ESG, Externalities, and the Limits of the Business Judgment Rule: TEPCO Derivative Suit on Fukushima Nuclear Accident and the Expansion of Caremark

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Abstract

The recent focus on ESG has led to extensive discussions about whether directors of stock corporations are permitted to take stakeholders' interests into consideration when making business decisions. Many different views have been presented to date, but it might not be so wrong to say that they tend to answer the above question positively in some way or another. The focus of recent discussions is shifting to another related question, whether such directors are obliged to take stakeholders' interests into consideration beyond the requirements of laws and regulations and should be held liable against their corporations for failure to do so. Unlike the previous question, there are two opposing approaches to this question. On the one hand, there is a traditional approach that denies such obligation and liability of directors emphasizing that directors owe their responsibility to the company and its shareholders, and that they are granted wide discretion in deciding how to improve the firm value. On the other hand, there are new developments in case law in Japan and the United States that limit the discretion of directors to a certain extent. In Japan, Tokyo District Court held in a shareholders' derivative suit concerning the meltdown of Fukushima 1st Nuclear Power Plant that former directors of Tokyo Electric Power Company were in breach of their duty of care for not taking preventive measures against the occurrence of a huge tsunami and ordered the defendants to pay 13.3 trillion Japanese Yen. Also in the United States, courts in the state of Delaware are recently expanding the scope of the so-called Caremark duty of oversight, denying motions to dismiss by directors in cases where there was no specific violations of laws or regulations. This expansion of the duty of oversight in Japan and the United States might be welcomed by some as a step toward a more sustainable society, it must be noted that the expansion of the duty of oversight may collide with the business judgment rule, which is arguably one of the fundamental principles of corporate law essential to incentivize optimal risk-taking, maximize corporate value, and promote economic growth. The combined impact of limiting the business judgment rule, with the imposition of an unimaginable quantum of personal liability which is exempt from D&O liability insurance, is likely to have a significant chilling effect on risk-taking by directors. From this perspective, the TEPCO Decision may discourage directors from engaging in an optimal level of risk-taking, which would be detrimental to corporations, their shareholders, and the economy. To avoid such a chilling effect, this article seeks to clarify when and why the business judgment rule should be limited when corporations are involved in businesses which may produce large negative externalities. The article analyzes the Tokyo District Court decision on the TEPCO derivative suit and recent discussions regarding the expansion of the Caremark duty of oversight. It analyzes multiple perspectives supporting the expansion of the duty of oversight to illuminate possible justifications for the expansion and depicts how the differences in these perspectives affect their scope of application. Ultimately, the article suggests that a directors' duty of oversight is highly contextual and is contingent on the types and the nature of the risks and externalities in question. "ESG" is a broad concept encompassing variety of issues, ranging from climate change to local environmental pollution, and from human rights in supply chains to consumer protection from company's products. As such, to avoid the deleterious consequences of an over-expansion of the duty of oversight, while still addressing the need to mitigate serious negative externalities, the concept of "ESG" must be unpacked to ensure that it is applied appropriately based on the specific characteristics of the externality in question.

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Abstract

The recent focus on ESG has led to extensive discussions about whether directors of stock corporations are permitted to take stakeholders' interests into consideration when making business decisions. Many different views have been presented to date, but it might not be so wrong to say that they tend to answer the above question positively in some way or another.

The focus of recent discussions is shifting to another related question, whether such directors are obliged to take stakeholders' interests into consideration beyond the requirements of laws and regulations and should be held liable against their corporations for failure to do so. Unlike the previous question, there are two opposing approaches to this question. On the one hand, there is a traditional approach that denies such obligation and liability of directors emphasizing that directors owe their responsibility to the company and its shareholders, and that they are granted wide discretion in deciding how to improve the firm value.

On the other hand, there are new developments in case law in Japan and the United States that limit the discretion of directors to a certain extent. In Japan, Tokyo District Court held in a shareholders' derivative suit concerning the meltdown of Fukushima 1st Nuclear Power Plant that former directors of Tokyo Electric Power Company were in breach of their duty of care for not taking preventive measures against the occurrence of a huge tsunami and ordered the defendants to pay 13.3 trillion Japanese Yen. Also in the United States, courts in the state of Delaware are recently expanding the scope of the so-called Caremark *duty of oversight, denying motions to dismiss by directors in cases where there was no specific violations of laws or regulations.*

This expansion of the duty of oversight in Japan and the United States might be welcomed by some as a step toward a more sustainable society, it must be noted that the expansion of the duty of oversight may collide with the business judgment rule, which is arguably one of the fundamental principles of corporate law essential to incentivize optimal risk-taking, maximize corporate value, and promote economic growth.

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The author would like to thank Anna Christie, Kyung-Hoon Chun, Paul Davies, Geneviève Helleringer, Jennifer Hill, Sang Yop Kang, Alan Koh, Thilo Kuntz, Luh Luh Lan, Ernest Lim, Lin Lin, Roza Nurgozhayeva, Kenichi Osugi, Dan Puchniak, Georg Ringe, Zennichi Shishido, Kristin van Zwieten, Umakanth Varottil, Thom Wetzer, and the participants of the 13th SNU-UT Corporate Law Workshop (August 22, 2022), the Commercial Law Workshop (December 23, 2022), 2023 The Next Corporate Governance Conference (September 22, 2023), the 2nd ASLI Distinguished Lecture (February 28, 2024), Oxford Business Law Workshop (March 6, 2024), and the Inaugural Asian Corporate Law Forum (April 12-13, 2024) for their valuable feedback and comments on earlier drafts of this article. Financial support from JSPS Grant-in-Aid for Scientific Research Numbers 20H01436 and 23H00033 is also gratefully acknowledged.

The combined impact of limiting the business judgment rule, with the imposition of an unimaginable quantum of personal liability which is exempt from D&O liability insurance, is likely to have a significant chilling effect on risk-taking by directors. From this perspective, the TEPCO Decision may discourage directors from engaging in an optimal level of risk-taking, which would be detrimental to corporations, their shareholders, and the economy.

To avoid such a chilling effect, this article seeks to clarify when and why the business judgment rule should be limited when corporations are involved in businesses which may produce large negative externalities. The article analyzes the Tokyo District Court decision on the TEPCO derivative suit and recent discussions regarding the expansion of the Caremark duty of oversight. It analyzes multiple perspectives supporting the expansion of the duty of oversight to illuminate possible justifications for the expansion and depicts how the differences in these perspectives affect their scope of application.

Ultimately, the article suggests that a directors' duty of oversight is highly contextual and is contingent on the types and the nature of the risks and externalities in question. "ESG" is a broad concept encompassing variety of issues, ranging from climate change to local environmental pollution, and from human rights in supply chains to consumer protection from company's products. As such, to avoid the deleterious consequences of an over-expansion of the duty of oversight, while still addressing the need to mitigate serious negative externalities, the concept of "ESG" must be unpacked to ensure that it is applied appropriately based on the specific characteristics of the externality in question.

