SUMMARY TRANSLATION

THE DAIWA BANK CASE (1999)

TSUYOSHI YAMADA*

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* Associate Professor at Niigata University Law Faculty in Japan. Visiting Scholar at Columbia Law School 2000-2001. I am grateful for special comments from Curtis Milhaupt, Fuyo Professor of Japanese Law and Legal Institutions and Director of the Center for Japanese Legal Studies at Columbia Law School. I also would like to thank Jeremy Friedman, J.D. Candidate (Columbia 2003), for checking my English.

I. COMMENTS

The following is a summary translation of a representative action brought by Daiwa Bank's stockholders against the Bank regarding the New York Daiwa Bank scandal. A Daiwa bond trader covered up $1.1 billion in losses incurred through illegal trades over the course of eleven years. This case was decided by the Osaka district court, and 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 approximately $775 million. This was first court decision that ordered directors to pay such a huge amount of money, and it fostered much debate about the derivative action system in Japan. Directors' groups and some politicians insisted that compensation be limited to two years salary of the director. The case was divided into two parts, Case A and Case B.

The Court found that the directors of Daiwa bank had a duty to establish a proper risk management system, but failed to do so. A proper risk management system would have included separation of front office from back office, and also of U.S. Treasury bill dealing business from custodian business. It also would have included the confirmation of a balance of U.S. Treasury bills in custody.

The court found the directors did not breach their duty concerning the first criterion of this test—separation of front office from back office. The court did, however, find gross negligence in regards to the confirmation of U.S. Treasury bills in custody.

Another aspect of the case was whether the $350 million in damages from the plea agreement arose out of a breach of the directors' duty. The court dealt with the relation between behavior in violation of United States criminal law and the business judgment rule.

One of the primary causes of this case was that the directors of Daiwa Bank refused to disclose information to the United States banking regulation authorities about the trader's transactions and the amount of damage he caused. Because the damage was $ 1.1 billion, the directors apparently feared that the existence of Daiwa Bank and financial system itself would be in danger. In short, the directors probably wanted to cover 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 did not notify United States authorities. The officer of the Japanese Ministry of Finance answered, "It's not a good time to open this up." Directors interpreted this answer as giving them permission not to disclose the incidents to the United States authorities. 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 September 18, 1995.

In order to understand this situation, one should appreciate the relationship between the Ministry of Finance and the banks in Japan. Until very recently, the Ministry of Finance was the authority of financial administration in Japan, and controlled every detail in the financial area. The Ministry of Finance's authority was so strong that financial institutions had no choice but to follow their guidance. Also, it is commonly acknowledged that is was much easier to obey the Ministry of Finance than to make decisions themselves.

The defendants insisted that the words "the statute" in the Japanese Commercial Code Art. 266 Sec.1 No. 5 did not include "foreign law," and as it does not include it, therefore, there was no negligence if they did not know the relevant foreign law or statutes. However, the court did not agree:

> "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 . . .Therefore, defendant Fujita, and the other directors who heard this from Fujita, breached the directors' duty of care and loyalty."

Finally directors claimed that not reporting to U.S. authorities was within their business judgment. Reporting to the Japanese Ministry of Finance is sufficient. It also means that they would not have to make any decisions themselves, as long as they obey the Ministry of Finance's official or unofficial guidance. The court ruled that:

> "Despite the fact that the 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 United States authorities. The defendants 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."

II. THE TEXT OF THE JUDICIAL DECISION[1]

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

Case A The director of Daiwa Bank who managed Daiwa's New York branch, defendant Kenji Yasui, breached his duty of care and loyalty, and is ordered to pay damages of $530 million in damages and interest. The court finds breach of the duty on the fact that Iguchi, a former employee of the New York branch, continuously made illegal off balance sheet transactions in U.S. Treasury bills in violation of the articles of transaction of Daiwa Bank, and sold the 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.

