

CAPITAL STRUCTURE, CREDITOR COMPOSITION, AND INSOLVENCY LAW IN JAPAN

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Abstract: This article identifies potential relationships between the methods by which large firms in the business sector are externally financed and creditors' determinations to resolve business failure through private negotiation or formal insolvency proceedings. Prior to the deregulation of Japan's capital markets in the 1980s, large firms relied heavily on bank debt as a source of external capital. Consequently, their capital structures and their creditor compositions were relatively homogenous. Japanese banks appeared to primarily resolve the failure of their borrowers through private reorganizations or liquidations rather than court proceedings, and evidence suggests that creditor homogeneity was a favorable condition for the negotiated resolution of business failure. Japan's corporate insolvency laws were used relatively infrequently and suffered from procedural and substantive defects that likely discouraged their use.

The deregulation of Japan's capital markets in the 1980s enabled large firms to raise debt capital by issuing bonds, which over time resulted in the diversification of firm capital structures and creditor compositions. This had significant consequences for the ability of creditors to negotiate the resolution of their borrowers' business failure. Japan's long recession in the 1990s pushed many firms close to insolvency, yet it appears that changes in capital structure and creditor composition adversely affected the availability of negotiated resolution of business failure, and Japan's insolvency laws remained problematic. This article suggests that Japanese banks developed unusual and seemingly irrational lending strategies for distressed borrowers, given their inability to resolve business failure through private negotiations or formal insolvency proceedings. At the turn of the century, the Japanese legal community spearheaded significant reforms of Japan's insolvency laws, and a prolonged surge in filing rates indicates that creditors quickly seized upon legal reforms to force reorganization of distressed borrowers. While this article's findings are preliminary, it represents an agenda for further research on this topic.

I. INTRODUCTION

The American appellate judge and legal scholar Frank Easterbrook observed that “[w]hen we see creditors resort to bankruptcy, they are telling us that the legal process is superior to market methods available to them.”¹

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¹ Frank Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 417 (1990).

This observation resonates in the context of Japan, where until recently corporate insolvencies were infrequently resolved through formal legal proceedings and creditors seemingly preferred to rely on market methods, such as negotiated resolution of business failure. Recent trends in corporate bankruptcy filings following major legal reforms suggest that the legal process has become relatively more valuable to creditors in resolving Japanese business failure.² This article highlights a major factor behind the recent gravitation of Japanese creditors to the use of the legal process in the resolution of business failure: limitations on the effectiveness of private restructuring imposed by increasingly complex creditor compositions.

Trends in the resolution of business failure from the high-growth period to the past decade suggest that market methods, such as private reorganizations and liquidations, were the dominant means by which creditors negotiated the resolution of business failure. However, during Japan's long recession in the 1990s, market methods became relatively less effective in resolving business failure. Indeed, Japanese banks lent heavily to many distressed firms during that decade, rather than negotiate the restructuring or liquidation of such firms. Creditors appeared reluctant to push distressed firms into formal insolvency proceedings. Finally, major insolvency law reforms at the turn of the century resulted in an unprecedented boom in insolvency filings, as creditors pushed tens of thousands of distressed debtors into formal reorganization proceedings.³

This shift, when viewed through the lens of Japanese corporate finance, suggests a relationship between the capital structure and creditor composition of large Japanese firms and the availability of market methods to resolve business failure. Where large Japanese firms raised capital primarily by borrowing from banks and where creditor composition was relatively homogenous, creditors appeared to rely on market methods more frequently than on legal process. The deregulation of Japan's capital markets in the late 1970s and 1980s enabled large firms to issue bonds in domestic and overseas capital markets, and resulted in the diversification of firm capital structures and creditor compositions. Throughout Japan's prolonged recession in the 1990s, market methods fell short of enabling creditors to privately resolve business failure, and existing substantive and procedural defects in Japan's insolvency laws continued to discourage the use of legal process. Therefore, insolvency law reforms may have enabled

² Kent Anderson, *Japanese Insolvency Law After a Decade of Reform*, 42 CAN. BUS. L.J. 2, 7 (2006).

³ *Id.* at 16.

diverse classes of creditors to resolve business failure through the legal process.

This analysis is structured chronologically, and attempts to relate developments in Japan's capital markets and the methods by which market participants resolved business failure. Accordingly, this article is organized into eight parts, as described below.

Part II reviews the factors that led large Japanese firms to rely primarily on bank debt as an external source of capital during Japan's economic modernization in the period ranging roughly from the 1950s to the 1970s. Part III discusses the private restructuring of Toyo Kogyo, identifying potential lessons regarding the significance of capital structure and creditor composition to the ability to resolve business failure through market methods. Part IV surveys prior scholarship on Japan's insolvency laws, private reorganizations, and liquidations, and explains why market methods were seemingly preferable to legal process where capital structures and creditor compositions were relatively homogenous. Part V describes the deregulation of Japan's capital markets in the 1980s, and suggests that this deregulation changed the capital structures and creditor compositions of large firms, with consequences for Japanese banks and implications for the resolution of business failure through use of market methods.

Part VI identifies possible barriers to the use of market methods and legal processes to resolve business failure during Japan's prolonged recession in the 1990s, and suggests that banks consequently developed seemingly irrational lending strategies for distressed firms to forestall insolvency. Part VII describes the insolvency law reforms that took effect in 2000, which resolved substantive and procedural deficiencies and enabled creditors to rely on legal process to restructure tens of thousands of distressed firms in the early 2000s. While further empirical work is necessary, Part VIII offers a tentative conclusion, suggesting possible relationships between capital structure, creditor composition, and the choice between market methods and legal process to resolve business failure.

II. THE CAPITAL STRUCTURE OF LARGE JAPANESE FIRMS: 1950S -1970S

During Japan's high-growth, post-war economy, falling roughly between the 1950s and the 1970s, bank debt was the dominant source of external finance for large Japanese firms.⁴ As discussed below, this reliance

⁴ Curtis J. Milhaupt, *On the (Fleeting) Existence of the Main Bank System and Other Japanese Economic Institutions*, 27 *LAW & SOC. INQUIRY* 425, 430-31 (2002); see also Sadahiko Suzuki & Richard W. Wright, *Financial Structure and Bankruptcy Risk in Japanese Companies*, 16 *J. INT'L BUS. STUD.* 97

upon bank debt arose from a confluence of factors, including: the main bank system, the role of Japanese bureaucracy in allocating scarce capital towards the development of export industries, and commercial laws that made it expensive and difficult for Japanese firms to raise funds through the capital markets by privileging banks as providers of debt capital.