Introduction

The recent focus on ESG, sustainability, and corporate purpose has led to extensive discussions about whether directors of stock corporations are permitted to take stakeholders' interests into consideration when making business decisions. Many different views have been presented to date, but it might not be so wrong to say that they tend to answer the above question positively, permitting directors to do so in some way or another. While there is a theoretical difference between those who permit such consideration as long as it advances the interests of the corporation and its shareholders[1] and those arguing that it should be permitted even when it does

[1] This is the enlightened shareholder value approach, embodied by Article 172 of the UK 2006 Companies Act and the Business Roundtable's 2019 Statement on the Purpose of a Corporation (available at https://opportunity.businessroundtable.org/opportunity-commitment). See also, Alex Edmans, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit* (Cambridge University Press, 2020) and Edward Rock, 'For Whom Is the Corporation Managed in 2020? The Debate over Corporate Purpose', *Business Lawyer*, Vol.76, p.363 (2021) at p.385.
For a critical analysis of this approach, see Lucian A. Bebchuk & Roberto Tallarita, 'The Illusory Promise of Stakeholder Governance', *Cornell Law Review*, Vol.106, no.1, p.91 (2020) at p.108-114 and Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita, 'Does Enlightened Shareholder Value Add Value?', *Business Lawyer*, Vol.77, No.3, p.731 (2022).

not advance such interests if that is supported by the majority of the shareholders[2] or if that advances the public interest[3], there may not be a large difference in reality as directors are granted wide discretion on how to promote the value of the corporation and their decisions will be respected by courts under the business judgment rule.[4]

The focus of discussions seems to be shifting to another related question, which has been relatively understudied. That is, whether directors are obliged to take stakeholders' interests into consideration beyond the requirements of laws and regulations and should be held liable against their corporations for failure to do so. Unlike the previous question, there are two opposing approaches to this question.

On the one hand, there is a traditional approach that denies such obligation and liability of directors emphasizing that directors owe their responsibility to the company and its shareholders, not to the general public, and that they are granted wide discretion in deciding how to improve the firm value[5]. The UK High Court and Singapore High Court recently took this approach[6].

On the other hand, there are new case-law developments in Japan and the United States that limit the discretion of directors to a certain extent. In Japan, Tokyo District Court held in a shareholders' derivative suit concerning the meltdown of Fukushima 1st Nuclear Power Plant following the Eastern Japan earthquake on March 11th, 2011 that former directors of Tokyo Electric Power Company (TEPCO) were in breach of their duty of care for disregarding a report

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[2] Oliver Hart & Luigi Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value', *Journal of Law, Finance, and Accounting*, Vol.2, No.2, p.247 (2017). See also, Oliver Hart & Luigi Zingales, 'The New Corporate Governance', *The University of Chicago Business Law Review*, Vol.1, No.1, p.195 (2022). For a critical analysis of this approach, see Robert P. Bartlett & Ryan Bubb, *Corporate Social Responsibility through Shareholder Governance* (ECGI Law Working Paper No.682/2023, available at https://ssrn.com/abstract=4354220).

[3] Einer Elhauge, 'Sacrificing Corporate Profits in the Public Interest', *New York University Law Review*, Vol.80, No.3, p.733 (2005).

[4] Holger Spamann & Jacob Fisher, *Corporate Purpose: Theoretical and Empirical Foundations/Confusions* (ECGI Law Working Paper No. 664/2022, available at https://ssrn.com/abstract=4269517), at p.11. But see Brent Horton, 'The "Significant Social Policy Issue" Exception to the Business Judgment Rule', *Seton Hall Law Review*, Vol.52, No.1, p.59 (2021) (proposing to apply the enhanced scrutiny test for board decisions that implicate significant social policy issues) and Thiago Spercel, *The Business Judgment Rule in Stakeholder Capitalism* (2024, available at https://ssrn.com/abstract=4765350) (proposing procedural limitations to the application of the business judgment rule to stakeholder-friendly managerial decisions to respond to the risk that managers are motivated by personal beliefs or reputational benefits).

[5] See Stephen M. Bainbridge, 'Don't Compound the *Caremark* Mistake by Extending It to ESG Oversight', *Business Lawyer*, Vol.77, No.3, p.651 (2022); Luh Luh Lan & Walter Wan, 'ESG and director's duties: defining and advancing the interests of the company', *Journal of Corporate Law Studies*, Vol.23, No.2, p.537 (2023).

[6] *ClientEarth v. Shell Plc, et al.* [2023] EWHC 1897 (Ch) and *Serene Tiong Sze Yin v. HC Surgical Specialists Ltd, et al.* [2020] SGHC 201. For details of these cases, see Lan & Wan, *supra* note 5 at p.550-552.

by a scientific government council noting the possibility that a huge tsunami may occur at some point that would impact the power plant and not taking appropriate preventive measures against it. As a result of the breach, the court ordered the defendants to pay a striking amount of 13.321 trillion Japanese Yen (approximately 85 billion US Dollars as of May 26, 2024) for damages caused to the company[7]. In the United States, courts in the state of Delaware are recently expanding the scope of the so-called *Caremark* duty of oversight, denying motions to dismiss by directors in cases where there was no violation of laws or regulations[8].

This expansion of the duty of oversight in Japan and the United States might be welcomed by some as a step toward a more sustainable society. In particular, when an action by a corporation entails enormous externalities like in the case of the Fukushima Nuclear Power Plant incident, how directors consider the risk in question could be crucial to the interests of stakeholders and society.

It must be noted, however, that the expansion of the duty of oversight may collide with the business judgment rule.[9] The business judgment rule is arguably one of the fundamental principles of corporate law essential to incentivize optimal risk-taking, maximize corporate value, and promote economic growth. The combined impact of limiting the business judgment rule, with the imposition of an unimaginable quantum of personal liability which is exempt from D&O liability insurance, is likely to have a significant chilling effect on risk-taking by directors. From this perspective, the TEPCO Decision may discourage directors from engaging in an optimal level of risk-taking, which would be detrimental to corporations, their shareholders, and the economy.

To avoid such a chilling effect, this article seeks to clarify when and why the business judgment rule should be limited when corporations are involved in businesses which may produce large negative externalities. The working paper analyzes the TEPCO Decision and recent discussions regarding the expansion of the Caremark duty of oversight. It analyzes multiple perspectives supporting the expansion of the duty of oversight to illuminate possible justifications for the expansion and depicts how the differences in these perspectives affect their scope of application.

Ultimately, this article suggests that the directors' duty of oversight is highly contextual

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[7] Tokyo District Court, July 13, 2022, *Hanrei Jiho* [Case Law Reporter], Vol.2580=2581, p.5.

[8] *Marchand v. Barnhill et al.*, 212 A.3d 805 (Del. 2019) and *In re Boeing Company Derivative Litigation*, 2021 WL 4059934 (Del. Ch. 2021). For the development of Delaware case law on the expansion of the *Caremark* duty, see Roy Shapira, 'Mission Critical ESG and the Scope of Director Oversight Duties', *Columbia Business Law Review*, Vol.2022, No.2, p.732 (2022) at p.744-756.