Case B Current and former directors of Daiwa bank, defendants Yasui, Yamaji, Tsuda, Abekawa, Fujita, Kaiho, Kawakami, Sunahara, Genjida, Katsuta, and Kuroishi breached their duty of care and loyalty as directors, and the court orders them to pay damages and delinquency charges as follows: 1) Defendants Yasui and Yamaji: $245 million on 15 charges of negligence; 2) Defendant Tsuda: $157.5 million 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

The other claims are dismissed.

III. FACTS AND REASONING

A. Summary of the Facts

1. 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 New York 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, one of whom was a New

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[1] This translation is based upon Shoji Homu No. 1573 (10/5/2000) p. 5, and Shoji Homu Shiryoban (Materials) No. 199 (Oct, 2000) pp. 248-257.

York branch manager at the time, breached their duty of care and loyalty as directors by failing to establish an internal compliance system, to prevent illegal transactions by bank officers, and to minimize the damage, i.e. in New York branch ex-officer Iguchi made unauthorized off-book transactions in U.S. Treasury bills from 1984-1995 of $ 1.1 billion, and he also sold bank holding U.S. Treasury bills in order to cover up this damage illegally (the unauthorized transactions), as a result Iguchi caused the damages, in this case.

b) The other directors and auditors breached the directors' and auditors' duty of care and loyalty to monitor the establishment of the above mentioned system to prevent illegal transactions and sales by Iguchi; such breach caused the damages in this case.

2. Case B

Daiwa Bank was criminally indicted 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 New York branch, for $350 million in damages for the transactions and failure to report them to the U.S. authorities, charged by the U.S. authorities and attorneys fees, on the following facts and grounds:

a) Concerning counts 14 through 20, the then representative directors and a New York branch manager, who was a director, breached the directors' duty of care and loyalty to establish an internal compliance system to prevent illegal transactions 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 New York branch manager, who was a director, breached the directors' duty of care and loyalty to observe the domestic law of the United States, the other directors breached the directors' duty of care and loyalty to monitor whether the then representative directors observed the domestic law in the United States

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 'stem, 2) Did defendants breach the duty of care and loyalty when they 'ated U.S. domestic law, and they didn't report this to U.S. authorities.

B. *Issue One: Whether there exists a breach of the duty of* *care and loyalty to establish an internal compliance system.*

1. Establishing an internal compliance system (risk management system) and the duty of care and loyalty: General Concepts

At first, the court discussed risk management systems in this case in the following manner: 1) In order to manage companies soundly, 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 determined 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 responsible for that 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 responsible for that area, has a duty to establish a risk management system. At the same time, a director has a duty to ensure that representative directors and directors 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 Code[2]), have a duty to review the management of the directors. Therefore auditors should not only audit whether directors have established a risk management system, but should also check system's performance.

In other words, the issue discussed here was whether or not the then representative directors, other directors who were once managers of the New York branch, prepared and maintained a risk management system, which includes a system that covers changing risk concerning transactions of U.S. Treasury bills and custody business. Furthermore, the issue also includes whether the other directors and auditors breached 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 when employees work for the company as a whole. Large companies with many employees, enterprises,

2 Called Shoho Tokureihou.

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 an internal compliance system to monitor employees and prevent them from acting illegally. This duty 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 legal compliance system. 2) Inherent in buying and selling 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 results in 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, directors must establish an internal compliance system (risk management system); only then can they evaluate and control those kinds of risk.

2. Conditions of risk management system: Separation of front office from back office, U.S. Treasury bill dealing from custodian business.

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.

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 in both divisions at the same time; if a dealer must hold an additional post in a back office, directors are at least requested to take countermeasures to address those situations. When trading U.S. 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 U.S. 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. Independent sectors check and balance each other, prevent illegal transactions in advance, and 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.

Daiwa Bank's New York branch had already established rules creating separate front and back offices by the time Iguchi began to perform illegal transactions in June 1984. These rules concerned the limitation of dealers' positions, and separated dealers from collation people. The Daiwa Bank New York branch gradually prepared for, and implemented its system after that time.

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 U.S. 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 as it operated in the of U.S. Treasury bill and custodian businesses.

