organizations. Consequently, the directors' responsibilities of care were to establish risk management and law abiding systems for employees and monitor them.²⁶⁴ Theories have recognized such responsibilities for many years.²⁶⁵ Establishment of the system was a fundamental part of the company management,²⁶⁶ so that its outline needed to be formalized in the board room.²⁶⁷ Representative directors and directors in charge of operations were responsible for establishing such a system, while other directors were responsible for monitoring the system.²⁶⁸

For a financial institution such as Daiwa Bank, establishment of such an internal control system was particularly important and constituted a part of the basic responsibilities of a director. It was written clearly in the financial inspection manual of the Financial Services Agency²⁶⁹ formulated in 1999 and it was self-evident that whether an internal control system concerning risk management and a compliance system was established, was the main objective of the financial inspection by the Financial Services Agency.²⁷⁰

However, it also must be realized that since such an internal control system had been introduced recently, it was not appropriate to judge the responsibilities of a director required at the time when the incident occurred with the level of internal control system currently required. One also should have considered the discretionary power given to a director as a management judgment issue. Nonetheless, even though it was not clearly recognized as an issue of establishing an internal control system, a risk management system or a law-abidance system per se,²⁷¹ it was fair to say that some of their concepts were part of a director's responsibility of care, especially as a part of the monitoring responsibility. Although the issue was related to the discretionary power

264. *Id.*

265. See KENICHI YOSHIMOTO, SHOUJI HOUMU [COMMERCIAL LAW] 1562, 40-42.

266. Court Decision, *supra* note 9, at 11.

267. *Id.*

268. *Id.*

269. The Financial Reconstruction Committee (FRC) was merged into the Financial Services Agency on January 6, 2001. The FRC had been working to restore stability and vitality in the financial system through the quick resolution of failed financial institutions under the Financial Revitalization Law and capital injection into viable institutions using public funds under the Financial Function Early Strengthening Law. Law No. 143 (1998). With these efforts, the environment surrounding financial institutions had on the whole regained stability. For details, see <http://www.fsa.go.jp>.

270. See *Check List for Inspection of Law Abidance System and Check List for Inspection of Risk Management System*, KINYU KENSAI MANYUARU [FINANCIAL INSPECTION MANUAL], July 1999.

271. Court Decision, *supra* note 9, at 34.

of a director, limits existed with such power, as can be seen from the status of a compliance system that was a target of a financial inspection. Part of the order for filing an improvement plan or a business stop order was issued according to the Japanese Banking Law²⁷² if the status was poor. This rule also applied to any corporation other than financial institutions, although the degree of severity might have varied by industry.

2. Responsibility of Care

If it is assumed that all agree on the notion that directors were responsible for establishing an internal control system, the next question is whether it was reasonable to seek the defendants' violations of specific duties related to the care in this regard as the court did.

The plaintiffs claimed the lack of separation between the securities trading department and the fund settlement/administration department, as well as an inadequate forced holiday system, as the problems with the risk management system of Daiwa Bank's New York office.²⁷³ These points claimed by the plaintiffs are certainly the check items for risk management found in the financial inspection manual.²⁷⁴ However, the court rejected all of these claims, except the claim pointing to the inadequacy of the routine to check the storage balance of actual T-bills.²⁷⁵

It was true that Iguchi's unauthorized transactions could have been exposed much earlier if such a check on actual T-bills was implemented. However, a more careful examination should have been made as to the legal evaluation whether the lack of confirmations of actual T-bills was extremely inadequate or not.

The defendants rebutted that the inspection method for checking the securities in storage by means of storage balance statements normally used by other banks and auditing firms,²⁷⁶ while the method of checking the storage balance by usually viewing actual T-bills at the secondary storage site was not necessarily used, even at that time.²⁷⁷ It was true that the fact that the same method that was used by other financial institutions could not be used as a basis for arguing that the particular inspection method was not inadequate, if the method was grossly deficient.²⁷⁸ However, one cannot deny the fact that the actual method practiced by

272. Japanese Banking Law, Law No. 21 of 1927, art. 26.

273. Court Decision, *supra* note 9, at 8.

274. *Supra* note 270.

275. Court Decision, *supra* note 9, at 34.

276. *Id.* at 10-13.

277. *Id.* at 39-40.

278. *Id.*

other Japanese bank branches and U.S. banks in New York could be used as a reference in judging whether the particular inspection method was grossly deficient or not. In that sense, the fact that, while the particular New York branch had been audited by an auditing company, 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, it was never demonstrated that there was any deficiency in the method of storage balance confirmation. This means that there was a possibility that all the U.S. and Japanese financial inspectors did not consider it a deficient method. One could not adopt today's level of risk management system as the basis for assessing the case. In addition, the level of risk management involved is a factor of management judgment, so that there would be room for a manager's discretionary power. Although the fact that there was no physical confirmation of actual T-bills, it may be considered a material deficiency of the risk control system at that time. Once the public knew what had transpired, it left a question in everyone's mind as to whether it was indeed such a severe deficiency at the time of the incident.