A. *Main Bank System*

Scholars of Japanese business have identified a post-war model of corporate finance characterized as the “main bank” system, in which large firms borrowed from a syndicate of lenders headed by a main bank, which was the bank with the largest share of loans to the firm.⁵ Under the main bank system, Japanese firms often developed a long-term borrowing relationship with a dominant lender, frequently but by no means exclusively situated within the same industrial group.⁶ While a large Japanese firm would borrow from a syndicate of lenders, the main bank would often provide a substantially larger proportion of loan capital than other lenders.⁷ Moreover, these loans were accompanied by long-term, cross-shareholdings between bank and borrower, which reaffirmed the stability of the lending relationship.⁸

Main banks monitored their borrowers, sometime by appointing bank directors to the boards of troubled borrowers, and there is evidence that main banks would share information with the a distressed borrower’s other lenders, reducing information asymmetries between lenders and enabling a coordinated approach to restructuring the debt obligations of a borrower.⁹ Finally, some scholars have argued that these main banks provided borrowers implicit rescue guarantees, charging above-market interest rates on loans when the borrower was in good financial health in order to

(1985) (in Japanese firms, it is common for borrowed funds to exceed owners’ equity by a factor of six); Takeo Hoshi, Anil Kashyap, & David Scharfstein, *Bank Monitoring and Investment: Evidence from the Changing Structure of Japanese Corporate Banking Relationships*, in ASYMMETRIC INFORMATION, CORPORATE FINANCE, AND INVESTMENT 105 (R. Glenn Hubbard ed., 1990) [hereinafter *Bank Monitoring and Investment*].

⁵ Masahiko Aoki, Hugh Patrick, & Paul Sheard, *The Japanese Main Bank System: An Introductory Overview*, in THE JAPANESE MAIN BANK SYSTEM 6 (Masahiko Aoki & Hugh Patrick eds., 1994).

⁶ *Id.* at 5-6.

⁷ *Id.* at 6.

⁸ *Id.* at 12.

⁹ Takeo Hoshi, Anil Kashyap, & David Scharfstein, *The Role of Banks in Reducing the Costs of Financial Distress in Japan*, 27 J. FIN. ECON. 68, 69 (1990) [hereinafter *The Role of Banks*]; Aoki, Patrick & Sheard, *supra* note 5, at 24.

compensate the bank for its rescue costs when the firm's financial health suffered.¹⁰

Under this system, bank rescue operations were ad hoc in nature and varied in form, but rescue operations generally had one or more of the following consequences: 1) reduction of required principal and interest payments on outstanding loans, 2) extension of the maturity dates on loans, and 3) exchange of debt for an equity stake in the firm.¹¹ Additionally, there is evidence that appointments of bankers to firm boards came largely in response to poor liquidity and cash flow problems, and that the liquidity of the distressed firm increased following the banker appointment.¹²

B. Administrative Guidance and Capital Allocation Policies

Government capital allocation policies also encouraged a bank debt-heavy capital structure. During the high growth period, Japanese bureaucrats sought to allocate scarce capital to the development of infant industries for global export.¹³ Government policies encouraged high rates of personal savings, enabling commercial and state-supported banks to direct credit to target industries.¹⁴ Additionally, stable sources of bank lending facilitated trade credit between suppliers and manufacturers within an industry, which was a vital component of the capital structure of the Japanese firm.¹⁵ This bureaucratic policymaking did not just encourage

¹⁰ Randall Morck & Masao Nakamura, *Banks and Corporate Control in Japan*, 54 J. FIN. 319, 321 (1999).

¹¹ Suzuki & Wright, *supra* note 4, at 103. Yoshiro Miwa and Mark Ramseyer have challenged the traditional account of implicit bank rescue guarantees, arguing that banks chose whether to pursue private restructuring on an ad hoc basis, and that bank monitoring, which often consisted of appointing retired bank directors to a troubled borrower's board of directors, did not constitute effective monitoring. See Yoshiro Miwa & Mark Ramseyer, *Conflicts of Interest in Japanese Insolvencies: The Problem of Bank Rescues*, 6 THEORETICAL INQ. L. 301, 302 (2005). They claim that creditors may sometimes choose to rescue a firm in order to maximize debt recovery, but that banks certainly were not bound by an implicit rescue guarantee. *Id.* Ad hoc recovery-maximizing decisions by banks are consistent with the observed consequences of those rescue operations that did occur.

¹² Morck & Nakamura, *supra* note 10, at 336 (reporting that banker appointments follow decline in liquidity and cash flow, and that liquidity is enhanced in the years following bank intervention); *Bank Monitoring and Investment*, *supra* note 4, at 107 (finding that the investment behavior of firms which weakened bank ties during the 1980s in favor of greater reliance on the bond markets appears more liquidity-constrained than firms that stayed more reliant upon banks).

¹³ See generally CHALMERS JOHNSON, MITI AND THE JAPANESE MIRACLE: THE GROWTH OF INDUSTRIAL POLICY, 1925-1975 (1982).

¹⁴ *Id.* at 15; see also Yoshiro Miwa & Mark Ramseyer, *Directed Credit? The Loan Market in High-Growth Japan*, 13 J. ECON. & MGMT. STRATEGY 171, 176 (2004) [hereinafter Miwa & Ramseyer, *Directed Credit?*] (providing a critical account of the scholarly literature on credit rationing).