3. The actual situation of risk management system: Confirmation of a balance of U.S. Treasury Bills in custody.

Custodian businesses run the risk that their officers will abuse their own positions by selling things in custody without permission, and misappropriate profits to benefit themselves or third parties. A balance of U.S. 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 U.S. Treasury bills in custody were not registered, they were issued as bill certificates by the government, and therefore the New York branch could not confirm a balance of the bill directly. Furthermore, the New York branch could only check balances properly by contacting the Bankers Trust in New York, where Daiwa re-entrusted their U.S. Treasury bills in custody. 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.

The confirmation of a balance of U.S. Treasury bills in custody was the most effective way to control the existing management risk. No other method, either individually or in combination with other investigating methods, is sufficient without properly checking this balance.

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 U.S. Treasury bills in custody to Bankers Trust in New York, then managers and officers should have contacted to Bankers Trust directly, instead of through officers in the custody section.

Nevertheless, the New York branch did not reconcile U.S. 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 a CPA audit every three years. Those investigations enabled Iguchi to forge the balance sheet of U.S. Treasury bills, so the New York branch could not discover or prevent unauthorized sales (charges 14 to 20). As a result, Daiwa Bank's risk management system did not function effectively.

4. 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.

5. Did directors of Daiwa Bank violate their 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 Bank manual which was checked and approved by Daiwa Bank's investigating division. In fact, branch investigations were based on the manual. Therefore, directors overseeing the investigation division, as directors on duty or directors who hold the position of employee, should be liable for violating the duty of care and loyalty for failing to implement an appropriate checking system for the balance of U.S. Treasury bills. 2) The in-branch inspection by internal auditors was held under authority of the New York branch manager. Therefore, the New York branch manager, as a director and an employee at the same time, should be liable for violating the duty of care and loyalty for failing to implement an appropriate checking system of the balance of U.S. Treasury bills. (3) The directors in charge of the U.S. project division in Daiwa Bank should be liable for violating the duty of care and loyalty for failing to implement an appropriate checking system of the balance of U.S. Treasury bills.

Based on this decision, the court confirmed that three of the defendants, Yasui, Yamaji and Tsuda, as former directors and New York manager, were liable for violating the duty of care and loyalty. Defendant Yasui, as a New York manager, extremely inadequately checked the balance of U.S. 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 (charges 14 through 20). Further, defendants Yamaji and Tsuda, as New York managers, extremely inadequately checked the balance of U.S. 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 New York manager in May 1994.

The court's decision about representative directors was as follows: 1) Daiwa Bank's New York branch was responsible for confirming the balance of U.S. 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 New York branch. (Note that no one proved that 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 directors. In large-scale enterprises like Daiwa Bank that have multiple subdivisions, it is inadequate and impossible from a view point of effective and rational management for both the President and the deputy President, both representative directors, to closely monitor every business. 3) The internal investigation division and New York branch division were responsible for confirming the balance of U.S. Treasury bills in custody. The directors in charge of both divisions should manage proper investigation in the bank. Therefore, both the President and the Deputy President 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 suspect the quality with which 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 New York branch, breached the directors' duty of care and loyalty as follows: 1) The other directors, who were not related to the investigation division or New York branch (including representative directors), are obligated to monitor not only topics discussed in the board of directors' meeting but also other things, including the company's risk management system. The court could not admit that the risk management system in the New York branch concerning U.S. Treasury bill transactions and custodian business established fundamental outlines and detailed devices. However, the court should find that the confirmation method of the U.S. Treasury bill balance was implemented inappropriately, given that the in-house investigating division was established precisely for investigation. Furthermore, it was very hard for the other directors to imagine that the in-house investigating division would make the mistake of letting the New York branch or custodian section collect a detailed statement of U.S. Treasury bills in custody from Bankers Trust, then refer them to the ledger of Daiwa Bank's New York branch. The in-house investigating division should have collected a detailed statement of U.S. 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 the New York branch, breached the directors' duty of care and loyalty, unless there were special circumstances relating to the balance of U.S. Treasury bills in custody. Yet 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, a former outside auditor, insisted that inside the Bank temporary, outside auditors principally played separate roles, such as participating in directors' meetings, listening to directors' reports at any time, and auditing pursuant to the reports 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 more aggressively and more objectively. They should have audited more like third parties. Furthermore, if the court found that each auditor represented the company, then even if auditors' meetings picked one auditor for a particular job, 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 auditors, even if they were temporary, were required to collect information actively and at all times. They should use the authority of investigation given by Commercial Code Art. 274 Sec. 2, not to passively audit 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 the case of the division chiefs' meetings mentioned above, full-time auditors should interview the New York branch manager. Full-time auditors also should audit other work, including the CPA's examinations, the report of the Japanese Ministry of Finance investigation and the Bank of Japan hearing. In this case, they could not find problems concerning confirmation methods of U.S. Treasury bills balances in the New York branch. Therefore, the court found that the auditors, except for those auditors who had been to the New York branch and checked the CPA's examination, could not have known the problem concerning confirmation methods of U.S. treasury bill balance. This is true regardless of whether the auditor was temporary or full-time, outside or inside. As a result, the other auditors were not responsible for confirmation methods of U.S. Treasury bill balances. 4) Defendant Okunuki (the other auditor) had been to the New York 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 20.