3. Principle of Trusting Right

The persons who were accused of job-related negligence concerning the establishment of the risk control system in the case A were the three directors D₂, D₆ and D₈, all of whom had served as New York branch managers,²⁷⁹ and who were accused of inadequacies in the method of confirming the storage balance of T-bills²⁸⁰ and the auditor, D₃₃, who visited New York branch in September 1993 for auditing, but failed to correct the method of confirming the storage balance of T-bills, although he could have found that it was inadequate.²⁸¹ As to D₁, who was the president, and D₃, who was the vice president, they were not accused of negligence of supervisory responsibilities on the ground that they were allowed to delegate their responsibilities to directors in charge of the inspection department, which was responsible for inspecting the storage balance of T-bills, and the directors in charge of the New York branch.²⁸² The corporate organization was structured in such a way that the president and the vice president were found not to have supervisory responsibilities, unless there were special circumstances that raised doubts about the job performance of those directors who had the

279. *Id.* at 39-41.

280. Court Decision, *supra* note 9, at 39-41.

281. *Id.*

282. *Id.*

frontline responsibilities.²⁸³ For the same reasons, other directors were also discharged of their supervisory responsibilities unless there were special circumstances that created doubts of adequate job performance.²⁸⁴

Such a thought in the court decision at that time was assumed to have its ground in the principle of "trusting right," whereby directors and auditors could delegate portions of their jobs to other directors and auditors, or employees, and the directors were allowed to assume that there were no problems in the delegated jobs unless there were special circumstances that created doubt about adequate job performance.²⁸⁵ Such a theory also could be found among Japanese academic circles.²⁸⁶

There was no question that directors could not do everything on their own in such a large company and that they had to delegate some of the work load to other directors in charge of special areas or employees. That was the reason why various internal organizations existed.²⁸⁷ It also was difficult for a director to monitor the details of the work performed by the people to whom the director had delegated his/her work.²⁸⁸ This idea has been wildly accepted in the United States and is called "Trusting Right."²⁸⁹ Such a protection in the U.S. was given to a director, however, only when the trust was reasonable and the individual worthy. In other words, the director could trustingly accept reports from a person whom he/she has delegated work without feeling the need to investigate them, except under special circumstances.²⁹⁰

The question then becomes, what kind of a circumstance would be considered a special case, and was a system established to enable the director to trust the person in charge. It was unrealistic to expect a director, who did not have the frontline responsibilities to perform such a detailed task, to check the storage balance report by visually checking the actual T-bills.²⁹¹ The author considers that the court decision to accept "trusting rights" therefore was appropriate.

VII. Responsibility of Information Disclosure

Despite the fact that Daiwa Bank learned of a huge loss due to Iguchi's unauthorized dealings, it issued 50 million shares of preferred

283. *Id.*

284. *Id.*

285. Court Decision, *supra* note 9, at 39-41.

286. KATSUO KANZAKI, HANHYO SHOUJI HOUMU [COMMERCIAL LAW], 1492, 76-78.

287. Court Decision, *supra* note 9, at 39-47.

288. *Id.*

289. A.L.I., *Principles of Corporate Governance: Analysis and Recommendations*, § 4.02.

290. Court Decision, *supra* note 9, at 41.

291. *Id.*

stocks on July 27, 1995.²⁹² If this is considered to be an act of deceiving shareholders, its directors could be indicted for criminal and civil responsibilities under the Japanese Securities Exchange Law.²⁹³ This point is not a count of this suit and there were no claims in this shareholders' derivative action as to this point.²⁹⁴ However, this should not be overlooked.

Although they knew about the huge loss described above, the management of Daiwa Bank delayed disclosure of that information to the FRB for a substantial period.²⁹⁵ The FRB thought that this delay was a serious violation of the reporting rule under the IBA.²⁹⁶ In addition, Daiwa Bank may have been required to disclose this important information, which logically is expected to influence the securities market for stockholders as well as to the public, which includes other stakeholders.²⁹⁷ While this is not the direct concern of the FRB, if the management of Daiwa Bank felt it had responsibility to the stockholders to disclose, it should have reported such information to the United States and Japanese authorities at the appropriate time. From this standpoint, whether the bank and its directors were obligated to disclose such information to the stockholders is deeply related to the reporting duty to the FRB. Furthermore, the Bank and its directors may have been responsible for the disclosure of important information under the Securities and Exchange Law of Japan, as Daiwa Bank's stock was traded on Japan's stock market.²⁹⁸

292. *Id.* at 30.

293. The Securities and Exchange Law of Japan also prohibits fraudulent operations with Article 58 against illegal trading which corresponds to Article 17(a) of U.S. Securities Act of 1933 and against manipulation of the stock market with Article 125 which corresponds to Article 9 of U.S. Securities Exchange Act of 1934. The difference between Article 58 and Article 125 is that Article 58 is a comprehensive prohibition rule to prohibit all fraudulent actions in general while Article 125 is intended to secure a free and open market. Due to the nature of these two rules, it often happens that a case violates Article 125 and Article 58 at the same time.

294. Court Decision, *supra* note 9, at 4-8.

295. A wide range of international observers desires the necessity for disclosure by Japanese banks. For example, Kevin Mellyrin, a consultant, and Arthur M. Mitchell, a lawyer, claimed that "[I]f Japan wants to develop world-class financial institutions that are necessary to secure its position in the world economy, it is necessary for Japan to ask for a more thorough and consistent disclosure practice from its bank." *Self-Renovation of Japanese Banks Desired Urgently*, NIHON KEIZAI SHIMBUN, Dec. 4, 1995, at 23.

296. Court Decision, *supra* note 9, at 43.

297. *Mechanisms for Management Information Disclosure Suggestions to be Installed in Daiwa Bank by Year End*, NIHON KEIZAI SHIMBUN, Oct. 13, 1995, at 7 [hereinafter *Mechanisms for Management Information Disclosure Suggestions*].