¹⁵ ULRIKE SCHAEDE, CHOOSE AND FOCUS: JAPANESE BUSINESS STRATEGIES FOR THE 21ST CENTURY 57 (2008); Christopher W. Anderson & Anil K. Makhija, *Deregulation, Disintermediation, and Agency Costs of Debt: Evidence from Japan*, 51 J. FIN. ECON. 309, 314 (1999)

targeted lending, but provided banks with greater information about the prospects of their borrowers, reducing the uncertainty costs associated with financing new industrial ventures.¹⁶

C. *Capital Market Regulations*

Regulatory restrictions on Japan's capital markets restrained competition among providers of capital, further emphasizing the importance of bank debt. While Japan had functioning equity markets from the 1950s onwards, numerous regulatory restrictions undermined the growth of these markets.¹⁷ First, Japanese shares issued at par value rather than at market value, limiting the capacity of Japanese firms to capture returns on equity issuance.¹⁸ Equity holdings in the high-growth years consisted in significant part of cross-shareholdings between a firm, its lenders, and trading partners, and cross-shareholdings were generally illiquid and oriented towards preservation of long-term business relationships rather than the maximization of investment return.¹⁹ To compensate shareholders for tying up their capital in illiquid shareholding arrangements, issuers customarily paid annual dividends at a fractional percentage of par value, regardless of firm performance.²⁰ The Foreign Capital Law restricted foreign ownership of Japanese equity securities, limited demand and trading volumes, and prevented foreign institutional investors from pressuring Japanese issuers to increase returns on equity.²¹

Japanese law prohibited the issuance of unsecured corporate debt, which constrained the market for corporate debt securities.²² Moreover, the Bond Issuance Committee ("Bond Committee"), comprised of major Japanese financial institutions, held a monopoly on the appointment of bond trustees to oversee the management of collateral against which corporate bonds were issued.²³ The Bond Committee performed credit ratings to

¹⁶ SCHAEDE, *supra* note 15, at 56 (MITI-sponsored research consortia diffused information about early-stage technologies among leading firms, indirectly upholding industry hierarchies and channeling investment among firms towards promising technologies).

¹⁷ Suzuki & Wright, *supra* note 4, at 100.

¹⁸ *Id.*

¹⁹ Milhaupt, *supra* note 4, at 429; Aoki, Patrick, & Sheard, *supra* note 5, at 12-14.

²⁰ Suzuki & Wright, *supra* note 4, at 100.

²¹ SCHAEDE, *supra* note 15, at 53. Additionally, the Foreign Exchange and Foreign Trade Control Law gave the Ministry of International Trade and Industry the authority to regulate all cross-border transactions. *Id.*

²² Anderson & Makhija, *supra* note 15, at 313.

²³ TAKEO HOSHI, ANIL KASHYAP, & DAVID SCHARFSTEIN, THE CHOICE BETWEEN PUBLIC AND PRIVATE DEBT: AN ANALYSIS OF POST-DEREGULATION CORPORATE FINANCING IN JAPAN 12-13 (Nat'l Bureau of Econ. Research, Working Paper No. 4421, 1993) [hereinafter PUBLIC AND PRIVATE DEBT].

determine which firms were permitted to issue bonds, using capital ratio criteria heavily weighted towards Japan's largest industrial companies.²⁴ The Bond Committee also dictated the interest rates and maturity date of bond issues, and trustee banks were by far the largest purchasers of bonds, purchasing on average 63.4% of the bonds issued during the 1960s.²⁵ Banks were well positioned to limit the volume of bonds issued and to ensure that their lending practices were left unchallenged, and bonds were issued almost exclusively to the same group of firms that already had access to bank debt.²⁶

Some scholars have suggested that, in return for their privileged role as a source of capital, banks were implicitly obligated to rescue distressed borrowers rather than let them fail.²⁷ In their scholarship, Miwa and Ramseyer argue that banks determined on an ad hoc basis whether to rescue troubled borrowers, and were certainly not bound by an implicit rescue guarantee. While banks did not always rescue troubled borrowers, banks sometimes rescued such borrowers, and the rescue of Toyo Kogyo (better known as the manufacturer of Mazda automobiles) by Sumitomo Bank in 1974 is illustrative of the powerful role that bank finance vested in Japanese financial institutions.

III. CASE STUDY: THE TOYO KOGYO BAILOUT

Pascale and Rohlen's account of the bank-led private reorganization of Toyo Kogyo, the manufacturer of Mazda automobiles, is an illustration of the role that Japanese banks played in resolving the financial distress of their largest borrowers. This Part recounts Pascale and Rohlen's major findings and discusses those findings in the light of subsequent scholarship.

Pascale & Rohlen provide a richly detailed case study of bank intervention in the operations of a financially distressed firm.²⁸ Although Toyo Kogyo successfully diversified from its core truck manufacturing operation to the production of passenger cars in the 1960s, the firm lost a significant domestic and international market share in the early 1970s.²⁹ By 1974, Toyo Kogyo was teetering on the brink of insolvency, with seventy-three lending institutions financing the firm's operation, led by Sumitomo

²⁴ *Id.*; Eric Grouse, *Banks, Bonds, and Risk: The Mycal Bankruptcy and its Repercussions for the Japanese Bond Market*, 12 DUKE J. COMP. & INT'L L. 571, 591 (2002).

²⁵ Grouse, *supra* note 24, at 591.

²⁶ *Id.* As Grouse notes, the banks composing the Bond Committee were uninterested in allowing the market for corporate bonds to disrupt their lending business. *Id.* at 592.

²⁷ Suzuki & Wright, *supra* note 4, at 102.

²⁸ Richard Pascale & Thomas P. Rohlen, *The Mazda Turnaround*, 9 J. JAP. STUD. 219 (1983).

²⁹ *Id.* at 222-23.

Bank and Sumitomo Trust Bank.³⁰ Sumitomo Bank alone had an exposure of \$234 million to Toyo Kogyo, and Hiroshima Bank, another large lender, was funding both Toyo Kogyo and many of its local suppliers. The troubled firm was relying on bank loans to meet its debt and trade finance obligations. In early 1974, Sumitomo increased its monitoring of the troubled borrower, placing a team of seven bank executives in Toyo Kogyo to supervise its operations.³¹

In late 1974, Sumitomo Bank formally intervened, calling a meeting of the firm's creditors and announcing its support for Toyo Kogyo, and designating a Sumitomo financial subsidiary to provide bridge financing for the firm's short-term obligations.³² Sumitomo also declared that its executives would lead an internal restructuring of Toyo Kogyo.³³ The bank's display of support consolidated resolve among lenders, and no lenders called in loans for expedited repayment or refused to turn over existing debt obligations as they came due.³⁴ Additionally, lenders carried promissory notes issued by Toyo Kogyo to its suppliers in 1975, enabling Toyo to finance its ongoing operations.³⁵

As Pascale and Rohlen observe, the support of Toyo Kogyo's creditors to the bank-led restructuring plan meant that the costs incurred by creditor resistance in the 1979 Chrysler bailout were avoided, allowing management and lenders to focus on restructuring rather than on political or legal battles.³⁶ Additionally, the bank's role in mobilizing creditor support enabled restructuring plans to move forward without reliance on government loan guarantees; Sumitomo's declared willingness to backstop other creditor's losses at Toyo Kogyo diminished the need for the government to play an active role in the bailout operations.³⁷

In contrast, Chrysler had around a dozen sets of institutional lenders—including banks in the U.S., Canada, Europe, Japan, Asia, and the Middle East—and six issues of publicly-held, unsecured debentures totaling over \$400 million, and Chrysler's financial subsidiary, Chrysler Financial Corporation, had substantially greater debt outstanding, all of which was

³⁰ *Id.* at 228-29.

