

The Daiwa Bank case filed on 2000. 9. 20 by Osaka District Court

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I. The Text of the Judicial Decision²

1. The claim against Defendant Hideaki Somiya, auditor of Daiwa Bank, seeking responsibility as a director, is rejected on the ground that there were illegal procedural defects in bringing the suit.

2. (Case A) The director of Daiwa Bank who was a manager of New York branch, defendant Kenji Yasui, breached the dire-

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2. This translation is based upon Shoji Homu No. 1573 (2000. 10. 5) p5-, and Shoji Homu Shiryoban (Materials) No. 199 (Oct, 2000) pp.248-257.

ctors' duty of care and loyalty, orders him to pay damage of \$530 million in damages and interest. The court finds a breach of the duty on the fact that former employee of New York branch, Iguchi continuously made illegal off balance sheet transactions in U.S. Treasury Bills in violation of the articles of transaction of Daiwa Bank, and sold U.S. Treasury Bills which Daiwa Bank held without authorization in order to cover up losses from the illegal transactions, as a result Iguchi caused \$1.1 billion in damages.

3. (case B) The current and former director of Daiwa bank, defendants Yasui, Yamaji, Tsuda, Abekawa, Fujita, Kaiho, Kawakami, Sunahara, Genjida, Katsuta, and Kuroishi breached the directors' duty of care and loyalty, and the court orders them to pay damage as follows and its delinquency charges: (1) Defendants Yasui and Yamaji: \$245 million on 15 charges of negligence; (2) Defendant Tsuda: \$157 million 500 thousand on 10 charges of negligence; (3) Defendants Abekawa, Fujita, Kaiho, Kawakami and Sunahara: \$105 million on 7 charges of negligence; (4) Defendants Genjida, Katsuta and Kuroishi: \$70 million on 5 charges negligence

4. The other claims are dismissed.

II. The Facts and Reasoning of the Case

1. A Summary of the Facts

(Case A) The plaintiffs, shareholders of Daiwa Bank, filed this lawsuit as a derivative action against the then representative directors and other directors, including the managers of the NY branch, seeking \$1.1. billion in damages for illegal transactions by a former Daiwa Bank officer, Iguchi, on the following grounds:

(a) The then representative directors and a NY branch manager, who was a director at same time, breached the directors' duty of care and loyalty by failing to establish an internal compliance system, to prevent illegal transactions by bank officers, and to minimize the damage, *i.e. in NY branch ex*

—officer Iguchi made unauthorized off-book transactions in U.S. Treasury Bills from 1984–1995 of \$1.1 billion (the unauthorized transaction), Iguchi sold bank holding U.S. Treasury Bill in order to cover up this damage illegally, as a result Iguchi caused the damage (the unauthorized sale), in this case.

- (b) The other directors and auditors breached the directors' and auditors' duty of care and loyalty to monitor the establishment the above mentioned system to prevent illegal transactions and sales by Iguchi, as a result caused the damages in this case.

(Case B) Daiwa Bank was criminally indicated on 24 counts related to the transactions in this case. Daiwa pled guilty to 16 of the 24 charges and paid a fine of \$340 million. The plaintiffs, shareholders of Daiwa Bank, filed this lawsuit as a derivative action against the then representative directors, other directors, and auditors, including managers of NY branch, for 350 million dollars in damages for transaction and failure to report them to the U.S. authorities, charged by US authority and attorneys fees, on the following facts and grounds:

- (a) Concerning charges 14 through 20, the then representative directors and a NY branch manager, who was a director, breached the directors' duty of care and loyalty to establish the internal compliance system to prevent illegal transaction by former bank officer Iguchi, and the other directors breached the directors' duty of care and loyalty to monitor whether the internal compliance system was adequate to prevent illegal transactions by former bank officer Iguchi.
- (b) Concerning counts 1 through 7, 23 and 24, the then representative directors and a NY branch manager, who was a director, breached the directors' duty of care and loyalty to observe the domestic law in the U.S, the other directors breached the directors' duty of care and loyalty to monitor whether the then representative directors observe the domestic law in the U.S.

In short, the issues of this case are: (1) Did defendants

breach the directors' duty of care and loyalty to establish the in-house checking system, (2) Did defendants breach the duty of care and loyalty when they violated the U.S. Domestic law, and they didn't report this to US. Authorities.

2. Issue1: Whether there exists a breach of the duty of care and loyalty to establish an internal compliance system.

(A) Establishing an internal compliance system (Risk Management System) and the duty of care and loyalty: General Concept

At first, the court discussed Risk Management Systems in this case as follows: (1) In order to manage sound companies, directors need to grasp the nature and character of the risks precisely, and control them properly, *i.e. Risk Management*. They also need to establish an internal compliance system (Risk Management System) according to the scale and characteristics of the business that the company manages. (2) The very important business activities mentioned in Shoho (Commercial Code) Art. 260. Sec. 2 should be decided by a board of directors. Furthermore, the fundamental principles of a risk management system which influences management of the company should be decided by a board of directors. Thus representative directors and directors charging the area should have a duty to implement a Risk Management System according to these fundamental principles. (3) In this context, a director, as a member of the board of directors or representative directors, and directors charging the area, has a duty to establish a Risk Management System. At the same time, a director has a duty to watch that representative directors and directors charging the area execute their duty of care and loyalty, namely to establish a Risk Management System. (4) Auditors, (except for auditors of the "small companies" which is regulated by Art. 22. Sec. 1 of Special Commercial Code³,) have a duty to review the management of the directors. Therefore auditors should not only audit whether directors have

3 Called Shoho Tokureihou.

established a Risk Management System, but should also check System's Performance.