298. If Daiwa Banks stocks were traded on the U.S. market, or if Daiwa Bank had been issuing its securities in the United States, so that there were stockholders in the United States, then the U.S. Securities Acts would have been applied. However, this was not the case.

What is notable here is that Daiwa Bank asked a third party to purchase its stock without disclosing the losses, thus causing damage to this third party. Daiwa Bank issued 50 million shares of preferred stock on July 27, 1995.²⁹⁹ Asahi Mutual Life Insurance Co. (Asahi Seimei), a major life insurance company in Japan,³⁰⁰ bought a large sum of Daiwa Bank's common stocks shortly before the incident was disclosed.³⁰¹ Asahi Seimei commented later that the stock purchase was made on the request of Daiwa and it was regretful that the loss disclosure was not made.³⁰²

The facts of this case reveal that a "director of Daiwa Bank urged Asahi Seimei to buy Daiwa Bank's stock from the open market without disclosing an important piece of information regarding Daiwa Bank that might affect the market negatively."³⁰³ Asahi Seimei already owned 2.7 million shares of Daiwa Bank stock at that point.³⁰⁴ Asahi Seimei decided, however, that additional shares would be helpful to enhance its business in the Kansai District, where Daiwa Bank had its head office, and thus, bought a total of five million shares in six installments between late August and late September 1995, immediately before the disclosure of this incident.³⁰⁵ During this period, Daiwa Bank shares traded at slightly over 800 yen per share. The price subsequently dropped to about 600 yen per share, causing the insurance company to incur an unrealized loss of ¥650 million (about \$6.5 million).³⁰⁶

The next question to be examined is whether Daiwa Bank had a duty to disclose this important information to stockholders, including Asahi Seimei, according to the Securities and Exchange Law of Japan. When a director discloses an important piece of information about a company, he or she may either disclose it or make the company disclose it. In either case, the director must always choose between the following duties: (1) the duty owed to stockholders to disclose the information as

299. Court Decision, *supra* note 9, at 30.

300. At that time, the fifth largest life insurance company in Japan.

301. *Daiwa Bank's Huge Loss Case, Disclosure Tardiness Undeniable: Finding of Preferred Stock Issuance After Former Bank Employee's Confession Causes Distrust in Domestic and Overseas Markets*, NIHON KEIZAI SHIMBUN, Nov. 29, 1995, at 3 [hereinafter *Daiwa Bank's Huge Loss Case*].

302. *Id.* Although a company is now allowed to own its own stocks in the form of Treasury Stocks in Japan as it is so in the U.S., it was forbidden to do so in Japan. Commercial Code, Law No. 48 of 1899, art. 210. Therefore, when a company wanted to ask the third party to obtain the company's stock or increase the number of stocks the third party owns, it was a common practice in Japan to ask the third party to purchase the company's stocks through the stock market. *Id.*

303. *Daiwa Bank's Huge Loss Case, supra* note 301.

304. *Id.*

305. *Id.*

306. *Id.*

soon as possible;³⁰⁷ and (2) the duty owed to the company not to disclose any information without first investigating thoroughly the accuracy of the information.³⁰⁸ In some cases, this choice can be extremely difficult. While the director did not sell the stock he owned to Asahi Seimei, Seimei would not have purchased Daiwa Bank stock if it had known of the negative information.³⁰⁹ Therefore, as far as the director's duty of disclosure is concerned, it is reasonable to assume that the case is similar to the director's selling of his own stock to another stockholder without disclosing the negative information. The *Asahi Seimei* case illustrates the difference in director's duties under United States and Japanese law.

The disclosure duty under the common law in United States is as follows: For liability to occur: (1) a party involved in a business transaction must intentionally prevent another party from obtaining an important piece of information by concealment or otherwise,³¹⁰ or (2) a party must owe to another party a duty "to exercise reasonable care to disclose matters known to him that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."³¹¹ Otherwise, a party cannot be sued for fraud based on its failure to disclose information. As for the fiduciary, however, the party not only has an "affirmative duty of utmost good faith, and full and fair disclosure of all material facts," but also has an affirmative duty to "employ reasonable care to avoid misleading his clients."³¹²

Under U.S. case law, it has been discussed extensively whether a fiduciary relationship exists between a director and a stockholder.³¹³ It is clear that such a fiduciary relationship does exist between a director and a stockholder when a director buys the company's stock from a stockholder and takes advantage of knowledge of internal information of the company.³¹⁴ Similarly, there exists the question of whether or not Daiwa Bank had a disclosure duty with regard to Asahi Seimei, a stockholder, in urging Asahi Seimei to buy shares from the market.

307. See *Oliver v. Oliver*, 118 Ga. 362, 368, 45 S. E. 232, 234 (1903); *Cady, Robers & Co.*, SEC 907, 911 (1961); *Rogen v. Ilikon Corp.*, 361 F. 2d 260, 268 (1st Cir. 1966) (discussing U.S. common law); see Court Decision, *supra* note 9, at 15 and 31 (discussing this case).

308. Court Decision, *supra* note 9, at 15 and 31.

309. *Id.* at 30.

310. RESTATEMENT (SECOND) OF TORTS § 550 (1976).

311. *Id.* at § 551(2)(a).

312. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). In equity law, fraud includes all actions, omissions, and concealment that cause damages to other people, with violations of duties, trusts, or confidence duly placed under the common law or the equity law, or all actions, omissions or concealment to deprive other people inappropriately and unconscientiously of opportunities to make profits.

313. *Speed v. Transamerica Corp. (I)*, 71 F. Supp. 457 (D. Del. 1947).

314. *Id.*

The "majority" rule is that, "officers and directors do not have active liabilities for disclosure responsibilities unless misstatement, unclear representation, or intentional concealment were made either verbally or by actions."³¹⁵ However, since they have fiduciary obligations to the company and the stockholders with regard to trading with the company and for the company, they have the disclosure duties."³¹⁶ According to this rule, it is fair to conclude that the directors of Daiwa Bank had a disclosure duty in the Asahi Seimei case.

The "minority" rule states that "the insider (officers, directors, and majority shareholders owning more than 10% of the stocks) of a company is construed to have a fiduciary relation with a stockholder in a stock trading so that the former has to make a complete disclosure on all important matters."³¹⁷ Based on this standpoint, there is no question that a disclosure duty exists for those Daiwa Bank directors in the Asahi Seimei case.³¹⁸

Against this backdrop of U.S. common law, the securities laws³¹⁹ contain several prohibitive rules against fraudulent activities. In particular, they deem illegal an "insider's" use of insider information in trading securities.³²⁰ Specifically, Section 10(b) of the Securities Exchange Act of 1934 obligates certain insiders, namely officers, directors, and major stockholders, to pay the company any profit they earned due to insider information within the past six months.³²¹ Whether such an action is to be construed as "insider trading" is judged according

315. The leading case for this view is *Carpenter v. Danforth*, 52 Barb. 581 (N.Y. Sup. Ct. 1868).

316. *Id.*

317. *Oliver v. Oliver*, 45 S.E. 232, 234-35 (1903); *Stewart v. Harris*, 77 P. 277, 279 (1904); *Jacobson v. Yaschik*, 155 S.E.2d 601, 605-06 (1967).

318. A third theory on this matter is an intermediate position in that it states that an insider owes a responsibility for non-disclosure in special circumstances. Even from this standpoint, the disclosure duty of Daiwa Bank is undeniable. See *Strong v. Repide*, 213 U.S. 419, 431 (1909) (discussing a third theory). The court held that the purchase of stocks from minor stockholders by a dominant stockholder and administrative general without disclosing the pending sale of a company asset, constituted an unlawful fraud. Its decision was based on its finding that it was the defendants' duties to act honestly and disclose the facts prior to the purchase, *given the defendants' positions as insiders and the special knowledge they had. Id.*

319. Unites States Securities Act of 1933, 15 U.S.C. §§ 77a-78mm (1934) and the Securities Exchange Act of 1934, 15 U.S.C. §§ 77a B 78jj (1934). The Act of 1933 was intended to achieve "truth in securities" related to the public offerings in the issuing market, while the Act of 1934 intends mainly to control offerings in the issuing markets, while the Act of 1934 intends mainly to control activities of brokers and dealers a well as the securities market where they operate; at the same time, it established a disclosure system (Securities Report System) that obligates them to disclose pertinent information continuously.

320. LOUIS LOSS, *SECURITIES REGULATION*, 1445-1473 (1961).

321. *Id.*

to Rule 10b-5, a derivative rule of Section 10(b).³²²

It is difficult to believe that the insiders of Daiwa Bank did not trade Daiwa Bank's stock at all while important information was being withheld. If there were any such trading, Rule 10b-5 should be applied in the U.S. The directors of Daiwa Bank must have had the choice "either to disclose the important information or to abstain from trading."³²³ It must have been the same in the case of asking Asahi Seimei to buy Daiwa Bank's stock from the market. The particular director of Daiwa Bank must have had the choice "either to disclose or not to ask for such a trade."³²⁴

In the United States, the disclosure duty, according to Rule 10b-5, is not limited to the case of a direct deal between an insider and a stockholder,³²⁵ but rather it imposes a wider duty on insiders to urge the company to disclose fully any important information that might influence the evaluation of the stock of the company on the stock market.³²⁶ It seems that, although the responsibility of disclosure by the company is stressed, the company's response is generally slow and limited by its pursuit of its own interests. Thus, the responsibility of disclosing to the general public seems to fall on the insiders themselves.

There is no question that insiders will be charged with violations of 10b-5 for distributing false information through reports, newspaper releases, comments by directors, or any other methods, even if they were not involved in any trading.³²⁷ The question, however, is whether or not they will be convicted of violating Rule 10b-5 when they fail to announce an important piece of information that most likely would have affected the market price.³²⁸ There is no Supreme Court case that deals

322. *Id.*

323. *Id.*

324. *Id.*

325. *Daiwa Bank's Huge Loss Case*, *supra* note 301.

326. *Id.*

327. In the Texas Gulf Sulphur case, where the focus of the lawsuit was a misleading newspaper report describing a large mineral deposit found in Canada as uncompromising, the Second Circuit Court stated in its final judgment that it seems that it is not unfair to hold the management of a company to be responsible to confirm the accuracy of any announcements the company makes to stockholders or the general public. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 861-6 (2d Cir. 1968), cert. denied sub nom.. *Coates v. SEC and Kline v. SEC.* 394 U.S. 976 (1969). In other words, the court delivered a judgment that rule 10b-5 is always considered to be violated in a case such as follows: when an announcement was made in a rationally calculated method in order to influence the investing public, e.g. by media reporting financial status, and said announcement was fraudulent or likely to cause misunderstanding or, so imperfect as to cause misunderstanding irrespective of whether the announcement was motivated by secret purpose of the officers of the company or not.