³¹ *Id.* at 229.

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.* at 230.

³⁶ *Id.*; see also Paul H. Wilson, Jr. & Peter L. Borowitz, *Working Out With the Government: The Chrysler Loan Guarantee Program*, 4 J. L. & COM. 19 (1984) (discussing Chrysler's struggles with its creditors and the U.S. government as it sought to restructure its debt in 1979).

³⁷ Pascale & Rohlen, *supra* note 28, at 230 (discussing the different roles that national government played in the Toyo Kogyo and Chrysler bailouts).

unsecured.³⁸ Chrysler's management spent more than a year fighting the firm's institutional lenders, while seeking government loan guarantee assistance from Congress and the Ford Administration before management could fully focus on restructuring the distressed firm.³⁹ Without a single large creditor to coordinate the reorganization and discipline other creditors, Chrysler was vulnerable to sporadic creditor defections. Canadian banks set off their claims against accounts of Chrysler's Canadian subsidiary; a European creditor temporarily set off its claims against funds transferred to Chrysler through that account; creditors initiated litigation against Chrysler in several U.S. states; Japanese banks refused to extend additional letters of credit financing for Chrysler's imports of Mitsubishi vehicles.⁴⁰

Creditor resistance may have also represented tensions between lenders. As Wilson and Borowitz observe, Chrysler's domestic lenders took the position that all banks should be subject to equal sacrifices, while foreign lenders viewed the Chrysler restructuring as primarily a U.S. problem, requiring only domestic lenders to make greater financial sacrifices.⁴¹ While Chrysler's lenders ultimately reached agreement on the restructuring arrangements, the process proved challenging.⁴²

After shoring up the stability of Toyo Kogyo's relationships with its borrowers, Sumitomo's executive team forced out the troubled firm's incumbent management and relied on local business leaders to appoint a successor capable of brokering a deal with the firm's suppliers and labor union.⁴³ Union negotiations led to the rescheduling of year-end bonus payments and the creation of a dispatched worker program that preserved union jobs while imposing cuts in vehicle production by turning production workers into traveling salesmen.⁴⁴ Negotiations with suppliers resulted in supplier price cuts.⁴⁵

While full recovery took several years, Sumitomo's initial display of support was vital to improving Toyo Kogyo's cash flow and stabilizing its existing credit lines.⁴⁶ The bank's executives had no particular expertise in auto manufacturing, but bank-led intervention was likely instrumental in preventing creditor panic and forcing suppliers and labor unions to accept

³⁸ Wilson & Borowitz, *supra* note 36, at 24.

³⁹ *Id.* at 34.

⁴⁰ *Id.*

⁴¹ *Id.* at 31.

⁴² *Id.*

⁴³ Pascale & Rohlen, *supra* note 28, at 238, 345.

⁴⁴ *Id.* at 239.

⁴⁵ *Id.* at 246.

⁴⁶ *Id.* at 257.

cost reduction measures.⁴⁷ Bank-led intervention may have also prevented unilateral action by creditors to accelerate repayment of outstanding debt or foreclose against collateral, and may have reduced informational asymmetries between creditors as the lead creditor in the restructuring communicated with other creditors of the firm.⁴⁸ It seems plausible that banks also had reputational incentives to avoid unilaterally seeking repayment, since they often participated in lending syndicates. A unilateral call for repayment to the detriment of other lenders in the syndicate could potentially result in retaliation by other banks with respect to other syndicated loans.

As mentioned before, Miwa and Ramseyer wisely caution against reading too much from the Toyo Kogyo case study. Specifically, they observe that the Toyo Kogyo case study does not necessarily indicate that banks were skillful turnaround managers.⁴⁹ Rather, the Toyo Kogyo case study suggests that where creditors are able to negotiate a private restructuring, formal legal process can be avoided.

Questions remain regarding the motivations of creditors to bear the costs and risks of private restructuring when formal insolvency procedures are available. Is the bank-led private reorganization of Toyo Kogyo the exception or the rule when it comes to corporate insolvency? In other words, do bailouts prevail over bankruptcies, and if so, why? Part IV proposes that large lenders and troubled borrowers may prefer private resolution of business failure to formal insolvency proceedings, and that this preference resulted from a combination of bank debt-heavy capital structures and substantive and procedural defects in Japan's insolvency laws.

IV. BAILOUTS OVER BANKRUPTCIES: CAPITAL STRUCTURE, BANKRUPTCY LAW, AND THE PREFERENCE FOR PRIVATE RESTRUCTURING IN JAPAN

As previously discussed, both Toyo Kogyo and Chrysler kept out of bankruptcy court, but the former spent far fewer resources than the latter to achieve the same outcome.⁵⁰ The bank debt-heavy capital structure of Toyo Kogyo resulted in a relatively small number of bank creditors that, alongside procedural and substantive defects in Japan's insolvency laws, may have contributed to this story. Judge Easterbrook tells us that creditors' choice of

⁴⁷ *Id.*

⁴⁸ *Id.* at 229-30.

⁴⁹ Miwa & Ramseyer, *Conflicts of Interest in Japanese Insolvencies*, *supra* note 11, at 309-10.