[9] In this article, the term "business judgment rule" is used NOT as a US-specific concept but rather as a generic one, referring to the idea that courts should defer to decisions made by disinterested and informed directors and should not second-guess the substantive merits of such decisions. See Part I, A.

and is contingent on the type and the nature of the risks and externalities in question. It is well-known that "ESG" is a broad concept encompassing various issues, ranging from climate change to local environmental pollution, and from human rights in supply chains to consumer protection from company's products. Directors might owe the duty of oversight for some ESG issues but not for others. As such, to avoid the deleterious consequences of an over-expansion of the duty of oversight, while still addressing the need to mitigate serious negative externalities, the concept of "ESG" must be unpacked to ensure that it is applied appropriately based on the specific characteristics of the externality in question.

The remainder of this article proceeds in three parts.[10] Part I will start by summarizing the rationales of the business judgment rule and then explain how the rule's well-known limits, namely violation of laws and regulations and conflict of interests, can be justified from such rationales. Part II takes up the Tokyo District Court's decision on the TEPCO case and analyzes the decision's unclear logic. Part III focuses on multiple perspectives supporting the expansion of the duty of oversight to illuminate possible justifications for the expansion and depicts how the differences in these perspectives affect their scope of application. Part IV is a short conclusion.

I. The business judgment rule, its rationales, and limits

A. The business judgment rule

The business judgment rule is a rule originally developed by state courts in the United States, directing that courts should not second-guess business decisions made in good faith by financially disinterested and duly informed directors who rationally believed that such decisions were in the best interest of the corporation[11]. It should be emphasized, however, that the idea that courts should defer to decisions made by disinterested and informed directors is recognized in many jurisdictions outside of the United States, although with varying formulations and scopes[12].

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[10] The author has published a Japanese version of this article with more focus on the implications to the discussions in Japan. Gen Goto, 'Torishimariyaku no gimu, keieihandan gensoku, soshite sutekuhoruda no reiki – Tokyo denryoku kabunushi daihyososho dai-isshin hanketsu ga teikisuru mondai – [Duty of Directors, the Business Judgment Rule, and the Interests of Stakeholders: Issues Posed by the District Court Decision on TEPCO Shareholders' Derivative Suit]', in Hideyuki Matsui et al. (eds.), *Shohogaku no saikochiku – Iwahara Shinsaku sensei, Yamashita Tomonobu sensei, Kanda Hideki sensei koki kinen* [Reconstructing Commercial Law Jurisprudence: Festschrift in Celebration of the 70th Birthday of Professor Shinsaku Iwahara, Professor Tomonobu Yamashita, and Professor Hideki Kanda] (Yuhikaku, 2023), p.183.

[11] William T. Allen & Reinier Kraakman, *Commentaries and Cases on the Law of Business Organization, 5th ed.* (Wolters Kluwer, 2016), at p.240, 243, American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (1994), §4.01(c).

[12] Reinier Kraakman et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach, 3rd ed.* (Oxford University Press, 2017), at p.69-70; Andreas Cahn & David C. Donald, *Comparative Company Law: Texts and Cases on the Laws Governing Corporations in Germany, the UK and the USA, 2nd ed.* (Cambridge University Press, 2018), at p.445, p.447-448. Even in the United Kingdom and the Commonwealth jurisdictions where it is often said that the US-style

For example, the Supreme Court of Japan has held in the *Apamanshop* case that directors should not be deemed to have violated their duty of care "so long as there are no significantly unreasonable aspects in the process and the substance of their decisions"[13]. This wording shows that, unlike courts in the United States, Japanese courts will review not only the procedural aspects of the decision but also its substantive merits[14]. This peculiarity of the Japanese-style business judgment rule should not be overstated, however, as the intention of the Supreme Court, which reversed the decision of the second instance court that held the directors liable by applying a stricter "reasonableness" standard for procedural aspects, seems to be in restraining the tendency of lower courts to intervene for unreasonableness of either the procedure or the merits of the decision in question.[15]

In the remainder of this article, the term "business judgment rule" will be used as a generic one to cover not only that in the United States but also similar rules in other jurisdictions. This means that the following description of the rationales and the limits of the "business judgment rule" will be a functional one and does not focus on specific formulations or terms adopted in a particular jurisdiction.

B. The rationales of the business judgment rule

So why is the business judgment rule necessary? While shareholders of listed corporations with fully diversified portfolios would be neutral to risks at the level of each investee corporation, directors tend to be risk averse as their human capital cannot be fully diversified[16]. At the same time, directors making a business decision have a wide range of options in front of them and there are no clear correct or wrong choices from an ex-ante point of view.[17] However, judges may not be fully aware of such a situation as they lack expertise in business and could be subject to hindsight bias to condemn directors for decisions that resulted in a loss[18]. This will have a chilling effect on risk-averse directors who would overvalue the risk of being held liable by such judges and prefer options that have a lower risk but lower return to decrease the possibility of the

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business judgment rule does not exist, courts do show deference to the decisions made by directors. See *ClientEarth v. Shell*, supra note 6 at para.28 and 30-32, *Tiong v. HC Surgical*, supra note 6 at para.61, and Lan & Wan, *supra* note 5 at p.552.

[13] The Supreme Court of Japan, July 15, 2010, *Hanrei Jiho* [Case Law Reporter], No.2091, p.90. For details of this case, see Dan W. Puchniak & Masafumi Nakahigashi, *A New Era for the Business Judgment Rule in Japan? Domestic and Comparative Lessons from the Apamanshop Case* (2012, available at https://ssrn.com/abstract=2257827).

[14] Puchniak & Nakahigashi, *supra* note 13 at p.9, p.11.

[15] Wataru Tanaka, 'Case note on the Supreme Court of Japan, July 15, 2010', *Jurisuto* [Jurist], No.1442, p.101, at p.103-104.

[16] Stephen M. Bainbridge, *Corporate Law, 4th ed*. (Foundation Press, 2020), p.135-136.

[17] Bainbridge, *supra* note 16 at p.136.

[18] Bainbridge, *supra* note 16 at p.136-137.

occurrence of loss.

The business judgment rule comes into play here to align the risk preference of directors to that of shareholders and to encourage optimal risk-taking by eliminating the above concern of directors[19].

C. The widely accepted limits of the business judgment rule

Of course, the business judgment rule is not without exceptions. It is widely accepted that the business judgment rule is not applicable when the interest of the director conflicts with that of the corporation with regard to the decision or conduct in question.[20] Also, a decision or conduct constituting a violation of law or regulation, even when it was intended to benefit the corporation, would not be protected by the business judgment rule.[21]

From a functional point of view, these two limits can be explained as cases where the above rationale of the business judgment rule does not apply. First, unlike general business decisions that have no clear correct or wrong choices from an ex-ante point of view, the codes of conduct in these cases are arguably clear enough for directors. Directors should not violate laws and regulations, nor should they prioritize their own or third party's interests above that of the corporation. Assuming that judges are relatively good at deciding whether a certain action is illegal or there is a conflict of interests, directors may not need to fear being mistakenly held liable for these reasons.[22]

Second, while optimal risk-taking is something to be encouraged for the sake of both shareholders and society, it is clearly unnecessary and undesirable to promote violations of laws and regulations or to let directors pursue their own interests at the cost of the corporation's interest.