328. *Loss*, *supra* note 320.

with this particular issue. Both the SEC³²⁹ and the U.S. courts³³⁰ consider it appropriate to temporarily withhold an important piece of information from the market if there is a sufficient business reason to do so. During this period, when the information is withheld, neither the issuer nor the insiders may conduct trading. If this concept is applied to the *Asahi Seimei* case, Daiwa Bank's (or its directors') request that the third party purchase the Bank's stock is equivalent to doing the trading by itself, and thus, a court is likely to find that it is not possible to conduct such trading legally while withholding such information for a substantial period of time.

Accordingly, leading stock exchanges in the United States request listed companies to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities and to "act promptly to dispel unfounded rumors which result in unusual market activity or price variations."³³¹

Taking these rules and regulations in the United States as the premise, the *Asahi Seimei* case, in which a director of Daiwa Bank asked, and actually made, the third party buy the Bank's shares, though acquired in the stock market, can be considered a violation of the law because of its similarity to the case where an insider would be involved in the transaction itself. In this case, the insider was obligated to disclose the important information known to him because of his position, but unknown to the other party, which would have affected the other party's investment judgment.³³² In such a case, a clash is inevitable between the Rule 10b-5 duty of a director to disclose important information as soon as possible and the duty of a director under the common law not to disclose information prematurely.³³³ If disclosure prior to the buying or selling is inappropriate or unrealistic, then the only choice left is to give up trading. Moreover, if it is proven that the director not only failed to disclose such important information, but also intentionally concealed it, there is a possibility that he would be accused of violating both the general fraud prohibition provision, Section 9(a)(4), which prohibits market manipulation, and Rule 10b-5.³³⁴

The present case, however, appears entirely different under Japanese law. It is difficult under Japanese law to establish a complaint against Daiwa Bank and its directors as to the non-disclosure of the important information. Although disclosing fraudulent information is an

329. Investors Management Co., Inc., 44 S.E.C. 633, 646 (1971).

330. *Dolgow v. Anderson*, 438 F.2d 825, 829 (2d Cir. 1971).

331. *New York Stock Exchange Listed Company Manual* 202.05 (April 8, 2004).

332. Loss, *supra* note 320.

333. *Id.*

334. *Id.*

offense under Japanese law as well, failure to disclose information that would affect the stock price is not an offense.

Based on the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934, the Securities and Exchange Law³³⁵ of Japan contains a detailed rule on disclosures by corporations. The Securities Exchange Law of Japan is intended to protect past and future investors in corporations by focusing on the disclosure system.³³⁶ While rules of investor protection existed in the Commercial Code, they did not sufficiently cover the disclosure of corporate accounting.³³⁷ Therefore, the Securities and Exchange Law was introduced as a supplement to secure smooth and fair-trading of securities, as well as to protect investors.³³⁸

Like Rule 10b-5 of the U.S. Securities Act of 1934, Japanese law also prohibits insider trading. However, if an insider owns the stock of his own company under the name of a third party or a fictitious person, voluntary reporting will probably be meaningless.³³⁹ In addition to the fact that it is practically impossible to detect the violation, the stipulation that the director who benefited from the insider trading must return the resulting profit to the company, makes it difficult to expect any significant effects, given the social custom of Japan, unless there is an internal power struggle within management.³⁴⁰ Consequently, it is less seldom that this Japanese insider-trading rule is activated.

335. Shoken Torihiki Ho (Securities and Exchange Law), Law No. 25 of 1948, [translated in 3 INT'L SEC. REG. JAPAN BOOKLET 2, at 14 (1992) [hereinafter Securities and Exchange Law]. Subsequent amendments to this law reflected developments in the United States. The occupation authorities enacted the Securities and Exchange Law at the end of the Second World War as a condition of the reopening of the securities exchange market in Japan.

336. ICHIRO KAWAMOTO AND KASUNAMI OHTAKE, SHOKEN TORIHIKIHO [THE SECURITIES EXCHANGE LAW], 34-35 (1996).

337. The Commercial Code Law No. 48 of 1899 was modeled after German laws, while the Securities and Exchange Law was copied from the U.S. laws after World War II. Germany is a civil law country, while the United States is a country of the common law. Any confusion in the concept of disclosure in Japan may be attributed to the slight difference in the disclosure rules of the two source countries. For an examination of the development of the Japanese securities market, see Mitsuru Misawa, *Securities Regulation in Japan*, 6 VAND. J. TRANSNAT'L L. 447 (1973). Further, as to the internationalization of the Tokyo Stock Market, see Mitsuru Misawa, *Tokyo as an International Capital Market B It's Economic and Legal Aspects*, 8 VAND. J. TRANSNAT'L L. 1 (1974). It is safe to say that when the loyalty of employees to the company is compared to their loyalty to their stockholders, the latter is given priority. The loyalty to the company not to disclose prematurely is a part of the traditional social system in Japan and the lifetime employment system goes hand in hand with this loyalty. This loyalty given by directors and employees to the company is one of the basic principles of the Commercial Code of Japan.