⁵⁰ Wilson & Borowitz, *supra* note 36, at 33 (noting that Chrysler's former CEO, Lee Iacocca, once stated that the government loan guarantee program had cost Chrysler one dollar in lost car sales and legal expenses for every two dollars it borrowed with loan guarantees).

bankruptcy proceedings demonstrates the superiority of legal process over market methods; conversely, where creditors prefer private negotiation to bankruptcy proceedings, this suggests that market methods are superior to the legal process available to them. The insolvency laws available to creditors likely influenced creditor preferences for market methods.

As discussed in this section, formal insolvency proceedings were relatively infrequently used, and suffered from both substantive and procedural defects. Bank-led private restructurings and trade creditor-led private liquidations were more frequently used, and both such mechanisms enabled creditors and borrowers to stay out of court.

A. Japanese Bankruptcy Law

Under the 1978 Bankruptcy Act, creditors in the U.S. face two basic procedural options: a liquidation procedure (Chapter 7)⁵¹ and a reorganization procedure (Chapter 11).⁵² Toyo Kogyo's creditors, on the other hand, would have found themselves confronted with five types of corporate insolvency procedures, including two types of liquidation procedures⁵³—Bankruptcy (*Hasan*)⁵⁴ and Special Liquidation (*Tokubetsu Seisan*)⁵⁵—and three types of reorganization procedures: Corporate

⁵¹ 11 U.S.C. § 701 (1986).

⁵² 11 U.S.C. § 1101 (1978).

⁵³ FRANK PACKER & MARK RYSER, THE GOVERNANCE OF FAILURE: AN ANATOMY OF CORPORATE BANKRUPTCY IN JAPAN (Ctr. on Japanese Econ. and Bus., Columbia Graduate Sch. of Bus., Working Paper No. 62, 1992). Packer and Ryser also identified two categories of business failure which do not fall under bankruptcy in the legal sense. First, there is "Internal Arrangement" (*Uchi Seiri*) which contains those firms for which a formal creditors' meeting was held and there was an unanimous agreement aimed at the continuation of the company (although this only applies to small and medium-sized firms and is distinct from private workouts at large Japanese firms); and "Suspension of Bank Transactions," a liquidation-forcing option by which firms whose promissory notes are dishonored twice at a local clearinghouse in a six-month period are subject to suspension of all current account transactions and loans by member banks for a two-year period. Packer and Ryser find that no firm has ever survived the enactment of "Suspension of Bank Transactions." *Id.* at 4-6.

⁵⁴ The Bankruptcy procedure was modeled on the 1923 German civil code, and was revised in 1952 to reflect American concepts of corporation law and the provision of discharge. *Id.* at 32. Application could be made by either the debtor or creditors, and the court would render an adjudication only if it was proven that the debtor was either incapable of covering its indebtedness, or had an excess of liabilities over assets. *Id.* As the authors note, this was often established through submission of a dishonored promissory note to the court. *Id.* Advance payment of costs was required under the procedure, and the payment required was scaled to the debtor's liabilities. *Id.* The court would typically issue an order for preservative measures immediately following the filing of the application, provisionally attaching the debtor's inventory and enjoining the debtor from making payments. *Id.* Secured creditors were capable of exercising their security rights outside of bankruptcy. *Id.*

⁵⁵ The Special Liquidation procedure was first introduced into Japan's Commercial Code in 1938, and was limited to stock companies already in the process of liquidation under the bankruptcy procedure. *Id.* at 33. The special liquidation procedure recognized a broader set of acceptable causes, including where "it is deemed that circumstances exist which would seriously impede the carrying out of the liquidation,"

Reorganization (*Kaisha Kosei*),⁵⁶ Corporate Arrangement (*Kaisha Seiri*),⁵⁷ and Composition (*Wagi*).⁵⁸

Packer and Ryser characterize Japanese bankruptcy law as “an array of strong proceedings, whereby the court is given powers to step in to settle a wide spectrum of financial recontracting problems, in combination with an

which has been interpreted to mean cases where multiple creditors “make the successful operation of ordinary liquidation difficult.” *Id.* at 34. While the court may have issued preservation measures through the bankruptcy proceeding, Packer and Ryser suggest that the additional preservation measures available through special liquidation were unlikely to prevent a creditor panic, since the firm’s shareholders were required to accept a resolution to dissolve the company under the bankruptcy procedure prior to initiation of special liquidation, and notice of the resolution was given two weeks prior to the vote. *Id.*

⁵⁶ The Corporate Reorganization procedure was introduced in 1952 and modeled after Chapter 10 of the 1938 United States Bankruptcy Act. Corporate reorganization was available to stock companies for which there was “the prospect of rehabilitation,” and an application could be filed upon the danger of insolvency or excess liabilities, or where the debtor was unable to pay its obligations “without exceedingly impeding continuation of its business.” *Id.* at 38. Applications could be made by the debtor, creditors, or shareholders with claims or shareholdings above ten percent of the debtor’s capital. *Id.* Advance payment of costs was required upon application, and the costs of corporate reorganization generally exceeded those of other reorganization proceedings. *Id.* The time period between the initiation of the procedure and a court decision in favor of the commencement of reorganization generally ran between three to six months, and a stay could not be issued against secured creditors prior to the court’s decision. *Id.* As Packer and Ryser observe, the most significant distinction between Japan’s corporate reorganization procedure and the reorganization procedure established by Chapter 11 of the United States Bankruptcy Code is that under the Japanese procedure, the debtor was not in possession of the firm. *Id.* Rather, the court was required to appoint a trustee to manage the debtor’s estate, and officers, directors and owners of the debtor were removed. *Id.*

⁵⁷ The Corporate Arrangement procedure was introduced in 1938, and was loosely based on procedures under U.K. and Swiss law. The procedure was developed to encourage the use of legal proceedings by stock companies and to reduce the prevalence of questionable private settlements. *Id.* at 36. The procedure could only be initiated if there was a danger of insolvency or excess liabilities. *Id.* Application could be made by the debtor, a creditor or shareholder with a claim or shareholding above 10% or 3% of the debtor’s assets, respectively. *Id.* Advance payment of costs was required upon application. *Id.* Upon application, the court was authorized to suspend any executor process that affected the debtor’s assets, and the court could extend the stay to secured creditors if it was “in accord with the interests of the creditors in general.” *Id.* at 37.

