aggravation of global environmental problems.

If the reliability of such non-financial information is important for an investment judgment and thus contributes to the purpose of the Financial Instruments and Exchange Act to enhance the reliability, transparency, and efficiency of markets by ensuring fair and smooth price making and other functions of the market, internal control regulations focusing only on financial reports must be described as one-sided. It will be shown that this is one of problems for the Japanese version of the SOX Act.

Corporate Scandals and Civil Liabilities of Directors: The Duty to Establish a Compliance System

Kengo MINAMI

This article deals with civil liabilities of directors involved in corporate scandals, with special focus on the directors' duty to establish a compliance system.

In general, directors of corporations have a duty to monitor their subordinates. However, directors of large corporations cannot physically monitor all subordinates at all times. In many cases, directors are not liable for unlawful acts by their subordinates, because they cannot reasonably be expected to be aware of them. Rather, what is required for directors to do is to establish and operate a corporate compliance system. In other words, directors may be liable if they do not establish a compliance system that prevents their subordinates from acting illegally. This has been a widely shared view among scholars as well as jurisprudence in the field of corporate law.

Despite this the wide recognition of the duty to establish a compliance system, in most cases, directors are found not liable for the failure to do so. The reason is that the director has discretion with regard to ways and means to establish a compliance system. That is to say, the content of the compliance system is the "business judgment" of directors. Thus, the opening question that this article focuses on is the relation between the "business judgment rule" and "duty to establish a compliance system".

This article also discusses the duty of directors to respond to illegal acts by their subordinates that have already occurred. How should they react afterward?

In the United States, especially in the state of Delaware, directors are waived from the duty to establish a compliance system in these circumstances. The Delaware Supreme Court, in Graham v. Allis-Chalmers in 1963 denied that that duty existed; nevertheless, scholars kept insisting that it did, as social and economic environments changed. Then, in 1996, the Delaware Chancery Court affirmed the duty in the Caremark case, in which the court found that the duty of boards of directors was to "exercise a good faith judgment that the corporation's information and reporting system [was] in concept and design adequate to assure the board that appropriate information [would] come to its attention in a timely manner as
a matter of ordinary operations, so that it [might] satisfy its responsibility” and that “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish a lack of good faith that is a necessary condition of liability.” However, the judgment was not clear about the meaning of the two phrases “a lack of good faith that is a necessary condition of liability” and “only a sustained or systematic failure of the board to exercise oversight.”

The meaning of “a lack of good faith” refers to the duty of good faith of directors. There had been a traditional assumption of good faith of directors in the context of the business judgment rule. After Smith v. VanGorkom, the legal concept of good faith of directors had been focused on. But, in Disney, the Delaware Supreme Court and Chancery Court determined a concept of duty of good faith of directors. The cases also formulated a concept of bad faith. Why does American corporate law emphasize the duty of good faith of directors? This is first because of Delaware General Corporate Law 102 (b) (7). Second, it is because of the many corporate scandals in the 21st century. Corporate-law scholars and judges have been willing to admit the existence of a liability for lack of good faith.

With regard to the meaning of “sustained or systemic failure,” a few judgments after Caremark have dealt with it. For example, Guttman v. Jen-Hsun Huang found that a sustained or systematic failure of the board to exercise oversight exists in cases where a corporation has no information-and-report system or audit committee in an accounting fraud case. More importantly, the Delaware Supreme Court in Stone v. Ritter determined “(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention”.

Therefore, in most American corporate law cases, directors of corporations are not liable for the duty to establish a compliance system, mainly because “the level of detail for any such system is a business judgment matter,” as was found in Caremark. Admittedly, in many Caremark-type cases, it is not literally clear in judgments whether or not the courts applied the business judgment rule. But, I think that this is related to the theoretical background of the business judgment rule.

Additionally, directors have a duty to response to “red flags” quickly and adequately, as is recognized in many case laws. Recently, McCall v. Scott and In re Abbott Laboratories Inc. focused on this duty. In those cases, the directors disregarded red flags, for example, the Qui Tam action, federal investigations and an investigation by the New York Times. For that reason, the directors’ motions to dismiss were denied in those cases.

My argument is that in terms of the duty to establish a compliance system in the US, directors have discretion. In addition, the function of a compliance system is improved not only by directors' civil liabilities, but by other means, for example, the duty of disclosures to the market. At least, I affirm that Japanese judg-
ments about compliance systems have been unwilling to identify liability of directors. Finally, I stress the duty to respond to red flags.

Debt Equity Swap under Japanese Company Law

Takahiro Matsushima

1 Introduction
Debt Equity Swap (hereafter DES) is a loan workout scheme where the relevant participating creditors (often only financial creditors) receive equity interests in a capital restructuring in exchange for debt claims against the company. For a DES, the Company Act 2005 (hereafter CA) provides for the regulation of contribution in kind; when a stock company solicits persons to subscribe to shares, relinquishing a money claim (limited to claims that have already fallen due) on the stock company can be the “properties contributed in kind” (Article 207 (9) (v) of the CA).

In the case of a DES, the most controversial issue is how to assess the money claim in terms of face value and fair market value. In a corporate rescue situation, the latter must be far below the former.

2 The face value and the fair market value theories
There are two theories here—the face value theory and the fair market value theory. The face value theory emphasizes the following two points:

(1) The value of money claims that have already fallen due should be equal to their face value.
(2) Through face value (as opposed to fair market value), corporate debt can be immediately converted to equity, so it is a short cut to cost-effective and speedy corporate restructuring DES.

The fair market value theorists criticize the face value theory saying that it unnecessarily dilutes the equity of existing shareholders.

3 Recent Trends in Practice
In 2001, the Tokyo District Court stated that the court shall apply the face value theory in a DES in accordance with the former Commercial Code (which was replaced by CA). Its statement affected DES in practice, making the face value theory in DES the mainstream in Japanese corporate rescues. Some regard Article 207 (9) (v) of CA as the legalization of the face value theory.

However, there is another stream under the CA. On 28 April 2009, the Tokyo District Court adopted the fair market value theory under the Corporation Tax Act despite the face value theory legalized by the CA. Since then, the fair market value theory has undergone a revival in Japanese DES practice.

4 The Range of Validity of the Face Value Theory in the CA
The aim of this presentation is to mark the validity range of the face value theory in the CA. In my view, the following two points matter.

First, recent trends in the Bankruptcy Law must be considered. Since the estab-