The next part will analyze the Tokyo District Court's decision in the TEPCO shareholders' derivative suit to see whether its exclusion of the business judgment rule can be explained similarly to the above. Although it is likely unnecessary and undesirable to promote an occurrence of accidents causing massive damage to society, it might be still unclear to directors,

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[19] Bainbridge, *supra* note 16 at p.137-138.
[20] Bainbridge, *supra* note 16 at p.141-142, American Law Institute, supra note 11, Comment *d* to §4.01(c). See also Wataru Tanaka, *Kaishaho (Dai 4-han)* [Corporate Law, 4th ed.] (Tokyo Daigaku Shuppannkai [University of Tokyo Press], 2023), at p.285.
[21] Bainbridge, *supra* note 16 at p.142-143, American Law Institute, supra note 11, Comment *d* to §4.01(a), first paragraph. See also American Law Institute, *The Restatement of Law: Corporate Governance* (Tentative Draft No.1, 2022), §4.02, Comment *o* and Reporter's Notes 17.
[22] Admittedly, there are cases where it is not completely clear whether a certain action is illegal or not and directors cannot obtain definitive legal advice. Allen & Kraakman, *supra* note 11 at p.280. One way to avoid chilling effects in such cases is to exclude the application of the business judgment only when directors are aware of or grossly negligent about the violation of law or regulation. Bainbridge, *supra* note 16 at p.144.

how they should act when the business of the corporation involves an enormous externality.[23]

II. In re *TEPCO* Shareholders' Derivative Suit

A. Shareholders' derivative suits and directors' duties and liability under Japanese law

Before going into the details of the Tokyo District Court's decision, a brief look at some of the characteristics of Japanese corporate law on shareholders' derivative suits and directors' duties and liability would be beneficial.

1. Shareholders' derivative suits

Shareholders of Japanese listed corporations face fewer restrictions in filing derivative suits compared to those in other jurisdictions.[24] First, while the scope is limited to the claims listed exhaustively by the statute, such as the liability of directors against the corporation for breach of their duties,[25] the only standing requirement for a plaintiff is the consecutive holding of at least one share for the preceding six months or more.[26] Since there is no requirement that the plaintiff must be a shareholder at the time of the alleged action by the defendant, it is possible to purchase a share after noticing wrongdoing by a director and to raise a derivative suit six months thereafter.

Second, unlike the United States, there is no requirement that a plaintiff of a derivative suit must "fairly and adequately represent the interests of shareholders … who are similarly situated in enforcing the right of the corporation…".[27] While a derivative suit could be dismissed if the plaintiff's purpose is to seek unlawful gains or inflict damage on the corporation,[28] the suit will not be dismissed just because a person acting to promote the success of the company for the benefit of its members as a whole would not seek to continue it.[29]

Third, although a shareholder seeking to file a derivative suit against a director must demand that the corporation sue the director in the first place, the shareholder can bring a suit herself if the corporation does not sue the director within 60 days of that demand.[30] There is no need to establish that there was a wrongful refusal or that making the demand was futile. Also, unlike Delaware,[31] courts cannot dismiss a derivative suit by referring to a decision of the special

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23 See Bainbridge, *supra* note 5 at 668.
24 For a more detailed description of Japanese law on derivative suits, see Gen Goto, 'Legally "Strong" Shareholders of Japan', *Michigan Journal of Private Equity & Venture Capital Law*, Vol.3, no.2, p.125, at p.138-139 (2014).
25 Japanese Companies Act [*Kaisha-ho*], Law No.86 of *Heisei* 17 (2005), Art.847(1).
26 Japanese Companies Act, Art.847(1).
27 Cf. US Federal Rules of Civil Procedure, Rule 23.1(a).
28 Japanese Companies Act, Art.847(1) proviso.
29 Cf. UK Companies Act, Art.263(2)(a). See also Singapore Companies Act, Art.216A(3)(c).
30 Japanese Companies Act, Art.847(1)(3).
31 *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

litigation committee of the corporation.

Due to the above characteristics of Japanese corporate law, not a small number of derivative suits have been filed in Japan till today by NGOs or groups of citizens pursuing social or political agendas to denounce corporate scandals and punish wrongdoers.[32] While some courts in other jurisdictions do not entertain derivative suits filed by shareholders with the above characteristics,[33] the stance of Japanese courts toward such shareholders seems to be more neutral.

2. Directors' duties and liabilities

Under the Japanese Companies Act, a director of a stock corporation owes the corporation the duty of care,[34] the duty of loyalty,[35] and the duty to comply with laws and regulations.[36] The duty of oversight and the duty to set up an effective internal control system are regarded as a part of the duty of care.[37] The duty of good faith is not recognized as a separate duty in Japan.

With regard to the distinction between the duties of care and loyalty, the Supreme Court of Japan once described the duty of loyalty as a mere elaboration of the duty of care as there is no difference in the burden of proof concerning the allegations of breaches of these two duties.[38] It must be noted, however, that the business judgment rule was not recognized at all in Japan at the time of this decision. While courts still tend to bundle the duty of care and the duty of loyalty following the Supreme Court, it is also generally accepted that he business judgment rule deals should not be applied to situations where there is a conflict of interests between directors and the corporation.[39]

Under the Japanese Companies Act, a director is liable for damages suffered by the corporation caused by a breach of the above duties unless he or she proves that he or she has not been intentional or negligent.[40] In other words, simple negligence suffices to hold a director liable, whether it is a breach of the duty of care, loyalty, or to comply with laws and regulations. It is

[32] Dan W. Puchniak and Masafumi Nakahigashi, 'Japan's Love for Derivative Actions: Irrational Behavior and Non-economic Motives as Rational Explanations for Shareholder Litigation', *Vanderbilt Journal of Transnational Law*, Vol.45, No.1, p.1 (2012).
[33] See for example, the UK High Court in *ClientEarth v. Shell*, supra note 6 at para.92-93 and Singapore High Court in *Tiong v. HC Surgical*, supra note 6 at para.73-77.
[34] Japanese Companies Act, Art.330, Japanese Civil Code [*Min-po*], Law No.89 of *Meiji* 29 [1896], Art.644.
[35] Japanese Companies Act, Art.355.
[36] Japanese Companies Act, Art.355.
[37] Kenjiro Egashira, *Kabushikigaishaho (Dai 9-han)* [Laws of Stock Corporations, 9th ed.] (Yuhikaku, 2024), at p.502.
[38] Supreme Court of Japan, June 24, 1970, *Saikosaibansho Minji Hanreishu* [Supreme Court Reporter on Civil Cases], Vol.24, No.6, p.625.
[39] See Tanaka, *supra* note 20 at p.279.
[40] Japanese Companies Act, Art.423(1), Art.428(1) and Japanese Civil Code, Art.415(1).

also worth noting that the Japanese Companies Act does not have a provision similar to Section 102(b)(7) of the Delaware General Corporation Law that permits corporations to exculpate their directors from liability for a breach of the duty of care. Consequently, it is not so difficult to find in Japan cases in which directors were ordered to compensate the corporation for the damages caused by breaches of their duties.[41]

B. The Tokyo District Court decision

1. Overview

Now, let us turn to the Tokyo District Court decision on the TEPCO derivative suit.[42]

On March 11, 2011, an enormous tsunami caused by the Eastern Japan Great Earthquake struck the east coast of Honshu, one of the four main islands of Japan, where the Fukushima 1st Nuclear Power Plant of TEPCO was located. The tsunami went over the seawalls and flooded the vital facilities of the power plant, causing the loss of electricity necessary for cooling nuclear reactors. This resulted in the meltdown of the reactors and the emission of radioactive materials on a massive scale.