In other words, the issue discussed here was whether the then representative directors, other directors who were once managers of NY branch, prepared and maintained a Risk Management System, which also meant the market price changing risk concerning transactions of U.S. Treasury Bills, and custody business, or not. Furthermore, whether did the other directors and auditors breach their duty of care and loyalty to monitor the other directors' behavior. More concretely: (1) Company directors must not only obey the law, but also prevent employees from acting illegally in advance when employees work for the company as a whole. Large companies with many employees, enterprises, or divisions should delegate corporate authority to lower levels such as division or section chief in order to manage more effectively. Because it is unsuitable and impossible for company directors to guide and manage all employees directly, they have a duty to set up Internal Compliance System to monitor employees and prevent them from acting illegally in advance. This duty also to prevent illegal employee activity was part of the director's duty of care and loyalty. In this context the requirement of a *Management Risk Checking System* meant the implementation of a Law Compliance System. (2) Inherent in the transaction of U.S. Treasury Bills is the risk that dealers will abuse their own position to make a profit for themselves or a third party. When *Market Price Changing Risk* confronted with a loss, dealers tend to cover up, or to increase their losses after trying more transactions. At the same time, a custodian business held *Management Risk* that custodians sold articles in custody without notice, and abuse that money. In order to prevent illegal transactions, or at least minimize losses, director must establish an Internal Compliance System (Risk Management System), only then they could evaluate and control those kinds of risk.

- (B) Conditions of Risk Management System : Separation of Front Office from Back Office, U.S. Treasury Bill dealing from Custody

dian business.

- (1) In order to control the *Management Risk* of dealing U.S. Treasury Bills properly, directors should regulate by using transaction rules, such as *dealer's position capacity or cut off the loss rule*.
- (2) Furthermore, in order to confirm whether dealers observe this rule or not, directors should systematically divide the *Front Office (transaction division)* from *Back Office (clerical work division)*. The Back Office would accept opponent dealers' receipts (confirmation letters), and collate them with Front office's slips. Directors must establish systems balance and check the divisions. In order to effectively implement this system, directors should consider position arrangement, so that one person could not hold positions from both divisions at the same time, even if a dealer should hold an additional post in a back office, directors are at least requested to take countermeasure against those situation. When transacting US Treasury Bills, dealers may try to conceal the losses, or may increase their losses by trying to recover the former loss. For custodian businesses, the risk exists that officers might abuse their position by selling without permission, and misappropriating rewards for the benefit of themselves or third parties. When dealers of US Treasury bills play the role of custodian at the same time, the banks' risk may increase very rapidly. Directors should organize systems that can properly control the separation between risk in the transaction sector and custodian sector's. Independent sectors would check and balance each other, prevent illegal transaction in advance, minimize the risk of crime. For this system to function effectively, directors should prevent the same person from holding two positions at the same time. If this situation occurs, directors should take measures to counteract it.
- (3) Daiwa Bank's New York branch had already established rules enabling separate front and back offices by the time Iguchi began to perform illegal transactions in June 1984.

These rules concerned the limitation of dears' position, and separated dealers from collation people. The Daiwa Bank New York branch gradually prepared for, and implemented its system after that time.

- (4) Iguchi's methods of unauthorized transaction sales are not clearly understood, so it is impossible for the court to declare that Daiwa's regulation system of US Treasury Bills was insufficient. The court could not conclude that the reason Iguchi could maintain the illegal transactions over such a long period was a defect of Risk Management in the New York Branch.

Consequently the court could not find that Daiwa Bank's New York Branch was unprepared and unsuitable, with respect to the Risk Management System, both as a whole system as well as each management system was put in place by transactions of US Treasury Bill and Custodian business.

(C) The actual situation of Risk Management System : The Confirmation of a balance of US Treasury Bills in custody.

- (1) Custodian businesses run the risk that their officers will abuse their own positions by selling things in custody without permission, and misappropriate the profit for the benefit themselves or third parties. A balance of US Treasury Bills in custody should be confirmed or investigated properly according to the character of the Bill in order to control this Management Risk. In this case, the US Treasury Bills in custody were not registered, issued as Bill certificates by the government, therefore the New York branch could not confirm a balance of the Bill directly. Furthermore, The New York branch could only check properly by contacting the Bankers Trust in New York, where Daiwa reentrusted their US Treasury Bills in custody. So in order to check a balance precisely, managers of the New York branch should have confirmed directly with Bankers Trust, not through the officers of the Custody Department in Daiwa Bank.
- (2) The confirmation of a balance of US Treasury Bills in cus-

today was the most effective way to control the existing Management risk. No other method, either individually or in the combination with other investigating methods, is sufficient without properly checking the balance.

- (3) In order for this system to function effectively, managers and directors should take proper measures to confirm balances by adopting appropriate methods according to the characteristic of the securities in Custody. When a Bill was issued, they should have compared the physical security with the book entry. On the other hand, if the government did not issue the Bill in custody and the Daiwa New York branch re-entrusted their US Treasury Bill in custody to Bankers Trust in New York, then managers and officers should have contacted to Bankers Trust directory, instead of through officers in custody section.
- (4) Nevertheless, the New York branch did not reconciled US Treasury Bills balance sheets with their own accounting books in every internal investigation, such as the monthly branch inspection, ad hoc inspections by internal auditors, bi-annual inspection and CPA audit every three years. Those investigations enabled Iguchi to forge the balance sheet of US Treasury bills, so the New York Branch could not discover or prevent unauthorized sales, charges 14 to 20 in this case. As a result, Daiwa Bank's Risk Management System did not function effectively.

(D) The following Risk Management System problems.

The court rejected plaintiffs' claims of directors' negligence:

- (1) improper dealing with mailing; and (2) Daiwa Bank did not have a system of compulsory holidays. The court found that these factors weren't related to directors' negligence.

(E) Did directors of Daiwa Bank violate the duty of care and loyalty?

Agreeing with plaintiffs' claims, the court found that Daiwa Bank directors violated the duty of care and loyalty in three respects: (1) The in-branch inspection was held by branch officers,

based on the Manual which was checked and approved by Daiwa Bank's investigating division. In fact, branch investigating was based on the Manual. Therefore the directors overseeing the investigation division, as a director on duty or a director who holds the position of employee, should be responsible for violating the duty of care and loyalty for failing to implement an appropriate checking system for the balance of US Treasury bills. (2) The in-branch inspection by internal auditors was held under authority of the NY branch manager. Therefore, the NY branch manager, as a director, and as an employee at then same time, should be responsible for violating the duty of care and loyalty for failing to implement an appropriate checking system of the balance of US Treasury bill. (3) The directors in charge of the US project Division in Daiwa Bank should be responsible for violating the duty of care and loyalty for failing to implement an appropriate checking system of the balance of US Treasury bills.