C. Issue Two: Did directors breach the duty of care and loyalty concerning Daiwa's violation of U.S. Banking Regulations?

1. Compliance Management

Company directors should obey the law, both in order to maximize shareholders' profit, and also for basic management of the company.

The Shoho (Commercial Code) Art. 266 Sec.1 No. 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 the 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 in accordance with 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? 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.

2. Whether or not the defendants breached their duty

With respect to charge No. 24, the court found the following: 1) Defendant Yamaji, former New York branch manager, was responsible under Charge No. 24, for violating U.S. Federal Law. He also breached the directors' duty of care. 2) Defendant Yasui, former U.S. division chief for bank business, did not commit charge No. 24. However, when he was a manager of the New York branch, he transferred traders to avoid inspection by New York state bank regulators. Defendant Yasui could have prevented that behavior, and thus his conduct broke U.S. law. Therefore defendant Yasui 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[3] on July 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 take control of 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 transactions 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 Japanese Ministry of Finance, but not to the U.S. Authorities. At the same time he organized the minimum settlement team, in which he named defendant Yasui

[3] Iguchi sent defendant Fujita a letter, in which Iguchi confessed that his unauthorized transactions caused 1.1 billion dollars worth of damages. He also admitted that he sold U.S. Treasury bills without permission in order to make up for this damage, and that he forged balance reports of U.S. Treasury bills in custody at Bankers Trust in order to cover up his error.

[Representative Director and Vice President] as chief, and defendants Yamaji [the chief of International division], Tsuda [New York branch manager], and Motohashi [the chief of International Financing and Securities division] as members. Fujita also entrusted his policymaking power to the chief and members. As representative directors, defendants Fujita, Yasui, Kaiho, Genjida, Kawakami, Sunahara, and Yamaji, like the former New York branch manager, defendant Tsuda, did not report to the U.S. authorities. Non-representative directors Abekawa, Katsuta and Kuroishi failed to urge the other representative directors to report to the U.S. authorities [Charge No. 1 and 2]. As far as the illegal behavior detailed by Charges 3 through 7 was concerned, defendant Tsuda, the New York branch manager, forged monthly balance sheets in custody of pension trust and trust division, as well as 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 defendant Fujita's plan.

Defendant Abekawa resigned as representative director in June 1995. He had held the authority to call directors board meetings and should have urged the other representative directors to report to the U.S. authorities, as he knew of Iguchi's unauthorized transactions from defendant Fujita's report. The court did not find that defendant Abekawa ordered or purposefully submitted a false report to the Federal Reserve Bank (FRB), or that he forged the bookkeeping ledger of the New York branch. Yet defendant Abekawa could have prevented the behavior comprising charges No. 1 through 7. The behavior mentioned above not only violated United States law, but defendant Abekawa also breached the directors' duty of care and loyalty, because he dared not to prevent the above-mentioned behavior.