A group of TEPCO's shareholders filed a derivative suit against five former directors, who were at the time of the incident the chairman of the board of directors, the president, and the directors in charge of the nuclear power branch, for damages suffered by TEPCO because of the Fukushima incident. The plaintiffs consisted mostly of members of a citizen's group that had been engaging in anti-nuclear power shareholder activism against TEPCO for a long time.[43] TEPCO joined the suit to assist the defendants.

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[41] For cases in which directors were held liable for breach of the duty of care including the duty of oversight, see for example, Osaka District Court, September 20, 2000, *Hanrei Jiho* [Case Law Reporter], No.1721, p.3 (inadequate internal control system); Tokyo High Court, May 21, 2008, *Hanrei Times* [Case Law Times], No.1281, p.274 (loss from derivative transactions made in violation of internal regulation of the corporation); Nagoya High Court, October 27, 2016, *Kinyu Shoji Hanrei* [Financial and Commercial Law Cases], No.1526, p.53 (failure to implement measures to prevent unauthorized lending). Also, while "shareholder suits successfully holding directors liable for breaking the law are extremely rare" in the United States (Elizabeth Pollman, 'Corporate Oversight and Disobedience', *Vanderbilt Law Review*, Vol.72, No.6, p.2013 (2019), at p.2016), directors in Japan are held liable for violations of law or regulation. See, for example, Tokyo District Court, Dec. 22, 1994, *Hanrei Jiho* [Case Law Reporter], No.1518, p.3 (bribery); Osaka High Court, Jan. 18, 2007, *Hanrei Jiho* [Case Law Reporter], No.1973, p.135 (failure to respond appropriately to a violation of the Food Sanitation Act); Tokyo District Court, Sep. 25, 2014, *Siryoban Shoji Homu* [Commercial Law Review: Materials] (illegal donation to a political party).

[42] Tokyo District Court, July 13, 2022, *Hanrei Jiho* [Case Law Reporter], No.2580=2581, p.5. In this article, this decision is cited not by the pages of the above case reporter but by those of the original decision that is available at the following website of the plaintiffs. http://tepcodaihyososho.blog.fc2.com/blog-entry-403.html (last visited May 26, 2024).

[43] As described earlier, the Japanese Companies Act does not consider it problematic even if the plaintiff of a derivative suit has a goal not shared by the corporation and other shareholders. See *supra* notes 32-33 and accompanying texts.

The 8th Civil Division of the Tokyo District Court, which is sometimes assimilated to the Chancery Court of Delaware for its expertise on corporate law issues, held that four of the five defendants had breached their duty of care for not taking appropriate preventive measures against the occurrence of a huge tsunami (TEPCO decision). A primary basis for the TEPCO decision was that the directors disregarded a report by a scientific government council noting its possibility. As a result of the breach, the court ordered the four directors to jointly pay TEPCO 13.321 trillion Japanese Yen (approximately 85 billion US Dollars as of May 26, 2024) as damages caused by the breach,[44] which consisted of the amount that had been actually paid out by TEPCO as compensation to the inhabitants of the surrounding area who were forced to evacuate, the cost for decontamination of the area, and the cost to decommission the reactors.

Both the plaintiffs and the defendants have appealed to Tokyo High Court, where the case is still proceeding as of May 26, 2024.

2. Tokyo District Court's logic on the duty of directors

The logic of Tokyo District Court is largely twofold. The first logic starts by emphasizing the duty of TEPCO to the public as follows:

> "Operators of nuclear power plants (NPP) have a duty to society and the general public to prevent a severe incident (i.e. meltdown causing massive emission of radioactive substance) by any chance based on current scientific knowledge..."[45]
>
> It is evident that the relevant regulations regarding NPP and the Nuclear Damage Compensation Act imposing strict liability for damages caused by the operation of NPP on its operators "are based on the premise as a matter of course that operators of NPP bear the primary responsibility to secure its safety."[46]
>
> "Therefore, when there is a risk of a severe incident caused by a tsunami that can be predicted based on current scientific knowledge, a company operating an NPP clearly owes a duty to the neighbors of the NPP and those who could suffer damage to their life, body, and property to take necessary measures to prevent such an incident, and its directors owe a duty of care to the company to order such measures."

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44 One of the major issues in this case was the causation between the alleged breach of duty by the directors and the damages of TEPCO. Tokyo District Court affirmed the causation, although the Supreme Court denied the causation just about a month before the decision of Tokyo District Court in a different suit against the Japanese government under the State Redress Act ([*Kokka-baisho-ho*], Law No.125 of *Showa* 22 (1947)), noting that it would have been not possible to prevent the meltdown by the preventive measures that could have been contemplated at the time by the defendants (Supreme Court of Japan, June 17, 2022, *Saikosaibansho Minji Hanreishu* [Supreme Court Reporter on Civil Cases], Vol.76, No.5, p.955). The issue of causation could be critical in the procedure at the appellate court, but it will not be further discussed in this article.

45 Tokyo District Court, *supra* note 42 at p.84.

46 Tokyo District Court, *supra* note 42 at p.84-85.

In contrast, the second logic seems to focus on the interest of TEPCO (and its shareholders) rather than that of the public:

> "Also, as the Nuclear Damage Compensation Act imposes strict liability for damages caused by NPP, a company operating an NPP would face an existential crisis by enormous liability once a severe incident occurs. Therefore, directors of the company owe a duty of care to the company to order measures necessary to prevent severe incidents by a tsunami that can be predicted based on current scientific knowledge so that the company would not bear such liability."[47]

Then, the court combines these two logics without paying attention to the difference in their orientations as follows:

> "From above, if the defendants who were directors of TEPCO had recognized or had been able to recognize the possibility of the occurrence of a severe incident at the Fukushima 1st Power Plant due to a huge tsunami that can be predicted by current scientific knowledge, but had failed to order taking measures necessary to avoid such an incident, such directors shall be deemed to have violated their duty of care against TEPCO regardless of whether such failure constitutes a violation of a particular law or regulation applicable to the corporation."[48]

The above twofold logic of the Tokyo District Court has several problems.

To begin with, the first logic seems to make a logical jump from the duty of TEPCO to the neighbors of NPP and the public, which would not be so debatable, to admitting the duty of the directors to TEPCO. How the latter duty can be derived from the former one in view of the business judgment rule is the question.

The second logic might seem easier to understand as it focuses on the interest of the corporation, but it still does not fully explain why such duty is necessary as shareholders with a diversified portfolio would be protected by limited liability even if the corporation becomes insolvent.