Based on this decision, the court confirmed that three defendants, among all of defendants, Yasui, Yamaji and Tsuda, as a former director and NY manager, were responsible for violating the duty of care and loyalty. Defendant Yasui, as a NY manager, extremely insufficiently checked the balance of US Treasury Bills during the in-branch inspection by internal auditors. And he did not improve his methods of investigation, so consequently he could not find or prevent Iguchi's sales in this case (the Charges 14 through 20). Further, defendants Yamaji and Tsuda, as NY managers, extremely inappropriately checked the balance of US Treasury Bills during the in-branch inspection by internal auditors. They did not change their methods of investigation, so consequently defendant Yamaji could not prevent Charges 14 through 20, defendant Tsuda could not prevent Charges 18 through 20. Defendant Tsuda was not responsible for Charges 14 through 17, because those charges occurred before he had become NY manager in May 1994.

The court's decision about representative directors was as follows: (1) Daiwa Bank's NY branch was responsible for confirm-

ing the balance of US Treasury bills. That unit was supposed to be managed by the President, a representative director, the deputy President, also a representative director, the investigation division chief, a director and employee, and the managing director, who was in charge of the NY branch. (*Note that nobody proved the deputy President was a representative director at that time*). (2) In Daiwa Bank, the President, who was a representative director, was thought to be in charge of all businesses, and the Deputy President, also a representative director, was thought to have managed all businesses run by every director. In very big enterprises like Daiwabank that have a lot of organizations, it is inadequate from a view point of effective and rational management, and impossible, for the President, a representative director and the deputy President, a representative director, to closely monitor every business. (3) The internal investigation division and NY branch division were responsible for confirming a balance of US Treasury Bills in custody. The directors in charge of both divisions should manage proper investigation in the bank. Therefore the President, who was a representative director, and the deputy President, who was a representative director, were permitted to entrust the other directors with managing their own business divisions. As such, the President, and the Deputy President would not violate the duty of care and loyalty to manage, unless there existed special circumstances to doubt how the directors in charge were doing their jobs. There were no such special circumstances in this case.

The court also decided whether the other directors, who were not related to the investigation division or NY branch, breached the directors' duty of care and loyalty as follows (1) The other directors, who were not related to the investigation division or NY branch (including representative directors), are obligated to watch, not only subjects of the board of directors meeting, but also other subjects, including the company's Risk Management System. The court could not admit that Risk Management System in the NY branch concerning US Treasury bill transacting and custodian business established fundamental outlines, and

detailed devices. However, the court should admit that the confirmation method of US Treasury bill balance was implemented inappropriately; given that the in-house investigating division was established for investigation. Further, it was very hard for the other directors to imagine that the in-house investigating division would make the mistake of letting the NY branch or custodian section collect the detailed statement of US Treasury bills in custody from Bankers Trust, then refer them to the ledger of Daiwa Bank NY branch. The in-house investigating division should have collected the detailed statement of US Treasury bills in custody directly from Bankers Trust. In this context, the court could not decide that the other directors, who were not related with investigation division or NY branch, breached the directors' duty of care and loyalty, unless there were special circumstances relating to the balance of US Treasury bills in custody. In this case, the court found no such special circumstances.

With respect to the auditors' breach of duty: (1) Auditors should review the directors' performance including the in-house investigating division, and whether directors in charge of the New York branch investigated properly. At the same time, auditors should review the CPA's methods of examining the books, and determine whether the results of the examination, were proper. (2) Defendant Hiraiwa, former outside auditor, insisted that in Daiwa Bank outside and temporary auditors principally played roles separately, such as participating in Directors' Meetings, listening to directors reports at any time, and auditing pursuant to the report from Auditors' Meetings. So unless there were special circumstances leading outside auditors to find directors' illegal behavior, they should be immune from responsibility. But outside auditors were expected to audit harder and more objectively. They should have audited more like third party. Further if the court found that each auditor represented the company, then even if Auditors' Meetings decided on one auditor, that decision would not relieve each auditor's obligation to review. (Shohotokureiho: Commercial Code Supplement Act, Art. 18-2, sec 2) On that ground, the court should have ruled that

outside directors, even if they were temporary, were required to collect information actively and at all time. They should use the authority of investigation given by Commercial Code Art. 274. Sec 2., not to audit passively according to the reports generated by the board of directors or Auditors' Meetings, at least when a full-time auditors report is not complete. Therefore the court could not accept defendant Hiraiwa's claims. (3) Full-time auditors should attend board of Directors' Meetings, Management Meetings (called *keieikaigi*), regular directors Meetings, and Meetings of the division chief in charge of branches and offices overseas. In case of division chief's Meetings mentioned above, full-time auditors should interview the NY branch manager. Full-time auditors also should audit other work, including the CPA's examination, the report of MOF's (Ministry of Finance) investigation and BOJ's (Bank of Japan) hearing. In this case, they could not find problems concerning confirmation methods of US Treasury bills balances in NY branch. Therefore the court found that the auditors, except for those auditors who had been to the NY branch and checked the CPA's examination, could not have known the problem concerning confirmation methods of US treasury Bill balance. This is true regardless of whether the auditor was temporary or full-time, or outside or inside. As a result, the other auditors were not responsible for confirmation methods of US Treasury bill balances. (4) Defendant Okunuki (the other auditor) had been to the NY branch in September 1993. He could, therefore, have known of the CPA's improper confirmation methods, but he failed to correct it. As a result, he did not prevent charges No. 15 through No. 20.

3. *Issue 2*: Did directors breach the duty of care and loyalty concerning the violation of US Banking Regulation?

(A) Compliant Management.