Defendant Fujita [Representative Director and President], defendant Yasui [Representative Director and Vice President in charge of the international division], and defendant Yamaji [Representative Director and the chief of international division] knew of Iguchi's unauthorized transaction and sale, but they did not report it to the U.S. authorities. They were charged as supervisors because they tacitly or clearly permitted (or failed to prevent) the submission of a false call-report to the FRB, and forged the ledger of accounting and official records of the Daiwa Bank New York branch. Therefore, the behavior based on charges No. 1 through 7 violated United States 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 the subsequent selling without permission, but they did not report it to the U.S. authorities. The court did not find that they tacitly or clearly permitted the submission of a false call-report to the FRB, or forged the ledger of accounting and official record of the Daiwa Bank New York branch. However, these activities could have been prevented by defendant Kaiho, and defendant Sunahara (No. 1 through 7), defendant Genjida[4] (charges No. 1, 2, and 5 through 7). Therefore the behavior based on the charges mentioned above violated U.S. federal law, and these individuals breached the directors' duty of care and loyalty.

As Defendants Katsuta and Kuroishi knew of Iguchi's unauthorized transactions, they should have urged the representative directors to report to United States authorities. The court could not, however, conclude that they either tacitly or clearly permitted the submission of a false call-report to the FRB, or forged the ledger of accounting and official record of the Daiwa Bank New York branch. Still, they could have prevented the behavior which led to charges No. 1, 2, and 5 through 7[5]. Furthermore, the behavior supporting the charges mentioned above violated U.S. federal law, and the aforementioned defendants breached the directors' duty of care and loyalty by not preventing these actions in advance.

Defendant Tsuda [the New York branch manager] knew of Iguchi's unauthorized transactions, but he did not report it to U.S. authorities. He himself submitted false call-reports to the FRB, and forged the ledger of accounting and official record of the Daiwa Bank New York branch (charges No. 1 through 7). Therefore he violated U.S. 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 transactions after the transactions had already occurred, and there were no special circumstances indicating that they could have known about the behavior earlier.

3. The Business Judgment Rule.

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[4] Defendant Genjida could have known of the transactions at earliest around 8/2/1995, but his actions alleged in charges No. 3 and 4 took place on 8/1/1995, so he was not liable for charges 3 and 4.

[5] 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 alleged in charges No.3 and 4 occurred on 8/1/1995, so they were not liable for charges 3 and 4.

The court ruled on the business judgment rule as follows: 1) Directors should observe the duty of care and loyalty,[6] meaning that they should work for the long-term benefit and maximum profit of the company, as management experts entrusted with the management of the company should work towards profit. In order to promote business and make a profit, directors should evaluate frequently by changing elements, such as the company's situation, the company's industry conditions, and international and domestic landscapes. Based on their evaluation, directors should estimate the long and short-term future, and subsequently make timely business judgments. 2) Therefore, directors' business decisions will lead to a breach of their duty of care and loyalty only if they misunderstand seriously and carelessly the facts upon which decisions were made, or if 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 the law.

The court made its decision based on the following facts: 1) Defendant Fujita, president and representative director, received the letter from Iguchi on July 24, 1995 and sent defendant Yamaji, the chief of international division, to N.Y. from July 28, 1995 to July 30, 1995 in order to investigate. Yamaji's report confirmed that, at the very least, selling without permission in this case was true, and that Daiwa Bank incurred damages in the amount of $1.1 billion[7]; 2) At that time, Fujita should have decided to report this unauthorized transaction and sale to the U.S. authorities, the FRB, and the banking division of Ministry of Finance in Japan, but not to the public[8]; 3) Fujita reported [the unauthorized transactions] to the Ministry of Finance immediately. He decided, however, not to report them to U.S. authorities for the time being, choosing instead to cover up the unauthorized transactions. On August 8, 1995, defendant Fujita personally reported this situation to Director Nishimura from the banking bureau of Japanese Ministry of Finance. Fujita, thinking that Daiwa Bank had a grace period until early October from the Ministry of Finance, made a false statement on a bookkeeping ledger, the official record of Daiwa Bank New York branch,

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[6] Regulated by Shoho (Commercial Code) Art. 254 Sec. 3, Minpou (Civil Code) Art. 644, and Shoho Art. 254-3.