Moreover, the differing orientations of the two logics and the lack of explanation of their relation make it difficult to interpret the scope of the decision, although the court might have sought to increase the persuasiveness of the decision by discussing the duty of the directors from different aspects.

Above all, the final phrase of the last excerpt above ("regardless of whether such failure constitutes a violation of a particular law or regulation applicable to the corporation") suggests

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[47] Tokyo District Court, *supra* note 42 at p.85-86.
[48] Tokyo District Court, *supra* note 42 at p.86.

that Tokyo District Court went beyond the widely accepted limitation of the business judgment rule and excluded its application in the absence of a violation of laws and regulations because there was a risk of an enormous negative externality (i.e. meltdown by tsunami). As the above logic of Tokyo District Court does not provide a sufficiently clear justification for this exclusion, the following section seeks possible explanations.

C. Possible explanations

1. The peculiarity of the Japanese-style business judgment rule?

One possibility is that the *TEPCO* decision is just another example of the peculiarity of the Japanese-style business judgment rule that allows courts to review substantive merits of directors' decisions, although to a limited extent. While it is not easy to exclude this possibility completely, the author believes that this is unlikely as recent decisions by the Tokyo District Court after the Supreme Court's decision in the Apamanshop case tend to allow wide discretion to directors, moving closer to the business judgment rule in the United States.[49]

2. Violation of regulatory guidance?

The second possible explanation is that the part of the *TEPCO* decision excluding the application of the business judgment rule in the absence of a violation of laws and regulations is a mere dictum, as some findings of the court suggest that *TEPCO* did not respect regulatory guidance.

To understand this, let us take a deeper look at the "current scientific knowledge" that the directors of TEPCO received and how they responded. In 2002, the Earthquake Research Promotion Headquarters, a scientific council organized by the Japanese government, issued a report titled "the Long-Term Evaluation of Earthquakes off the Coast from Sanriku to Boso". According to this report, the likelihood of an earthquake causing a huge tsunami around Fukushima was around 6% within 30 years and was around 9% within 50 years.[50]

In 2008, employees of TEPCO reported to the director in charge of the nuclear power branch that according to their calculation based on the "Long-term Evaluation", the waves of a huge tsunami caused by an earthquake could be high enough to flood the vital facilities of the Fukushima 1st power plant necessary for cooling reactors and suggested that it was necessary to take measures such as the construction of seawalls.[51] The director, however, dismissed this

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[49] For example, see Tokyo District Court, October 8, 2015, *Hanrei Jiho* [Case Law Reporter], No.2295, p.124 (denied breach of duty of care for investment in a startup that eventually failed) and Tokyo District Court, March 1, 2018, *Kinyu Shoji Hanrei* [Financial and Commercial Law Cases], No.1544, p.35 (denied breach of duty of care for purchase of bonds that were not repaid).

[50] Tokyo District Court, *supra* note 42 at p.80-81, p.122-123.

[51] Tokyo District Court, *supra* note 42 at p.315-320.

proposal by downplaying the significance of the "Long-term Evaluation", arguing that its view was still scientifically disputed, and ordered to seek a second opinion from other scientists who were closer to TEPCO.[52] Tokyo District Court condemned this response, holding that the "Long-term Evaluation", as a product of a serious joint study by Japan's top scientists at a governmental council, was scientifically reliable enough to oblige TEPCO's directors to take necessary measures against possible tsunami unless it can be shown that the "Long-term Evaluation" was significantly unreasonable from a scientific point of view.[53]

Interestingly, the court noted that in 2006 the Japanese Nuclear Security Committee had issued guidance on the safety goals regarding nuclear reactors following those set by the International Atomic Energy Agency. According to this guidance, the permissible level of the likelihood of an occurrence of mass emission of radioactive materials is one out of one million per year.[54] The likelihood of an earthquake causing a huge tsunami around Fukushima reported by "the Long-term Evaluation", 6% within 30 years and 9% within 50 years, clearly exceed this threshold.[55] The court also noted that the Japanese Nuclear Safety Agency had revised its standard on the earthquake-proofness of nuclear power plants requiring to take very rare but possible earthquakes into consideration and specifically requested TEPCO and other nuclear power plant operators to consider the possibility of a huge tsunami exceeding its assumption.[56] The director who downplayed the significance of the "Long-term Evaluation" obviously did not respect this request.

These guidance, standards, and requests may be of a soft-law nature, rather than a hard law, but obviously nuclear power plant operators were expected to comply with them. Therefore, the court could have excluded the business judgment rule by analogy to violations of laws or regulations.[57] While this explanation is compatible with the widely accepted limitation of the business judgment rule, it contradicts the explicit wording of the court.

3. Inadequate response to risk information?

The third possible explanation is that the court decided to limit directors' discretion

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52 Tokyo District Court, *supra* note 42 at p.321-322.
53 Tokyo District Court, *supra* note 42 at p.309, p.356-358.
54 Tokyo District Court, *supra* note 42 at p.90-92.
55 Tokyo District Court, *supra* note 42 at p.310-311.
56 Tokyo District Court, *supra* note 42 at p.171-174.
57 Professor Kennichi Osugi argues that the duty of directors to comply with laws and regulations should be slightly expanded to include compliance with soft-law principles established or utilized by regulatory agencies and seeks to understand the *TEPCO* decision from this perspective. See Kennichi Osugi, 'Sofutoro to torishimariyaku no gimu – Tokyo denryoku kabunushi daihyo sosho jiken Tokyo chisai hanketsu wo sanko ni [Soft Law and Duty of Directors: Insights from Tokyo District Court's Decision on TEPCO Derivative Suit]', *Shoji Homu* [Commercial Law Review], No.2341 (2023), p.4 at p.6, p.21.

when a response to risk information is in question. Seen this way, the decision of the Tokyo District Court in the *TEPCO* derivative suit dovetails with recent developments in the Delaware courts expanding the Caremark duty of oversight beyond regulatory compliance.[58]

The question is whether and how this limitation of directors' discretion can be reconciled with the rationale and the limits of the business judgment rule. As described earlier, the business judgment rule aims to promote optimal risk-taking by risk-averse directors by eliminating the risk of directors being held liable ex-post by hindsight bias when it is unclear ex-ante how directors should act. The two widely accepted limits of the business judgment rule, namely conflict of interests and violations of laws or regulations, are cases where directors have clear codes of conduct and there is no need to promote the actions in question.

Then, was it clear enough to the directors of TEPCO how they should act when they received the information regarding the "Long-term Evaluation"? Don't directors have discretion on how to evaluate and respond to risk information? If so, why should it be limited in the case of TEPCO? The actual response taken by the directors of TEPCO may be nothing to be praised of, but isn't the decision of the Tokyo District Court a hindsight bias that the business judgment rule sought to avoid?

As the Tokyo District Court decision does not provide sufficient answers to these questions, the next part turns to the academic views supporting the expansion of the Caremark duty for a clue.

III. Analyzing the expansion of the *Caremark* duty through *TEPCO*

A. Divergence among the pro-*Caremark* expansion views

Since the seminal decision by the Delaware Supreme Court in *Marchand v. Barnhill*, the idea to expand the *Caremark* duty of oversight beyond legal risks to ESG risks is gradually getting traction.