(1) Company directors should obey the law, both to maximize shareholders' profit, and also for basic management of the company. (2) The Shoho (Commercial Code) Art. 266 Sec. 1 Nr. 5 requires that directors obey the domestic law of Japan, and

when the company operates in foreign countries by establishing branches or representative offices, it must also comply with the laws of those countries. Obeying foreign statutes and other law is part of directors' duty of care regulated by Shoho (Commercial Code) Art. 254 Sec. 3, and Minpo (Civil Code) Art. 644. The issue here is whether Daiwa Bank directors managed the company while obeying the law. In other words, did they make an appropriate business decision as experts of management, or did they exceed their allowed discretion concerning business judgment. At the same time, the other directors and auditors breached their duty to monitor or audit. The court decided whether the defendants breached their duty, based on the court's admission of charges No. 24 and 1 through 7.

(B) Whether did the defendants breach their duty or not?

With respect to Charge No. 24, the court found the following:

(1) Defendant Yamaji, former NY Branch manager, was responsible under Charge No. 24, for violating US Federal Law, and he also breached the directors' duty of care. (2) Defendant Yasui, former US division chief for bank business, did not commit charge No. 24. However, when he was a manager of NY branch, he transferred traders, in case of inspection by NY state bank regulators. Defendant Yasui could have prevented that behavior, so that his conduct broke US Law. Therefore defendant Yasuda breached the directors' duty of care and loyalty. (3) There was no evidence submitted that the other directors in the case B knew in advance of defendant Yamaji's behavior concerning Charge No. 24.

With respect to charges No. 1 through 7, defendant Fujita, representative director and president, received *the letter*⁴ on July,

4 Iguchi sent Defendant Fujita a letter, in which Iguchi confessed that his unauthorized transaction caused 1.1 billion dollars damages. He also admitted that he sold US Treasury bills without permission in order to make up for this damage, and that he forged balance report of US Treasury Bill in custody in Bankers Trust. CO. to cover up.

24. 1995, and then reported it to Defendant Abekawa, former president and chairman of the board of directors. The court found that defendant Fujita and others did as follows: (1) He tried to grasp the whole transaction in this case with the cooperation of Iguchi. (2) He controlled the information so it would not to leak out during the process of investigation. (3) He decided that the damage to Daiwa Bank which arose from the unauthorized transaction and Sale case should be redeemed at one time in an settlement of account during the September half accounting period in 1995. (4) He decided to report the problems to the to Japanese Ministry of Finance, but not to the US. Authorities. At the same time he organized the minimum settlement team, in which he assigned defendant Yasui [Representative director and Vice president] as a chief, defendant Yamaji [the chief of International division], Tsuda [NY branch manager], and Motohashi [the chief of International Financing and Securities division] as members. Furthermore, he entrusted his power to make concrete policy to the chief and members. As representative directors, defendants Fujita, Yasui, Kaiho, Genjida, Kawakami, Sunahara, and Yamaji, like former NY branch manager, defendant Tsuda did not report to the US authorities. Non-representative directors, Abekawa, Katsuta and Kuroishi failed to urge the other representative directors to report to the US authorities [Charge No. 1 and 2]. As far as the illegal behavior on the Charge from No. 3 through 7 was concerned, defendant Tsuda [NY branch manager] forged monthly balance sheets in custody of pension trust and trust division, and balance sheets in custody in Bankers Trust. Defendant Motohashi [the chief of International Financing and Securities division] filed false transfer papers, along with the official letter trying to carry out the defendant Fujita's plan.

Defendant Abekawa [resigned as representative director in June 1995. Held the authority to call directors board meeting] should have urged the other representative directors to report to US authorities, because he knew of Iguchi's unauthorized transaction and Sales from defendant Fujita's report to him.

The court did not find that defendant Abekawa ordered or purposefully submitted a false report to FRB, or that he forge the bookkeeping ledger of the NY branch. Yet defendant Abekawa could have prevented the behavior comprising charges No. 1 through 7. The behavior mentioned above not only violated the US Law, but defendant Abekawa also breached the directors' duty of care and loyalty, because he dare not prevent above mentioned behavior.

Defendant Fujita [Representative Director and President], Defendant Yasui [Representative Director and Vice President in charge of the international division], and Yamaji [Representative Director and the chief of international division] knew of Iguchi's unauthorized transaction and Sale, but they did not report to US authorities. They were charged as supervisors because they tacitly or clearly permitted (or failed to prevent) the submission of a false call-report to FRB, and a forged the ledger of accounting and official record of Daiwa Bank NY branch. Therefore, the behavior based on Charges No. 1 through 7 violated US Federal Law, and breached the directors' duty of care and loyalty.

Defendant Kaiho [Representative Director and vice President], defendant Genjida [Representative Director] defendant Kawakami [Representative Director], and defendant Sunahara [Representative Director] knew of Iguchi's transaction without notice and selling without permission, but they did not report to US authorities. Though the court did not find that they tacitly or clearly permitted the submission of a false call-report to FRB, or forged the ledger of accounting and official record of Daiwa Bank NY branch. However, these activities could have been prevented by defendant Kaiho, and defendant Sunahara (No. 1 through 7), defendant Genjida⁵ (Charge No. 1, 2, and 5 through

5 Defendant Genjida could have known of the transaction and selling in this case at earliest round 8. 2. 1995, but the behavior based on the charge Nr. 3 and 4 was done on 8. 1. 1995, so he had no take responsibilities on the charge 3 and 4.

7). Therefore the behavior based on the Charges mentioned above violated US Federal Law, and these individuals breached the directors' duty of care and loyalty.

As Defendant Katsuta and Kuroishi knew of Iguchi's unauthorized transaction and Sale, they should have urged the representative directors to report to US authorities. The court could not, however, conclude that they either tacitly or clearly permitted to submission of a false call-report to FRB, or forged the ledger of accounting and official record of the Daiwabank NY branch. Still they could have prevented behavior leading to Charge No. 1, 2, and 5 through 7⁶. Further the behavior supporting the Charges mentioned above violated US Federal law, and they breached the directors' duty of care and loyalty by not preventing it in advance.

Defendant Tsuda [NY branch manager] knew of Iguchi's unauthorized transaction and Sale, but he did not report to US authorities. He himself submitted false call-report to FRB, or forged the ledger of accounting and official record of the Daiwabank NY branch (Charges No. 1 through 7). Therefore he violated US Federal Law, and breached the directors' duty of care and loyalty.