[7] Iguchi forged the balance of U.S. Treasury bilsl in custody with 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 Daiwa Bank N.Y. branch to the original balance by Bankers Trust.

[8] The court agreed that making the information public was too dangerous to the existence of the Daiwa Bank and domestic and international financial systems, because they had not completed a precise investigation.

and forged a U.S. Treasury Bill balance statement sheet kept by Bankers Trust. In violation of U.S. federal law, Fujita did not report this to the U.S. authorities until Sep 18, 1995; 4) Defendants (Abekawa, Yasui, Kaiho, Genjida, Kawakami, Sunahara, Yamaji, Katusta, Tsuda and Kuroishi) who learned of the transaction in this case from Fujita directly and indirectly did not oppose the policy mentioned above, and so played their own role in the deception; 5) As this discussion has shown, the defendants' decision was a major error, one that brought about a severe punishment by United States 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 around the world to worry about the Japanese financial system. The directors needed to make highly complicated and difficult business decisions in a timely fashion, while simultaneously facing changes in management surroundings. At that time, the directors knew that taking appropriate measures for Daiwa Bank in order to survive was extremely difficult, and that they needed to consider not only Daiwa Bank's existence, but also its influence upon both the international and domestic financial systems; 7) Defendant Fujita and others did not recognize that Daiwa Bank in the United States was under U.S. regulation. Consequently, they chose not to report to U.S. authorities and violated U.S. banking regulations. Therefore defendant Fujita, and the other directors, breached the directors' duty of care and loyalty.

The court considered defendants' claim in case B that there was no possible expectation that the defendants would have reported the unauthorized transactions to U.S. authorities in spite of the 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 U.S. authorities; 2) As long as Daiwa Bank operated in the United States, it had a duty to comply with U.S. domestic banking regulations. So defendant Fujita and others, as bank managers, had a duty to make proper business judgments; 3) Despite the fact that the Japanese economy is developed and expanding on a global scale, defendant Fujita and the 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, and the court couldn't adopt the defendants' reasoning.

At the same time, the court rejected defendant's assertion in Case B that they did not understand the U.S. banking regulations. 1) If the defendants, as managers of a company that conducted business in the United States, were not aware of the specific banking regulations applicable 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 transactions 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, directly or indirectly, neglected to check and investigate U.S. banking regulations. It was not until August 25, 1995 that the defendants had, through a Japanese law firm, contacted American counsel, based on Daiwa Bank's U.S. 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 U.S. banking regulations at the time of charge No. 1 through 7, it would have been obvious that there was negligence by defendants as managers of a bank conducting bank business in the United States, and furthermore there were no special circumstances to justify their 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 judgments as company managers, they breached the directors' duty of care and loyalty.

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

1. Whether there was damage in case A, if so how much?

Defendant Yasui, as a managing director in charge of New York branch and a managing director who has the position of employee, breached his director's duty by improperly confirming the balance of U.S. Treasury bills in custody, and by failing to utilize proper methods. But defendant Yasui should not be responsible for the loss incurred before he became the New York branch manager. Consequently, the court found him liable, except for the \$530 million that already existed when he became the New York branch manager.

The court declined to find the other defendants liable.

2. Whether there was damage in case B, and if so, how much?

Daiwa Bank's plea agreement with U.S. Department of Justice, resulted in its admission of the charges in this case and Daiwa Bank subsequently paid $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 firms' fees. The court found no special circumstances in this case.

The court apportioned defendants' liability regarding 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 U.S. Treasury bills in custody held by the New York branch, it could have prevented Iguchi's violation of charges No. 14 through 20. Furthermore, Daiwa Bank would not have been fined, and thus the court would not have found a legal causal relationship.