As the twofold logic of the *TEPCO* decision, however, the views supporting the expansion of the *Caremark* duty are not uniform. There is a remarkable divergence in how they justify the limitation of the business judgment rule, which will affect the extent of the limitation and its clarity to directors.

The following analysis will also bring to light that the extent of directors' duty of oversight depends on the types and the nature of the risks and externalities in question. "ESG" is a broad concept encompassing various issues,[59] ranging from climate change to local

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[58] See *supra* note 8 and accompanying texts. Whether this phenomenon is a convergence of Japanese law and Delaware law on the business judgment rule or just a coincidence might be another interesting topic for comparative corporate law, which will not be explored in this article.

[59] Elizabeth Pollman, *The Making and Meaning of ESG* (ECGI Law Working Paper No.659/2022, available at https://ssrn.com/abstract=4219857), at p.29-31.

environmental pollution, or from human rights in supply chains to protection of consumers of the company's product. Directors might owe the duty of oversight for some ESG issues but not for others. For the discussion of the duty of directors, the concept of "ESG" should be unpacked to allow individualized analysis based on the characteristics of the externality in question.

1. Expanding the *Caremark* duty in the interest of the public and stakeholders

The views supporting the expansion of the *Caremark* duty can be divided into two groups by the grounds for the expansion.

The first group supports the expansion of the *Caremark* duty as it would promote the interest of the public or stakeholders. Most notably, former Chief Justice Leo Strine, Jr., who delivered the opinion of the court in *Marchand v. Barnhill*, unsurprisingly welcomes the development and argues that expanding the *Caremark* duty to cover ESG issues allows corporations to "meet the demand for improved corporate citizenship in a cost-effective manner that does not add undue burdens to their employees, top managers, or directors."[60] The range of issues intended by the former Chief Justice is very wide, from climate change to various environmental pollution, or from consumer safety or protection of personal data to stagnant wages and growing social inequality.[61]

Professor Elizabeth Pollman, who criticizes the pre-*Marchand* cases limiting *Caremark* duty to legal compliance and not expanding it to business risks,[62] also emphasizes that the role of directors' duties of obedience and oversight is to protect the interest of society and the public, not that of the corporation.[63] In this regard, Professor Thilo Kuntz also emphasizes, in a descriptive manner, that the growing number of ESG-related legislations and the voluntary commitment to ESG-related soft laws by corporations will strengthen the bite of directors' duties of compliance and oversight and consequently weaken the business judgment rule.[64]

Another possible explanation, not mentioned explicitly by any, is that directors should monitor and respond to a risk of massive externality to prevent losses to the victims whose tort

[60] Leo E. Strine, Jr., Kirby M. Smith, and Reilly S. Steel, '*Caremark* and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective *Caremark* and EESG Strategy', *Iowa Law Review*, Vol.106, No.4, p.1885 (2021), at p.1889. See also *ibid* at p.1905.

[61] Strine, Smith & Steel, *supra* note 60 at p.1902-1903, p.1905-1906.

[62] Pollman, *supra* note 41 at p.2035.

[63] Pollman, *supra* note 41 at p.2026-2030. See also Jennifer Arlen, *Evolution of Director Oversight Duties and Liability under* Caremark*: Using Enhanced Information-Acquisition Duties in the Public Interest* (ECGI Law Working Paper No.680/2023, available at https://ssrn.com/abstract_id=4202830).

[64] Thilo Kuntz, *ESG and the Weakening Business Judgement Rule* (2023, available at https://ssrn.com/abstract=4395003), at p.15, p.22, p.24, p.27-28.

claims would not be fully compensated once the corporation becomes bankrupt.[65] The range of risks covered by this explanation would be limited to those that would give rise to enormous liabilities driving the corporation insolvent.

2. Expanding *Caremark* duty in the interest of shareholders

The second group supporting the expansion of the *Caremark* duty consists of the views that try to explain the expansion from the traditional theory that directors owe their duty to the corporation and its shareholders. How they explain, however, is also diverse.

For example, Professor Roy Shapira argues that directors of a corporation must oversee the ESG risks that are "mission critical" to that particular corporation as inattention to such risks would cause the corporation reputational damage and make it difficult to attract talented employees, to access capital, and to broaden the customer base.[66] In other words, expanding the *Caremark* duty to cover "mission critical" ESG risks is "good for shareholders".[67] Similarly, Professors Stavros Gadinis and Amelia Miazad propose, from the viewpoint of shareholders' interest, to impose on directors a duty to gather ESG-related information from stakeholders to identify and manage downside risks beyond legal requirements.[68] These views by Shapira or Gadinis and Miazad overlaps with that of the second logic of the Tokyo District Court's decision[69] as they focus on the losses to the corporation.

In contrast, Professors John Armour and Jeffrey Gordon focus on the risk of loss for shareholders as diversified investors rather than individual corporations, arguing that the rationale of the business judgment rule does not apply to activities that create a risk of market-wide loss, such as lending by financial institutions as a bank failure may lead to a financial crisis.[70]

These different explanations, while they may not be mutually exclusive, have different scopes of application. Gadinis & Miazad do not seem to limit the scope of their proposal by types of ESG risks as they focus on the information-generating aspect of directors' duty and do not discuss specifically how ESG risks will affect the interest of the corporation and its shareholders.[71]

In contrast, the explanation by Armour and Gordon that requires the risk in question to have a systemic aspect has the most limited scope. Interestingly, emissions from a nuclear power

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65 The second logic of the *TEPCO* decision (supra note 47 and accompanying texts) refers to the possibility of TEPCO being burdened with enormous liability, but focuses on the interest of the corporation (and its shareholders), not that of the victims.

66 Shapira, *supra* note 8 at p.765-767.

67 Shapira, *supra* note 8 at p.788.

68 Stavros Gadinis & Amelia Miazad, 'Corporate Law and Social Risk', *Vanderbilt Law Review*, Vol.73, No.5, p.1401 (2020), at p.1410-1411, p.1458-1460, p.1465.

69 See *supra* note 47 and accompanying texts.

70 John Armour & Jeffrey N. Gordon, 'Systemic Harms and Shareholder Value', *Journal of Legal Analysis*, Vol.6, No.1, p.35 (2014) at p.50-56, p.67-68.