⁵⁸ The Composition procedure was introduced in 1923 and had its origins in the Austrian Composition Code. *Id.* at 34. As Packer and Ryser note, some scholars believe that the composition procedure was deemed necessary due to the severe reputational harm arising from forced composition under bankruptcy in Japan, which was not a viable option for a debtor that sought to continue operating as a going concern. *Id.* at 35. Unlike the other procedures, only debtors were eligible to file a petition for composition, although the circumstances under which the procedure could be invoked were the same as bankruptcy, thus limiting the procedure’s applicability to debtors on the verge of bankruptcy. *Id.* The debtor was required to submit a plan for composition, and the court would then appoint a commissioner to investigate the debtor’s finances and evaluate the feasibility of its plan, following which the court could issue an order of commencement if it determined the plan feasible and in the best interest of creditors. *Id.* While the court was authorized to order preservation measures in order to prevent creditor panic and the suspension of bank transactions, the composition procedure did not prohibit payments to creditors outside the proceedings, nor did preservative measures apply to secured creditors. *Id.* Unlike bankruptcy, the debtor remained in possession of the firm during composition. *Id.* A vote of creditors was required to accept the plan, and if the plan failed to receive acceptance by three-quarters of unsecured creditors, the debtor would be pushed into bankruptcy. *Id.* at 36. Following acceptance of the plan, the court provided no further supervision of the enforcement of the plan, and had no power under the composition procedure to avoid fraudulent conveyances made prior to submission of the plan. *Id.*

array of ‘weak’ proceedings, whereby the court’s powers are far more limited and designed to serve more as a ‘hands-off’ approach to private settlement.”⁵⁹ Additionally, Japanese courts made extensive use of “gatekeeping mechanisms” to pre-screen bankruptcy filings and prevent the abuse of protections under bankruptcy law.⁶⁰ These gatekeeping mechanisms included: requirements for the advance payment of costs by the debtor, the discretion to grant a stay against creditors, and various judicial interpretations of the extent of these discretionary powers.⁶¹ Moreover, application to the most powerful reorganization court in Japan required the removal of management upon the initiation of the procedure.⁶²

Given the financial costs and rigorous procedural requirements necessary to initiate and pursue formal insolvency proceedings, it seems likely that Japanese bankruptcy laws discouraged many potential applicants from initiating formal reorganization proceedings. While Easterbrook rightly looks to the incentives of creditors to pursue market mechanisms versus legal processes, the incentives of incumbent management in the distressed firm should not be overlooked. As Packer and Ryser argue, these gatekeeping mechanisms also produced the risk of “near-default costs caused by non-optimal operating strategies taken by managers to avoid default.”⁶³ The potential costs of private action were lowered, however, by the existence of private liquidation and reorganization procedures driven by bank and trade creditors.⁶⁴

B. *Bank-Led Private Reorganizations*

As Packer and Ryser note, bankruptcy filings accounted for only a very small proportion of business failures in Japan, and private liquidation and reorganization measures constituted the dominant practices for resolving business failure.⁶⁵ As discussed below, Suzuki and Wright’s seminal study of private reorganization identifies structural preferences for bank debt-heavy capital structures that may have reduced the negotiating costs of private reorganization relative to formal legal proceedings. Additionally, Hoshi, Kashyap, and Scharfstein’s findings indicate that the addition of non-

⁵⁹ *Id.* at 2.

⁶⁰ *Id.*

⁶¹ *Id.* at 3.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

bank bondholders to the capital structure of Japanese firms may have increased the costs of private resolution of business failure.

Specifically, Suzuki and Wright argue that Japanese firms' preference for debt finance was matched by the willingness of Japanese lenders to create long-term financing arrangements for borrowers, and to continue lending to financially distressed borrowers.⁶⁶ They identify this willingness to lend as arising from the Bank of Japan's ("BOJ") tolerance of large loan-out ratios (loans to deposits) through "overloans," as well as banks' reliance on nondeposit sources of funds, including the BOJ's rediscount window and the call money market in which other financial institutions place surplus funds.⁶⁷

Because of this institutional architecture designed to promote debt finance and bank-borrower relationships, Suzuki and Wright propose that large Japanese firms purchase security against financial distress by ceding control to their major lenders, either in the form of bank rescue or by engineering mergers or takeovers.⁶⁸ The authors look at three measures of firm health—accounting measures, social importance measures, and main-bank relationship measures—and conclude that accounting measures, such as worsening cash flow, falling profits, and increasing debt accurately describe the approach of the firm towards financial distress, but do not predict whether the firm will file for bankruptcy.⁶⁹ Rather, they suggest that measures of a company's social importance and the strength of its main bank relationship may be more accurate indicators of a distressed firm's chance of survival.⁷⁰

While Suzuki and Wright identify broad indicators of a distressed firm's survival, Hoshi, Kashyap, and Scharfstein scrutinize more closely the role of banks in mitigating the costs of financial distress. They propose that free-rider problems reduce incentives for creditors to grant financial relief or extend credit where creditors are numerous, since any given creditor may feel less inclined to risk its own capital where it cannot predict the behavior of its fellow creditors, but that these disincentives become less severe where creditors are fewer in number.⁷¹

Large and diffuse classes of bondholders pose special challenges in debt restructuring, since bondholders are unlikely to be well-informed about the conditions of the distressed firm and cannot easily know whether it is in

⁶⁶ Suzuki & Wright, *supra* note 4, at 99-101.

⁶⁷ *Id.* at 101.

⁶⁸ *Id.* at 102.

⁶⁹ *Id.* at 105.

⁷⁰ *Id.*

⁷¹ *Bank Monitoring and Investment*, *supra* note 4, at 68-69.

their interests to push for accelerated repayment or to accept delayed repayment or debt-for-equity swaps.⁷² Large lenders to the firm often have better information about the distressed firm's prospects and can communicate this information to fellow lenders in private negotiations.⁷³ Because Japanese banks often hold significant proportions of the bonds issued by their borrowers,⁷⁴ it seems plausible that the informational asymmetries that typically arise between bank lenders and bondholders are mitigated by the dual role of Japanese banks as lenders and bondholders.