The other defendants did not breach the directors' duty of care and loyalty on the ground that they learned of Iguchi's unauthorized transaction and sales after they already occurred, and there were no special circumstances showing that showed they could have known about the behavior earlier.

(C) The Business Judgment Rule.

The court ruled on the business Judgment Rule as follows: (1)

6 Defendant Katsuta came to know of the transaction and selling in this case at the earliest on 8. 7. 1995, defendant Kuroishi on 8. 9. 1995. The behavior based on charge No. 3 and 4 occurred on 8. 1. 1995, so they had no responsibilities on the charge 3 and 4.

Directors should observe the duty of care and loyalty⁷ meaning that they should work for the long-term benefit and maximum profit of the company, as management experts entrusted company management for profit. In order to promote business and make a profit, directors should evaluate frequently- changing elements, such as the company's' situation, the industry surrounding the company, and international and domestic landscape. Based on their evaluation, directors should estimate the future from long and short point of view, and make timely business judgments. (2) Therefore, directors' business decisions will lead to breach of their duty of care and loyalty, only if they misunderstand seriously and carelessly the facts upon which decisions were made, or the Decision-making process and contents are illogical and improper. (3) Directors are granted very broad discretion, as long as they obey the law, including foreign law, in the management of the company. However, they are not granted discretion over whether to comply with law.

The court made its decision more concretely as follows. (1) Defendant Fujita, who received the letter from Iguchi on July, 24, 1995, sent defendant Yamaji [the chief of international division] to NY from July, 28, 1995 to July, 30, 1995 in order to investigate. Based on Yamaji's report, he confirmed that at least selling without permission in this case was true, so that Daiwa Bank was damaged in the amount of \$1.1 billion⁸. (2) At that time, Fujita should have decided to report this unauthorized transaction and Sale to the US authorities and the FRB and

7 Regulated by shoho (Commercial Code) Art. 254. Sec. 3, Minpou (Civil Code) Art. 644, and shoho Art. 254-3.

8 Iguchi forged the balance of US Treasury Bill in Custody by Bankers Trust so as to cover up the selling without permission in this case. But he could have checked that by comparing the balance in Daiwabank NY branch to the original balance by Bankers Trust.

Banking division of MOF in Japan, but not to the public⁹. (3) Defendant Fujita, President and Representative director, reported [the unauthorized transactions] to the Japanese Ministry of Finance immediately. He decided, however, not to report them to U.S. authorities for the time being, and to cover up the unauthorized transactions. On August, 8, 1995, defendant Fujita personally reported this situation to Director Nishimura, banking bureau of Japanese Ministry of Finance. Fujita, thinking that Daiwa Bank had a grace period until early October from Ministry of Finance, made a false statement on a bookkeeping ledger, (the official record of Daiwa Bank New York branch,) and forged a balance statement sheet of US Treasury bill kept by Bankers Trust. In violation of US Federal law, defendant Fujita did not report this to US authorities until Sep 18, 1995. (4) The defendants (Abekawa, Yasui, Kaiho, Genjida, Kawakami, Sunahara, Yamaji, Katusta, Tsuda and Kuroishi) who learned of the transaction and selling in this case from defendant Fujita directly and indirectly did not oppose the policy mentioned above, and so played their own role. (5) As this discussion has shown, the defendants' decision was a big mistake, one that brought about a severe punishment by US authorities. (6) After defendant Fujita and the other directors heard of these activities, Daiwa Bank was at a critical turning point, and it was unclear whether the bank would survive or disappear. As the defendants in this case insisted, this case caused many people internationally to worry about the Japanese financial system. The directors needed to make highly complicated and difficult business decisions in a timely fashion, while facing changing management surroundings. They are, judged from the standpoint that taking appropriate measures for Daiwa Bank in order to survive was extremely

9 The court agreed that making the information public was too dangerous to the existence of the Daiwabank and domestic and international Financial systems, because they had not finished precise investigating.

difficult, and that they needed to consider not only Daiwa Bank's existence, but also its influence upon international and domestic financial system. (7) Defendant Fujita and others did not recognize that Daiwa Bank in the US was under US authorities. U. S. regulation of foreign banks in the US was very strict, despite Daiwa Bank was dealing businesses in the US. Consequently, the defendants made choices that they did not report to US authorities, and violated US banking regulations. When directors manage companies abroad, they have very broad discretion as long as they obey the law (including foreign law). They are not authorized to ignore the law including foreign law. Therefore defendant Fujita, and the other directors, breached the directors' duty of care and loyalty.

The court considered the defendants' claim in case B that there was no possible expectation for defendants to report the unauthorized transaction and sale to US authorities in spite of Ministry of Finance's request or suggestion: (1) There is insufficient evidence to conclude that the Ministry of Finance directed or ordered defendant Fujita and the others not to report (the unauthorized transactions) to US authorities. (2) As long as Daiwa Bank operated in the US, it had a duty to obey US domestic banking regulations. So defendant Fujita and others, as bank managers, had a duty to make proper business judgments. (3) Despite the fact that Japanese economy is developed and expanding on a global scale, defendant Fujita and other directors persisted in utilizing local rules applicable only in Japan. They relied only on the authority and prestige of the Banking bureau director of the Ministry of Finance in order to overcome the Daiwa Bank crisis. Consequently, they invited a harsh penalty by U.S. authorities. The defendants in case B insisted that they could manage based on the Ministry of Finance's decision. This would have permitted the defendants not to act based on their responsibility: The court couldn't adopt the defendants' reasoning.

At the same time, the court rejected case B's defendant's insistence that they did not understand the US banking regulation.

(1) If the defendants, as managers of a company that conducted business in the U.S., were not aware of specific Banking Regulation at the time of Charges No. 1 through 7, they should have checked immediately for regulations concerning these very rare incidents. This is because the incident that caused the bank to lose \$1.1 billion by the unauthorized transaction and sale was so extraordinary and unusual. (2) Unfortunately, defendant Fujita (President) who received the letter from Iguchi, and other directors who heard the news concerning the unauthorized transaction and sale, directly or indirectly, neglected the duty of checking and investigating US banking regulations. It was not until 8. 25. 1995 that the defendants had, through a Japanese Law firm, contacted American counsel through American law firm, based on Daiwa Bank US planning Section's suggestion in late August of 1995. The court concluded that the investigation was too late. If the defendants had known the precise contents of US Banking regulations at the time of Charge No. 1 through 7, it would been obvious that there was negligence for defendants as managers whose bank was dealing bank business in the US, further there were no special circumstances about not knowing.