71 See Gadinis & Miazad, *supra* note 68 at p.1432-1434.

plant or a deep-sea oil well are mentioned as possible examples.[72] Armour and Gordon, however, differentiate these cases from bank failures as the costs of physical harms from accidents caused by these businesses could be internalized through tort liabilities,[73] and as the government would punish corporations causing such accidents rather than bailing them out.[74]

The explanation of Armour and Gordon might have a stronger bite on climate change, the issue at the forefront of ESG, as climate change is likely to cause a market-wide loss in the future. Whether a director would be actually held liable to the corporation for not decreasing carbon emission sufficiently is another question,[75] however, as the extent of the corporation's contribution to the materialization of a market-wide loss and to the damage suffered by that corporation is not so clear.[76]

Shapira also limits the scope of his argument but in a different manner. As Shapira focuses on the reputational effects of failing to address ESG risks, his proposal only covers ESG risks that are "mission critical" to the corporation in question. Whether a certain ESG risk is "mission critical" for a particular corporation depends on the nature of its business.[77] Clear examples are food safety for food manufacturers (as in *Marchand v. Barnhill*) and aircraft safety for aircraft manufacturers (as in *Boeing*).[78] In the same vein, nuclear power plants' safety would also be "mission critical" for TEPCO.[79]

It is worth emphasizing that Shapira argues that despite its importance for humankind and the planet, climate change would not fit into his "mission critical" framework for corporations other than carbon majors as the reputation of such corporations would not be seriously affected by their carbon emissions.[80] This restrictive nature of Shapira's "mission critical" framework,

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72 Armour & Gordon, supra note 70 at p.57.
73 Armour & Gordon, supra note 70 at p.46, p.57.
74 Armour & Gordon, supra note 70 at p.47, p.57-58. Contrary to the assumption of Armour and Gordon, the Japanese government bailed TEPCO out to avoid its bankruptcy or reorganization as that would render full compensation to the victims impossible. For TEPCO's bailout, see Takayuki Nagato, 'Tax Losses and Excessive Risk Taking under Limited Liability: A Case Study of the TEPCO Bailout after the Fukushima Nuclear Disaster', *Columbia Journal of Asian Law*, Vol.32, No.2, p.139 (2019).
75 The reliefs sought in *ClientEarth v. Shell* were a declaration that the directors of Shell had breached their duty and an injunction to limit Shell's emissions, not a payment of damages suffered by Shell. See *ClientEarth v. Shell*, *supra* note 6 at para.19.
76 Shapira, *supra* note 8 at p.778.
77 Shapira, *supra* note 8 at p.
78 Shapira, *supra* note 8 at p.781.
79 Although electric power companies often enjoy government-granted regional monopoly and thus might not need to worry about the reputation among consumers, they could still face difficulties in the labor market or in obtaining local municipalities' consent for building new power plants.
80 Shapira, *supra* note 8 at p.778-779. See also, Sarah Barker, Cynthia Williams & Alex Cooper, *Fiduciary Duties and Climate Change in the United States* (2021, available at https://ccli.ubc.ca/wp-content/uploads/2021/12/Fiduciary-duties-and-climate-change-in-the-United-States.pdf), at p.33 ("Directors face potential liability when they consciously disregard red flags concerning major

however, is sometimes overlooked.[81]

B. The business judgment rule and directors' discretion

The above views also differ on how much respect they give to the business judgment rule and the discretion of directors.

Within the limited scope of their argument, Armour and Gordon simply deny the business judgment rule to directors of systemic firms and instead propose to apply negligence-based standard for liability regarding oversight on the level of risk-taking.[82]

In contrast, Shapira intends to preserve the tenet of the business judgment rule that "calls on judges to focus on the process, and to leave the merits of specific managerial choices alone", and "interfere only in cases where directors failed to even consider a critical factor."[83] As the risk of hindsight bias is greater for non-legal risks than for legal risks, Shapira argues that "there is reason to apply *Caremark* to ESG more judiciously than when applying it to classic illegalities."[84] Gadinis and Miazad also state that while "developing an ESG function and providing the company with a mechanism for early risk discovery and prevention is an imperative for directors and officers," "[h]ow the board treats the information that reaches it through the sustainability function should remain its prerogative, provided it shows due care in considering the information" and that "[t]he board should remain free to reach its own judgment, provided it receives adequate information".[85]

It should be noted, however, that these standards proposed by Shapira or Gadinis and Miazad still limit directors' discretion to some extent in how they evaluate and respond to risk information.[86] Given the enormous liability imposed by Tokyo District Court in the *TEPCO* case, these standards could have a chilling effect on directors to take a risk-aversive approach even when the risk information received is a minor one. Whether such a chilling effect can be avoided

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business risks that impact the core of their company's business. Liability in this category of cases is especially likely for directors operating within industries under intense public and scientific scrutiny, such as the fossil fuels, electricity, and transportation industries.")

81 For example, Kuntz, *supra* note 64 at p.25 states, citing Shapira (*ibid*. at p.23, note 143), that for industries "which heavily rely on fossil fuels and other non-renewables, not only in terms of energy supply, but also as a necessary ingredient for the production process as such", "rising energy prices, mounting pressure from society and government, and shrinking pools of resources means that the 'E' in ESG will become or, in many cases, already is "mission critical" if the relevant actors want to survive."

82 Armour & Gordon, supra note 70 at p.64.

83 Shapira, *supra* note 8 at p.790, p.798.

84 Shapira, *supra* note 8 at p.799-800.

85 Gadinis & Miazad, *supra* note 68 at p.1466-1467.

86 The Tokyo District Court's decision imposing liability on TEPCO's directors could be upheld under these standards as they "failed to even consider a critical factor" or they did not show "due care in considering the information".

depends on the clarity and the width of the scope of the expansion of the *Caremark* duty analyzed earlier in this part.[87]

IV. Conclusion

On July 13, 2022, Tokyo District Court held in a shareholders' derivative suit concerning the meltdown of Fukushima 1st Nuclear Power Plant that former directors of TEPCO breached their duty of care for disregarding risk information regarding the possibility of the occurrence of a huge tsunami and failing to take appropriate preventive measures against it, "regardless of whether such failure constitutes a violation of a particular law or regulation applicable to the corporation."[88] This decision seems to dovetail with the recent Delaware decisions, such as *Marchand v. Barnhill*, that expanded the scope of the so-called *Caremark* duty of oversight in cases where there was no specific violation of laws or regulations.

These new developments in Japan and the United States pose a question: what about the business judgment rule? Excluding the protection by the business judgment rule might have chilling effects on directors and incentivize them to be overly risk-aversive.

Seeking to clarify when and why the business judgment rule should be limited in the absence of a specific violation of laws or regulations, this article first discussed how the widely accepted limits of the rule, namely violation of laws and regulations and conflict of interests, can be justified from the rationales of the business judgment rule and focused on the clarity of the code of conduct for directors. Then, this article criticized the unclear logic of the *TEPCO* decision and analyzed the academic views supporting the expansion of the *Caremark* duty, emphasizing the diversity within these views on how they justify the expansion, the types of risks covered by the expansion, and how much respect is given to the business judgment rule. Such a diversity could be ambiguous for directors and cause a chilling effect. To avoid such a chilling effect, further discussions on the justifications for the limitation of the business judgment rule and the extent of their scope would be necessary.

Ultimately, this article suggest that the directors' duty of oversight is highly contextual and is contingent on the type and the nature of the risks and externalities in question. It is well-known that "ESG" is a broad concept encompassing a variety of issues, ranging from climate change to local environmental pollution, and from human rights in supply chains to consumer protection from company's products. As such, to avoid the deleterious consequences of an over-expansion of the duty of oversight, while still addressing the need to mitigate serious negative externalities, the concept of "ESG" must be unpacked to ensure that it is applied appropriately based on the specific characteristics of the externality in question.

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[87] See *supra* III.A.
[88] Tokyo District Court, *supra* note 42 at p.86.

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