338. *Id.*

339. KAWAMOTO, *supra* note 336.

340. *Id.*

As a result, the question of whether or not a director of a company has a duty to inform the other party about inside information when trading his or her own company stocks has been met generally with a negative answer. In fact, except in a clear case of fraud, the contract will not be negated. A director will not be obligated to indemnify the other party just because the director failed to disclose a piece of inside information about the company that the director came to know in the course of his or her work, unless the other party asked the director to disclose such information. Moreover, a director will not be held legally accountable for his or her company's nonfeasance in failing to disclose important information, even if it was information that could be reasonably expected to have a substantial influence on the securities market according to this rule.³⁴¹ Therefore, it is impossible to label the responsibility of any particular director for non-disclosure of the information in the Asahi Seimei case as a violation of Section 189 of the Securities and Exchange Law of Japan, which corresponds to Rule 10b-5 of the U.S. Securities Exchange Act of 1934.³⁴²

Even in Japan, however, the situation would be different if a person is actively involved in concealing information, in addition to delaying its disclosure.³⁴³ Although it is difficult to seek punishment based on violation of the Insider Trading Prohibition, Article 189 of the Securities and Exchange Law of Japan, as those cases in the United States³⁴⁴ are not established in Japan, such action can probably be prosecuted as an illegal transaction that violates the general fraud rule.³⁴⁵

In essence, one must conclude that it is difficult to hold a director in Japan legally accountable in these cases, unless the failure to disclose important information is accompanied with some fraudulent action, such as concealment. While numerous investors, in addition to Asahi Seimei, must have brought Daiwa Bank's stock prior to the disclosure of the

341. The disclosure of important information based on the request of the stock exchange also is not uncommon in Japan as a follow-up procedure of information already announced. After the incident was disclosed, the possibility of merger between Daiwa Bank and Sumitoma Bank was rumored. In response to this, the Tokyo Stock Exchange requested both banks to disclose information in writing, but both banks responded by saying that "there is no specific merger plan." *Chairman of Tokyo Stock Exchange Asks for Disclosure if any Changes Exist in Sumitoma Bank and Daiwa Bank Merger*, NIHON KEIZAI SHIMBUN, Nov. 22, 1995, at 4. The Tokyo Stock Exchange further asked both banks to "disclose information as quickly as possible if any changes occur, since the merger was expected to affect the stock prices." *Id.*

342. See *MOF's Confusion at its Peak*, *supra* note 253.

343. See *supra* text accompanying note 295.

344. *Investors Management Co., Inc.*, 44 S.E.C. 633, 646 (1971); *Dolgow v. Anderson*, 438 F.2d 825, 829 (2d Cir. 1971).

345. See *supra* note 341 and accompanying text.

incident and incurred damage due to the price drop of the stocks,³⁴⁶ there is no legal remedy based on the Securities and Exchange Law of Japan.³⁴⁷ The only way to obtain a remedy was to bring a derivative suit under the Commercial Code,³⁴⁸ charging a violation of the duty of loyalty of the directors to the company.

Although MOF did not comment on the case of Asahi Seimei's purchase of the stocks, it commented on the issuance of preferred stocks in Japan by Daiwa Bank immediately before the incident was disclosed, saying, "there is no specific procedural problem in regard to the Securities and Exchange Law."³⁴⁹

VIII. Effect of Court's Decision in 2002

This decision profoundly effected directors' responsibilities in Japanese companies and how the shareholder's representative action system should be. It resulted in an amendment³⁵⁰ of the Commercial Code in December 2001 concerning corporate governance.³⁵¹

(1) Abatement of Shareholder's Responsibility to Corporation; Rationalization of Shareholder's Representative Action

1. Abatements of Responsibilities of Directors and Others to Corporation

Although it had been ruled that the responsibility of a director to its corporation cannot be removed without consent of the entire shareholders, the new rule states that any portion that exceeds four times the particular director's annual compensation could be pardoned with a special voting decision of the shareholder's

346. No Procedural Fault in Issuing Preferred Stocks After Confession for Former Employees, MOF's Vice Minister Asserts, *NIHON KEIZAI SHIMBUN*, Oct. 6, 1995, at 7.

347. As the result of the experience, Daiwa Bank installed an internal proposal organization to promote the disclosure of the management information by the end of 1995. This was received as a progressive effort. In order to prevent any recurrence of such an incident and to improve the transparency of the management, an organization called "Action Direction Committee," a permanent proposition organization consisting of outsiders was started. The committee members included owner/operators of other companies, scholars, and professionals, journalists, and general saving customers, totaling about ten people. The committee discussed and proposed ideas relating to the issues of how to retain customers and corporate customers and how to provide more informative communications to the stockholders. *Mechanisms for Management Information Disclosure Suggestions*, *supra* note 297.

348. See *supra* note 337 and accompanying text.

349. See *MOF's Confusion at its Peak*, *supra* note 253.

350. Enacted on December 5, 2001. Implemented on May 1, 2002.

351. See Japan Auditor's Association, *Amendments of the Commercial Code*, June 13, 2002, at arts. 4-5, 11-25, at http://www.kansa.or.jp/PDF/el03_kh14613.pdf. [hereinafter *Amended Commercial Code*].

meeting or a voting decision of the board of director's meeting based on the rules of the article of association unless the director failed to perform its duty conscientiously and there was a material mistake on the director's part.³⁵² However, the ceiling amount is six years for a director with a representative director and two years for an outside director or an auditor.³⁵³

2. Abatement of Outside Director's Responsibility

It is permissible to have an agreement to limit the responsibilities of an outside director in advance.³⁵⁴ However, it is required, as a prerequisite condition, to establish a rule in the article of association that a limited responsibility agreement could be established.³⁵⁵