Therefore, even in view of the very difficult situation of Daiwa Bank at that time, because defendant Fujita and the other directors made markedly irrational and improper business judgment as company managers, they breached the directors' duty of care and loyalty.

3. Whether there was damage, and if so, how much?

(A) Whether there was damage in case A, if so how much?

Defendant Yasui, as a managing director in charge of NY branch or a managing director who has the position of employee, breached his director's duty by improperly confirming the balance of US Treasury bills in custody, and by failing to utilize proper methods. But defendant Yasui should not be responsible for damage that already existed when he became a NY branch manager. Consequently, the court found him responsible, except

for the \$530 Million damage that already existed when he became a NY branch manager.

The court failed to find the other defendants responsible.

(B) Whether there was damage in case B, and if so, how much?

Daiwa Bank's plea agreement with US Department of Justice, resulted in its admission of the charges in this case, and paid subsequently \$340 million, plus \$10 million in attorney fees. (1) With respect to the fine, 11 defendants breached the directors' duty in this case. Even though a plea-bargain occurred in this case, there were no special circumstances demonstrating that the result of the legal bargaining was very different from normal expectation. The court could not therefore, deny legal causal-relationship between the defendants' negligence concerning the breach of directors' duty, and damages resulting in the fine. The court found no special circumstances in this case. (2) Concerning law firms' fees, as long as there were no special circumstances, the court could not deny legal causal-relationship between the defendants' negligence concerning the breach of directors' duty, and the amount of the law firm's fees. The court found no special circumstances in this case.

The court apportioned defendants' responsibility about legal causal-relationship according to their own contribution toward damages. Consequently the court decreed that they should pay damages and delinquency charges as follows: (1) Defendant Yasui and Yamaji: \$245 million on the violation of 15 charges; (2) Defendant Tsuda: \$157 million 500 thousand on the violation of 10 charges; (3) Defendants Abekawa, Fujita, Kaiho, Kawakami and Sunahara: \$105 million on the violation of 7 charges; and (4) Defendants Genjida, Katsuta and Kuroishi: \$70 million on the violation of 5 charges.

If Daiwa Bank had adopted proper investigation methods for the balance of US Treasury bills in custody held by the NY branch, it could have prevented Iguchi's violation charges No. 14 through 20 from occurring. Furthermore, Daiwa Bank would not have been fined, so the court would not have found a legal

causal relationship.

III A List of Charges against Daiwa Bank by US Authority

1. Charge No. 1 : Conspiracy of Fraud against FRB in 1995 (Violation of 18 U.S.C. § 371)

According to the 12 U.S.C. § 208, 20 and 12 U.S.C. § 211, 24, FRB requires Daiwa Bank NY branch to submit criminal reports to the US judicial authorities, when employees might have committed a crime. In case the crime needed emergency response, Daiwa Bank needed to report that to the US authorities by telephone immediately. In addition, they were required to submit report on the issue within 30 days.

Instead, from 7/17/95 to 9/18/95, Daiwa Bank did the following: (1) Commit fraud against the government of the U.S.A (US authorities have the right to investigate branches of foreign banks, to receive genuine periodical reports and other information suitable for the US domestic law and FRB's Regulation, and not to receive the forged balance sheet. Daiwa Bank harmed, prevented, and cheated the FRB's legal function.) (2) Submit false statements to Federal Institutions. (Daiwa Bank made false, fictional, and fraudulence statements, and let other parties make such statement, violating 18 U.S.C. § 1001.) (3) Make false account entries in NY branch documents. (Daiwa Bank made or allowed to be made false entries of items in the account book, document, or balance sheet of the NY branch with intent to commit fraud, in violation of 18 U.S.C. § 1005.) (4) Conspire to conceal the purpose to discuss with Iguchi.

In sum, with Iguchi: (1) Daiwa Bank made a false item entry in a NY branch document, made and distributed false balance sheets in custody, and submitted false call-reports to FRB in violation of 18 U.S.C. § 1005, 1005. (2) Daiwa Bank neglected to submit a criminal report to the US authorities within the time required by law. (3) The Daiwa Bank covered up the \$1.1 billion

damage from FRB during the time from 7. 17. 1995 to 9. 18. 1995.

2. Charge No. 2: Concealing a Felony Act (Violation of 18 U.S.C. § 2, 4)

Daiwa Bank concealed various felony acts. They did not report to US authorities, in spite of knowing they had abused bank's and customers' assets in violation of 18 U.S.C. § 656, making false entry of items in the accounting book and documents in violation of 18 U.S.C. § 1005, and conspiring to violate 18 U.S.C. § 1005 during from 7. 21. 1995 to 9. 15. 1995.

3. Charge No. 3: Making false entries in the account book and documents of the bank (1) (Violation of 18 U.S.C. § 1005, 2,)

Daiwa Bank made false monthly balance sheets in custody based on Pension Trust division accounting with intent to commit fraud of FRB and investigators, on around 8. 1. 1995.

4. Charge No. 4: Making false entries in the account book and documents of the bank (2)

Daiwa Bank made false monthly balance sheets in custody based on Trust division accounting with intent to commit fraud of FRB and investigators, on around 8. 1. 1995.

5. Charge No. 5: Making false entries in the account book and documents of the bank (3)

Daiwa Bank forged Bankers Trust's balance sheets in custody for the month of July, with intent to commit fraud of FRB and investigators, on around 8. 15. 1995.

6. Charge No.6: Making false entries in the account book and documents of the bank (4)

Daiwa Bank made false orders to transfer US Treasury bills worth \$600 million from NY branch to the Daiwabank, with intent to commit fraud of FRB and investigators, on around 8. 31.

1995.