This argument is consistent with Hoshi, Kashyap, and Scharfstein's finding that distressed firms whose capital structure contains a higher proportion of debt finance from their largest lender invest more and sell more than other firms,⁷⁵ and that the costs of financial distress are higher for firms with many creditors than for firms with relatively few creditors.⁷⁶

C. Trade Creditor-Led Private Liquidations

While private reorganizations were more commonly bank-led, as in the case of Toyo Kogyo, the trade creditors of the distressed firm often initiated private liquidations. Extensive reliance on trade credit was a corollary to long-term business relationships within Japanese supply chains, and trade creditors often had outstanding accounts receivable from the distressed firm.⁷⁷ Business failure of a single firm could send shockwaves through the delicate networks of trading partners, triggering a chain of business failures.⁷⁸ Thus, trade creditors had strong incentive to manage the orderly liquidation of a distressed trade debtor.

Where bank rescue was not forthcoming—and it was not often forthcoming in the business failures of small and medium sized enterprises (“SMEs”)—trade creditors would take the situation into their own hands, sometimes resorting to self-help measures by seizing the distressed firm's assets in midnight raids before organized liquidation proceedings are initiated.⁷⁹ Indeed, Packer and Ryser describe a stereotypical SME business

⁷² *Id.* at 68.

⁷³ *Id.* at 69.

⁷⁴ Grouse, *supra* note 24, at 591-92.

⁷⁵ *The Role of Banks*, *supra* note 9, at 86.

⁷⁶ *Id.*

⁷⁷ PACKER & RYSER, *supra* note 53, at 20. Anderson & Makhija find that trade credit comprised the largest proportion of current liabilities on firm balance sheets between 1980-1992. Anderson & Makhija, *supra* note 15, at 314.

⁷⁸ PACKER & RYSER, *supra* note 53, at 20 (nearly 20% of Japanese bankruptcies during the observed period were directly or indirectly attributable to the bankruptcies of related companies).

⁷⁹ *Id.* at 21.

failure, with management fleeing the scene as creditors break into a factory and pile capital equipment and inventory into trucks.⁸⁰

While creditor raids were not the norm, they reflect the anxiety among trade creditors about the prospects of repayment under circumstances in which negotiated resolution appeared difficult to achieve.⁸¹ For their part, banks rarely participated in private liquidations, instead setting-off outstanding credits against the distressed firm's deposits and relying on the procedure of civil execution to satisfy additional outstanding credits against the collateralized assets of the firm.⁸² Banks were vulnerable to the seizure of collateralized equipment and inventory by unsecured trade creditors, but foreseeing the risk of asset-stripping, banks preferred to collateralize loans against real property, which did not bear the risk of loss from trade creditor raids.⁸³

In fact, private liquidations shared many similarities with the private reorganization procedure utilized in the Toyo Kogyo case study. In private reorganizations, the main bank of the distressed firm would call a creditors' meeting and serve as the de facto chairman, describing the condition of the distressed firm and proposing a plan for financial restructuring of the firm's debts.⁸⁴ The appointment of main bank executives to the board of the distressed firm, as in Toyo Kogyo, served to monitor and discipline management and incentivize their compliance with the interests of creditors.⁸⁵

Similarly, in private liquidations, it was typical for a leading trade creditor or the distressed debtor to call a creditors' meeting, at which an explanation would be given for the business failure of the firm and the current conditions of the distressed firm and its assets and liabilities would be presented.⁸⁶ At this meeting, creditors would select a creditors committee and appoint a chairman.⁸⁷ The chairman would solicit and receive letters of entrustment from the creditors of the firm, and would seek to obtain the cooperation of the debtor in subsequent creditor meetings.⁸⁸ The chairman would oversee the liquidation of three classes of assets: the account receivables of the distressed debtor; movables, including machines and

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.* at 22.

⁸³ *Id.* at 24.

⁸⁴ Suzuki & Wright, *supra* note 4, at 102.

⁸⁵ See Pascale & Rohlen, *supra* note 28, at 228-30; see also Aoki, Patrick, & Sheard, *supra* note 5, at 16-20 (discussing bank monitoring of distressed firms).

⁸⁶ Aoki, Patrick, & Sheard, *supra* note 5, at 23.

⁸⁷ *Id.*

⁸⁸ *Id.*

inventory; and real property (although real property was usually secured against bank loans).⁸⁹

The chairman in a trade creditor-led private liquidation played a role similar to that of the trustee in a formal bankruptcy proceeding, evaluating creditors' claims and overseeing the distribution of proceeds from liquidation of the firm's assets.⁹⁰ The chairman's role, however, was weaker than that of a trustee in bankruptcy court in regard to preventing holdout creditors from disrupting the liquidation process, since the chairman could neither impose a mandatory stay upon creditors nor rely on voting mechanisms to force a "clamp-down" on recalcitrant creditors.⁹¹ Additionally, the chairman was dependent upon the good-faith actions of the distressed debtor in private liquidation; a non-cooperative debtor could hide or fraudulently convey the assets of the firm, creating obstacles to resolution that would slow down the liquidation process.⁹²

Despite the difficulties attendant in private liquidation, there were efficiency advantages in both the size of distribution and the length of procedure relative to formal liquidation proceedings in court. Packer and Ryser find that distribution rates in Nagoya and Tokyo were somewhat higher in private liquidation than in bankruptcy cases.⁹³ The time savings were more pronounced: private liquidations in Nagoya and Tokyo were on average five months to one year, while bankruptcy proceedings usually lasted significantly longer, with 50.3% of all such proceedings concluded in 1989 lasting for more than three years, and 24% lasting for more than five years.⁹⁴

Packer and Ryser's study suggests, however, that some types of business failures were statistically more likely to go to formal legal proceedings than others. For instance, debtors in court-based liquidation cases had nearly 20% larger amounts of outstanding liabilities than debtors in private liquidations, which suggests either that the transaction costs of private negotiation increased as the number of creditors of the firm increased, or that formal proceedings were still necessary to resolve the thorniest cases.⁹⁵ Packer and Ryser's account suggests that, consistent with

⁸⁹ *Id.* at 24.

⁹⁰ PACKER & RYSER, *supra* note 53, at 24.

⁹¹ *Id.* at 25.

⁹² *Id.*

⁹³ *Id.* at 25-26.

⁹⁴ *Id.* at 26.

⁹⁵ PACKER & RYSER, *supra* note 53, at 29.