IV. A LIST OF CHARGES AGAINST DAIWA BANK BY U.S. AUTHORITIES

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, the FRB requires Daiwa Bank New York branch to submit criminal reports to the U.S. judicial authorities, when employees are suspected to have committed a crime. In case the crime needed an emergency response, Daiwa Bank needed to report that to the U.S. authorities by telephone immediately. In addition, they were required to submit a report on the issue within 30 days.

Instead, from July 17, 1995 to September 18, 1995, Daiwa Bank did the following: (1) Defrauded the government of the United States (U.S. authorities have the right to investigate branches of foreign banks, to receive genuine periodical reports and other information related to U.S. domestic law and the FRB's regulation, and not to receive forged balance sheets. Daiwa Bank harmed, prevented, and cheated the FRB's legal function.) (2) Submitted false statements to federal agencies. (Daiwa Bank made false, fictional, and fraudulent statements, and let other parties make such statements, violating 18 U.S.C. § 1001.) (3) Made false account entries in New York branch documents. (Daiwa Bank made or allowed the making of false entries in the account book, documents, or balance sheets of the New York branch with intent to commit fraud, in violation of 18 U.S.C. § 1005.) (4) Conspired to conceal the intent to discuss with Iguchi.

In sum, concerning Iguchi: (1) Daiwa Bank made false entries in New York branch documents, made and distributed false balance sheets in custody, and submitted false call-reports to the FRB in violation of 18 U.S.C. § 1005, 1005. (2) Daiwa Bank neglected to submit a criminal report to the U.S. authorities within the time required by law. (3) The Daiwa Bank covered up the $1.1 billion damage from FRB from July 17, 1995 to September 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 U.S. authorities, although they knew the Bank had abused their and customers' assets in violation of 18 U.S.C. § 656, made false entry of items in the accounting book and documents in violation of 18 U.S.C. § 1005, and conspired to violate 18 U.S.C. § 1005 during from July 21, 1995 to September 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 defraud the FRB and investigators, on around August 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 defraud the FRB and investigators, on around August 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 August 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 U.S. Treasury bills worth $600 million from N.Y. branch to the Daiwa Bank, with intent to defraud FRB and investigators, on around August 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 which indicated that the purpose of transferring $600 million in Treasury bills was to maintain financial liquidity. Daiwa Bank in fact intended to defraud the FRB and investigators, on or around September 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 defraud the 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 defraud the 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 defraud the FRB and investigators in December 1989.

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

Daiwa Bank forged Bankers Trust's June 1990 balance sheets in custody, with intent to defraud the 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 defraud the 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 defraud the 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 defraud the 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 July 1, 1995, in order to misappropriate customers' U.S. 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 July 1, 1995, in order to misappropriate customers' U.S. Treasury bills worth of $377 in the branch.

21. Charge No. 21: Mail 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 July 1, 1995, in order to misappropriate customers' U.S. Treasury bills worth of $377 million in the bank.

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

Daiwa Bank and Iguchi mailed false balance sheets in custody to the trust division of Daiwa Bank on around July 1, 1995, in order to misappropriate customers' U.S. 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 following: (1) Commit fraud against the U.S. government (U.S. authorities could not effectively investigate the branch of foreign bank, or receive genuine periodical reports and other information relating to U.S. 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 agencies. (Daiwa Bank made 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 New York branch. (Daiwa Bank made or allowed to be made false entries of items in the account book, documents, or balance sheets in custody of the N.Y. branch, with intent to defraud the FRB and investigators, in violation of 18 U.S.C. § 1005.)

Furthermore, Daiwa Bank conspired with Iguchi, and released incomplete and misleading information concerning the separation between its U.S. Treasury bills business and custodian business in the New York branch to FRB on or 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 on or 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 U.S. 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 U.S. 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 intentionally misled or tried to mislead FRB's Investigators, by transferring the officer in charge of U.S. Treasury bills from its downtown office to its midtown office during the investigation of FRB in around November 1994.