7. Charge No. 7: Making false entries in the account book and documents of the bank (5)

Daiwa Bank made a false statement in writing that indicated that the purpose of transferring \$600 Million in Treasury bills was to maintain financial liquidity. Daiwa Bank had the intent to commit fraud of FRB and investigators, on around 9. 7. 1995.

8. Charge No. 8: Making false entries in the account book and documents of the bank (6)

Daiwa Bank forged Bankers Trust's November 1986 balance sheets in custody, with intent to commit fraud of FRB and investigators in December 1986.

9. Charge No. 9: Making false entries in the account book and documents of the bank (7)

Daiwa Bank forged Bankers Trust's November 1988 balance sheets in custody, with intent to commit fraud of FRB and investigators in December 1988.

10. Charge No. 10: Making false entries in the account book and documents of the bank (8)

Daiwa Bank forged Bankers Trust's January 1990 balance sheets in custody, with intent to commit fraud of FRB and investigators in December 1989.

11. Charge No. 11: Making false entries in the account book and document of the bank (9)

Daiwa Bank forged Bankers Trust's June 1990 balance sheets in custody, with intent to commit fraud of FRB and investigators in July 1990.

12. Charge No. 12: Making false entries in the account book and documents of the bank (10)

Daiwa Bank forged Bankers Trust's December 1991 balance

sheets in custody, with intent to commit fraud of FRB and investigators in January 1992.

13. Charge No.13: Making false entries in the account book and documents of the bank (11)

Daiwa Bank forged Bankers Trust's December 1992 balance sheets in custody, with intent to commit fraud of FRB and investigators in January 1993.

14. Charge No. 14: Making false entries in the account book and documents of the bank (12)

Daiwa Bank forged Bankers Trust's June 1993 balance sheets in custody, with intent to commit fraud of FRB and investigators in July 1993.

15. Charge No. 15: Making false entries in the account book and documents of the bank (13)

Daiwa Bank forged Bankers Trust's December 1993 balance sheets in custody, with intent to commit fraud of FRB and investigators in January 1994.

16. Charge No. 16: Making false entries in the account book and documents of the bank (14)

Daiwa Bank forged Bankers Trust's June 1994 balance sheets in custody, with intent to commit fraud of FRB and investigators in July 1994.

17. Charge No. 17: Making false entries in the account book and documents of the bank (15)

Daiwa Dank forged Bankers Trust's December 1994 balance sheets in custody, with intent to commit fraud of FRB and investigators in January 1995.

18. Charge No. 18: Making false entries in the account book and documents of the bank (16)

Daiwa Bank forged Bankers Trust's June 1995 balance sheets

in custody, with intent to commit fraud of FRB and investigators in July 1995.

19. Charge No. 19: Telegram Fraud (1) (Violation of 18 U.S.C. § 1343, 2)

Daiwa Bank and Iguchi sent false balance sheets in custody by fax to the pension trust division of Daiwa Bank on around 7. 1. 1995, in order to misappropriate customers' US Treasury bills worth \$377 million in the bank.

20. Charge No. 20: Telegram Fraud (2)

Daiwa Bank and Iguchi sent false balance sheets in custody by fax to the trust division of Daiwa Bank on around 7. 1. 1995, in order to misappropriate customers' US Treasury bills worth of \$377 in the branch.

21. Charge No. 21: Mailing Fraud (1) (Violation of 18 U.S.C. § 1341, 2)

Daiwa Bank and Iguchi mailed false balance sheets in custody to the pension trust division of Daiwa Bank on around 7. 1. 1995, in order to misappropriate customers' US Treasury bills worth of \$377 million in the bank.

22. Charge No. 22: Mailing Fraud (2)

Daiwa Bank and Iguchi mailed false balance sheets in custody to the trust division of Daiwa Bank on around 7. 1. 1995, in order to misappropriate customers' US Treasury Bill worthy of \$377 million dollars in the bank.

23. Charge No. 23: Conspiracy to commit Fraud against FRB in 1995 (Violation of 18 U.S.C. § 371)

Daiwa Bank did the followings: (1) Commit fraud against the U.S.A.(U.S. authorities could not effectively investigate the branch of foreign bank, or receive genuine periodical reports and other information suitable for the US domestic law and FRB's regulation. Daiwa Bank also sent a forged balance sheet, and

harmed, prevented, and cheated the FRB's legal function.) (2) Submit false statements to Federal Institutions. (Daiwa Bank made seriously false, fictional, fraudulent statements, and allowed other parties to make similar statements, in violation of 18 U.S.C. § 1001.) (3) Make false entries of items in the accounts or documents of the NY branch. (Daiwa Bank made or allowed to be made false entries of items in the account book, documents, or balance sheets in custody of NY branch, with intent to commit fraud against FRB and investigators, in violation of 18 U.S.C. § 1005.)

Furthermore, Daiwa Bank conspired with Iguchi, and disclosed incomplete and misleading information concerning the separation between its US Treasury bills business and custodian business in the NY branch to FRB in around November 1993. This occurred after Daiwa Bank transferred the securities transaction division members from its downtown office to its midtown office during the FRB's Investigation in around November 1992. Despite Daiwa Bank's letter to FRB's investigators, in which it declared that it would transfer the officer in charge of US Treasury bills from its downtown office to its midtown office permanently, it allowed Iguchi, chief of the custodian division, to continue auditing the officer in charge of US Treasury bills from November 1993 to September 1995.

24. Charge No. 24: Disturbance of Investigation against Financial Institution (Violation of 18 U.S.C. § 1517)

Daiwa Bank disturbed or tried to disturb FRB's Investigators, by transferring the officer in charge of US Treasury bills from its downtown office to its midtown office during the investigation of FRB in around November 1994.

IV. Comments

This case was decided by Osaka district court, but it had a very strong impact not only among corporate directors, but also

all over Japan, because directors of Daiwa Bank were ordered to pay \$775 million. This was first ever court decision to order directors to pay such much money, and since then there has been much debate about the derivative action system in Japan. The directors groups and some politicians insisted that compensation be limited to two years salary of the director. That is the reason I translated this case, because the case had provoked strong debate. I will make two brief comments about case A and B.