(2) Rationalization of Shareholder's Representative Action

1. Extension of Consideration Period

The revised law extends the consideration period for a company to decide whether to take legal action, when the shareholders demand that the company take an action against its directors' seeking their responsibilities, from the previous period of thirty days to sixty days.³⁵⁶ The intention behind the revision was to provide a sufficient length of time for the auditors to investigate whether such an action was needed.³⁵⁷

2. Revision Concerning Public Announcement and Notice to Shareholders

The revised law requires a company to make a public announcement and notify its shareholders without delay when it takes a legal action against its directors seeking their responsibilities or when the company received a notice of a shareholder's representative action from the shareholders.³⁵⁸

3. Improvement on Rules Concerning Amicable Settlement on

352. *Amended Commercial Code*, *supra* note 351, at arts. 266-7 B 266-11, 266-17 - 266-18.

353. *Id.*

354. *Id.* at arts. 266-19 - 266-23.

355. *Id.*

356. *Id.* at arts. 267-1 - 267-3.

357. *Amended Commercial Code*, *supra* note 351.

358. *Id.* at arts. 268-4.

Action

The revised law allows a company to make an amicable settlement with its defendant directors without consent from the entire shareholders when it takes legal action against its directors seeking their responsibilities.³⁵⁹

4. Company's Assistance for Defendant Directors in Shareholder's Representative Action

The revised law explicitly allows a company to participate in a shareholder's representative action and assist defendant directors, on the condition that an agreement from its entire auditors is available, except in case of a small corporation specified in the Special Case Law of the Commercial Code.³⁶⁰

In September 2000, at the same time as the amendment to the Commercial Code was passed,³⁶¹ and the Osaka District Court issued a decision for a shareholder's representative action concerning a huge loss of Daiwa Bank New York branch and ordering eleven directors to pay damages in the total amount of ¥83 billion (\$775 million), the defendants gave up the right of appeal and sought a settlement for a joint payment of ¥250 million (\$2.3 million).³⁶²

It was originally predicted that the case would go all the way up to the Supreme Court, but it was said the parties involved agreed in an early settlement.³⁶³ However, the value of this first trial as the leading case of shareholder's representative actions in Japan was not tarnished by the early settlement.³⁶⁴

IX. Conclusion

In all of the cases preceding the present case, directors' responsibilities were recognized almost exclusively in cases where directors were involved in malicious illegal acts themselves, while cases of being charged with responsibilities of negligence were almost non-existent, partially because the management decision principle was admitted. None of those cases ended up with such a huge amount of damages as in the *Daiwa Bank* case. Most cases ended up with rejections or withdrawals for reasons of disobeying the pledge offering

359. *Id.* at arts. 268-5 - 268-7.

360. *Id.* at arts. 268-8.

361. *Supra* note 337.

362. ASAHI SHIMBUN, Dec. 12, 2001, at 11.

363. *Id.*

364. *Id.*

orders, or dismissal of claims. In almost no circumstance could directors be charged for responsibilities if they had conscientiously conducted their jobs as long as the facts were studied carefully and the legal principles were applied correctly. Thus, the present case, in which the defendants were asked to pay a phenomenal amount of damages totaling several tens of billions yen, just as a loss recovery, was an extremely unusual case.

Although the case attracted the attention of many people, it is an unusual case among precedents, so that it is not appropriate to discuss the entire precedence of shareholders' representative actions and criticize the shareholder's representative action system, based on this action alone.

However, the decision sounded a very important alarm about how Japanese corporations are managed. The background that allowed Japanese companies to be run loosely seems to be the fact that the supervising authorities and the legal system failed to pursue the lack of risk management and concealment of responsibilities rigorously. In this case, Iguchi succeeded in hiding the location of the custody operation from the MOF's inspection, thereby deceiving the inspector, but, to this point it is unknown if the ministry has tried to punish MOF severely for the oversight. Additionally, it is unknown if any severe punishment was made, or responsibility was sought after, based on the Securities Exchange Law in the case of the bank issuing preferred stocks, concealing the unauthorized dealings. In Japan, lack of stern punishment by the authorities, strictly according to the law, invites a lack of loose risk management, negligent adherence to laws, and concealments of illegal acts.³⁶⁵

As for the disclosure, there was a marked difference between the United States and Japan regarding strictness in the pursuit of disclosure duties of corporations. It was safe to say that an average Japanese company did not feel a need to immediately disclose important information until now. One lesson from the *Daiwa Bank* case is it is important for Japanese banks to observe the disclosure principle more stringently and to disclose pertinent operating information to stakeholders, such as stockholders and corporate customers, earlier, more quickly, more frequently, and more thoroughly, rather than reporting it privately to authorities, such as the MOF. The more thoroughly Japanese banks conduct disclosure, the higher their market valuations will be. By assuming full and strict responsibility of management and supervision, they will be able to regain the trust of the international securities market.

This lack of sternness in the law enforcement system has created sloppy risk managements and concealing attitudes among Japanese

365. *MOF's Confusion at its Peak*, *supra* note 253.

companies, which resulted in the current case when one of such Japanese companies operated in the U.S. with the same loose attitudes. In order to prevent this kind of case, more rigorous attitudes are necessary to ensure that directors are more responsible for their duties. That should provide incentives to Japanese companies to establish effective risk management and law-abidance systems. It is notable that shareholder's representative actions finally have started to function as an effective means of law enforcement in Japan.