1. (Case A, and partially case B) Did the \$1.1 billion in damages from Iguchi's unauthorized transactions come from the directors' breach of the duty of care and loyalty, in the form of a duty to establish a proper, in-house checking system?

The judge stated:

"Because it is unsuitable and impossible for company directors to guide and manage all employees directly, they have a duty to set up Internal Compliance System to monitor employees and prevent them from acting illegally in advance. This duty also to prevent illegal employee activity was part of the director's duty of care and loyalty. In this context the requirement of a Management Risk Checking System meant the implementation of a Law Compliance System.

So the directors of Daiwa Bank had a duty to establish a proper Risk Management System, but they failed to do so. A Risk Management System would included: (1) Separation of Front Office from Back Office, and of U.S. Treasury Bill dealing business from Custodian business; and (2) The Confirmation of a balance of US Treasury Bill in custody.

Concerning the Separation of Front Office from Back Office, the judge stated:

"...The Daiwa Bank New York branch gradually prepared for, and implemented its system after that time."

The court also stated:

"(the court) could not find that Daiwa Bank's New York Branch was unprepared and unsuitable, with respect to the Risk Manage-

ment System, both as a whole system as well as each management system was put in place by transactions of US Treasury Bill and Custodian business."

In short, the court stated the directors did not breach their duty on this issue. I think this decision is reasonable, because it is impossible to set a perfect checking system. Financial transactions progress so rapidly that we should not label this behavior as gross negligence.

With respect to the second issue (about the Confirmation of a balance of US Treasury Bill in custody,) I agree with court decision, that there was gross negligence. The court said :

"Nevertheless, the New York branch did not reconciled US. Treasury Bills balance sheets with their own accounting books in every internal investigation, such as the monthly branch inspection, ad hoc inspections by internal auditors, bi-annual inspection and CPA audit every three years. Those investigations enabled Iguchi to forge the balance sheet of US Treasury bills, so the New York Branch could not discover or prevent unauthorized sales, charges 14 to 20 in this case. As a result, Daiwa Bank's Risk Management System did not function effectively

What the Daiwa directors did here was to make a thief check the remainder. How could the thief tell the truth? Even worse, Daiwa Bank continued to let Iguchi audit the officer in charge of US Treasury bills between November 1993 and September 1995, even after FRB advice¹⁰. Can't we find gross negligence of directors from these facts? So finally the court declared that "*(one of defendants) responsibility... which became \$530 million*" In Japan most people fixate on the amount, but I think the problem is whether or not we can admit there was gross negligence. Even if it was impossible for an individual director to check everything by himself or herself, but as a professional of bank business is it impossible to admit the duty to check? Furthermore, banks accept enormous deposit, and when they go bankrupt,

10 See, Charge Nr. 23.

they receive fiscal rescue from the government. So when we decide whether there was a gross negligence, can we not take those factors into consideration? I think there should be a standard to decide whether there was gross negligence according to the character of business. Therefore bank directors would have their own gross negligence standard.

2. (Case B) Did the \$350 million in damages from the plea agreement arise out of a breach of the directors' duty?

In this paragraph, I will discuss charges No. 1 through 7, 23, and 24, which dealt with the relation between behavior against US criminal law and the Business Judgment Rule.

First of all, I think that the primary cause of this case was that, the directors of Daiwa Bank refused to disclose information about Iguchi's transactions and their damage. Because the damage was \$1.1 billion, the directors feared that the existence of Daiwa Bank and financial system itself would be in danger. In short, the directors wanted to cover it up until they found out everything was safe.

Next, Daiwa Bank directors consulted with officers of Japanese Ministry of Finance about these incidents confidentially, but not with US authorities where their businesses were managed. The officer of the Japanese Ministry of Finance answered, "It's not a good time to open this up." Directors misunderstood that this answer gave them permission not to disclose the incidents for a couple of months, though that was a mere personal opinion. So they forged business documents including the Bankers Trust's balance book (Violation of 12 U.S.C. § 208·20, 211·24) and failed to file a report until 9. 18. 1995. But according to the US Code, at the latest, they should have reported within a month, by 8. 17. 1995, after directors had known of the incidents (Violation of 18 U.S.C. § 371).

In order to understand this situation, you should appreciate the relationship between the MOF and the banks in Japan. Until very recently, the MOF was the authority of Financial Admini-

stration, and controlled every detail in the financial area. MOF's authority was so absolutely strong, that financial institutions should follow their guidance. It was much easier to obey the MOF than to make decisions themselves.

Then Daiwa Bank was prosecuted, plea-bargained, and paid \$350 million. The defendants insisted that the word 'the statute' in the Japanese commercial code Art. 266 Sec. 1 Nr. 5 did not include 'foreign law', and if it does not include, therefore, there was no negligence not to know the foreign law or statute in this case. But the court discussed whether 'the statute' includes 'foreign law' : ,

"Directors are granted very broad discretion, as long as they obey the law, including foreign law, in the management of the company. However, they are not granted discretion over whether to comply with law."

Furthermore, concerning the negligence, the court said,

"If the defendants, as managers of a company that conducted business in the U.S., were not aware of specific Banking Regulation at the time of Charges No. 1 through 7, they should have checked immediately for regulations concerning these very rare incidents. This is because the incident that caused the bank to lose \$1.1 billion by the unauthorized transaction and sale was so extraordinary and unusual."

At last, the court acknowledged "Therefore, defendant Fujita, and the other directors who heard this from Fujita, breached the directors' duty of care and loyalty." I think this was a natural conclusion.

Finally directors claimed that not reporting to US authorities was within their Business Judgment. That means that if they report to the Japanese MOF, they do not have to do anything else. This also means that they admit they don't have to make any decision as long as they obey the MOF's official or unofficial guidance. The court ruled that :

"Despite the fact that Japanese economy is developed and expanding on a global scale, defendant Fujita and other directors persisted in utilizing local rules applicable only in Japan. They

relied only on the authority and prestige of the Banking bureau director of the Ministry of Finance in order to overcome the Daiwa Bank crisis. Consequently, they invited a harsh penalty by U.S. authorities."

Although it was hard for the directors to report against the MOF's advice, directors should obey the law. I believe it is that simple.