The present case served to reveal the fact that it is extremely dangerous for Japanese financial institutions to try to operate overseas without mending their lack of risk managements and their sloppiness in legal compliance. Japanese financial supervising authorities must also accept this new mindset. Such an incident could invite international mistrust in the Japanese society itself. The current status of the legal and organizational systems of the Japanese financial supervising authorities is not up to the level necessary to handle international financial businesses.

Economic relations between Japan and the United States have been turbulent in recent years due to the trade imbalance problem. Various disagreements in thinking were exposed between the two countries in the *Daiwa Bank* case. This incident provided a new and serious impact on relations between the two countries. The central issue of this incident is not that an employee of Daiwa Bank engaged in illegal operations, nor is it the huge loss that those operations caused. Those things often occur in both countries, and such a thing should not cause such a profound impact. The real problems are that Daiwa Bank failed to report to U.S. authorities, and that the Bank covered up its losses for an extended period of time.

Moreover, the MOF failed to notify the U.S. authorities quickly after it was contacted by the Bank. The fact that the Director-General of the Banking Bureau, and other officials of the MOF, failed to report the unauthorized transactions to the U.S. Financial Supervisory Authority, was a material violation of the international agreement between banking supervisory authorities of member countries. This surely triggered a great mistrust of the Japanese officials in the minds of the officers the U.S. Financial Supervisory Authority.

These delays are the reason why the United States is calling the Japanese activities "a serious betrayal of the trust between the United States and Japan."³⁶⁶ A further problem is that the Japanese, including the MOF, seem to lack any awareness that they may be at fault. "There was no mishandling of the matter," said the MOF. "The reason the

366. See *supra* note 337 and accompanying text.

Americans are upset stems from the cultural difference between the two countries.”³⁶⁷

This difference in perspective between the two countries makes this case more complex and multifaceted. It includes an essential problem that cannot be brushed away as a difference of culture. A wide discrepancy exists between the two countries in the way in which the laws regarding the disclosure system of corporate information are applied. It is mandatory for U.S. corporate management to release, in a timely manner, any information that might affect the market for the securities.³⁶⁸ However, it is quite different in Japan. It generally is thought that a disclosure should be made at a carefully selected point. Even the MOF agrees with this concept. This misconception between the two countries was the largest factor causing this case and created the difference in the perceptions of the seriousness of the matter. As a result of that misconception, the handling of the matter by the Japanese was criticized extensively.

Japanese industries should understand clearly that their legal interpretations, as well as people's conceptions and manners of dealing with various matters, while acceptable in Japan, may not necessarily be correct in the United States. It is common sense that, as long as one wishes to conduct business in the United States, one should obey the rules of the United States. In Japan, we have our own version of the saying, “When in Rome, do as the Romans do.” This important realization was missing from Daiwa Bank and the MOF.

Japanese companies operating overseas today are all confronted with a question: to what extent should the Japanese way of thinking, i.e. Japanese management style, be implanted into their overseas subsidiaries.³⁶⁹ The backdrop to that dilemma is that, although the Japanese management style was thought of highly at one time, more criticisms of it are arising, especially in foreign countries, with the demise of the Japanese economic boom.³⁷⁰

The present case clearly shows how far it is possible to press the Japanese way of thinking and way of handling matters overseas. It is a great lesson, which teaches Japanese companies that there is a limit in applying their management styles on foreign soils. This is especially true

367. *See Suggestions of Splitting MOF Surfaced Abruptly*, *supra* note 244.

368. NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL, 202.05 (April 8, 2004).

369. For the difference of the management styles, *see* Mitsuru Misawa, *New Japanese-Style Management in a Changing Era*, COLUM. J. WORLD BUS., Winter 1987, at 9.

370. For a recent criticism of Japanese management styles, *see* Mitsuru Misawa, *Portrait of the International Entrepreneurs* [Interview with Japanese Business Leaders in the United States], SEKAI SHUHO, Jan. 31, 1995, at 44-45 (1995).

of Japanese companies, which are undergoing internationalization. It has been nearly twenty years since the full-scale internationalization of Japanese industries commenced. As international corporations, they have done from being "infant industries," to now entering the age of maturity. The present case is arguably something Japanese companies were destined to experience as they mature into full-fledged multinational corporations.

Because of this incident, Japanese banks are paying a hefty intangible penalty, namely the loss of trust in the international market. This penalty against Japanese banks will eventually be born by all Japanese industries. It is necessary for Japanese industries to have a positive attitude and accept these legal, economical, and social penalties, and not try to resist them. Instead, these industries must learn the lessons necessary for them to grow further and make a fresh start. It also is necessary for Japan to rethink the relationship between the government and industries, which has been taken for granted until now, and to make necessary changes in its thinking. Restructuring the excessively large government may be necessary.

The Japanese people must have the modesty to analyze this case thoroughly through multiple approaches and learn whatever there is to be learned. On the other hand, the American people should not repel Japan simply by labeling them "different," but rather, understand better the viewpoint of the Japanese people, and industries that are in the midst of a process of internationalization. Americans should study how the Japanese thought and reacted in this case and should try to understand the Japanese legal, economical and sociological situations. The further improvement of relations between these two countries will create a consensus regarding international business between them through mutual understanding. In that way, some consolation can be found in this extremely regretful case. As is said in Japan, it is not impossible to turn bad luck into good luck.