Judge Easterbrook's observation, recourse to formal legal processes occurred more frequently as the costs of negotiated resolution increased.⁹⁶

D. Implications

The aforementioned studies of private reorganizations and liquidations suggest that private resolution of business failure was more likely to succeed where creditor composition was relatively small and homogenous. In contrast, where creditors were more numerous and diverse, negotiating costs were higher and the ability of creditors to avoid formal legal proceedings was diminished.

Miwa and Ramseyer demonstrate that while creditor composition may have influenced the preference for market methods over recourse to formal legal process, bank-led private reorganizations were far from ubiquitous and often unsuccessful.⁹⁷ Many firms that sought bank assistance did not receive it, and many firms that did receive initial bank support were unable to turn around their performance and eventually failed or were merged into another firm.⁹⁸ The proportion of debt finance in the firm's capital structure increased the risk of default, but creditor concentration and main bank affiliation did not fully hedge against that risk.

In their empirical study, Miwa and Ramseyer found that Japanese banks made loans to financially distressed firms, but that banks increased their loan levels to financially distressed firms at a slower rate than to solvent firms, and that main bank lending to insolvent firms did not necessarily keep such firms from failing.⁹⁹ Indeed, their research indicates that main banks reduced their exposure to financially distressed borrowers, and that the closer the ties a firm had to a main bank, the greater the cuts in that bank's exposure to the borrower following the onset of financial distress.¹⁰⁰ Moreover, Miwa and Ramseyer find that distressed borrowers switched main bank affiliation as frequently as did solvent firms, suggesting that firms did not expect their existing main bank to initiate rescue operations in accordance with an implicit rescue guarantee.¹⁰¹ While further empirical research is needed, it appears that while bank debt capital structures and small, homogenous creditor compositions were not determinative of the approach taken by creditors, these factors nonetheless

⁹⁶ *Id.* at 31.

⁹⁷ Miwa & Ramseyer, *Conflicts of Interest in Japanese Insolvencies*, *supra* note 11, at 309-15.

⁹⁸ *Id.*

⁹⁹ *Id.* at 321.

¹⁰⁰ *Id.* at 331.

¹⁰¹ *Id.* at 336.

may have influenced the decision to rely on market methods rather than legal process. As discussed in Part V, the deregulation of Japan's capital markets in the 1980s enabled firms to raise capital more widely, with significant effects on capital structure and creditor composition.

V. CAPITAL MARKET DEREGULATION, CHANGING CAPITAL STRUCTURES,
AND THE BUBBLE ECONOMY: COLLUSION BETWEEN LAW AND MARKETS
IN THE 1980S

Over the course of the 1980s, large Japanese firms diversified their capital structures as ongoing deregulation of capital markets enabled them to raise increasingly large proportions of their capital in domestic and foreign-currency denominated debt and equity markets.¹⁰² A concomitant decline in the importance of bank finance was observed. A pair of statistics suggests the speed and scale of the transition in capital structure. Between 1971 and 1975, bank borrowing comprised 84% of all external finance of the large Japanese firm. From 1981 to 1985, however, bank finance only comprised 57% of total external financing of large Japanese firms.¹⁰³ In their study of Japanese corporate balance sheets, Anderson and Makhija find that between 1980 and 1992 trade credit and long-term lending declined substantially as a proportion of debt, while the proportion of corporate bond-backed financing nearly quadrupled from 3.3% to 12.5%, and equity finance as a proportion of assets rose from 19% to 32%.¹⁰⁴

This Part discusses the deregulation of Japan's capital markets throughout the 1980s and considers the consequences of deregulation for Japanese banks. This Part concludes by identifying the implications of deregulation for the private resolution of business failure through the use of market methods.

A. *Deregulation of Capital Markets*

It is important to note that capital market deregulation arose from much more modest efforts in the late 1970s to ease interest rate restrictions on Japanese sovereign bonds, as the Government of Japan began to run budget deficits.¹⁰⁵ Previously, no secondary market for Japanese sovereign bonds existed. Rather, the Ministry of Finance pressured banks to hold low-yielding government bonds, while high growth enabled the Bank of Japan to

¹⁰² Anderson & Makhija, *supra* note 15, at 313.

¹⁰³ *Bank Monitoring and Investment*, *supra* note 4, at 110.

¹⁰⁴ Anderson & Makhija, *supra* note 15, at 313-14.

¹⁰⁵ PUBLIC AND PRIVATE DEBT, *supra* note 23, at 13.

monetize these bonds without risking inflation.¹⁰⁶ By 1977, Japanese banks challenged this policy and demanded the relaxation of interest rate restrictions on government bonds.¹⁰⁷ The government agreed and held its first public auctions on government bonds in 1978.¹⁰⁸

The liberalization of sovereign debt jeopardized the market for corporate bonds, which were subject to even greater interest rate restrictions than sovereign bonds, and had persistently delivered below-market returns to corporate bondholders.¹⁰⁹ As other scholars have noted, “it became apparent that the demand for corporate bonds would have been destroyed by the liberalization of the government bond market.”¹¹⁰

Japanese regulators responded by easing regulatory restrictions on corporate bond issuance. While continuing to require that corporate bonds be fully secured against the assets of the issuer, the government replaced fixed interest rate ceilings with flexible ceilings adjusted in line with market conditions and removed interest-rate ceilings altogether on convertible bonds, and the market for convertibles grew quickly.¹¹¹ The next major reform came in 1980 with the amendment of the Foreign Exchange Law, which removed traditional impediments to the issuance of foreign-currency denominated corporate bonds in international capital markets, including approval by the Bond Committee.¹¹² Under the amended Foreign Exchange Law, firms were no longer required to seek permission to issue foreign-currency denominated bonds in overseas capital markets; firms needed only to provide notice to the Ministry of Finance that they intended to issue such bonds.¹¹³ More importantly, these bonds had no security requirement, providing Japanese firms with their first taste of unsecured debt markets and lowering the entry costs of bond issuance. Japanese firms quickly adapted to this liberalized debt market environment and raised nearly half of their capital in overseas bond markets by 1983.¹¹⁴

The government followed these deregulatory measures with the legalization of warrant bonds in 1981, and the warrant option was made

¹⁰⁶ *Bank Monitoring and Investment*, *supra* note 4, at 109.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ PUBLIC AND PRIVATE DEBT, *supra* note 23, at 13. See also Takeo Hoshi & Anil Kashyap, *The Japanese Banking Crisis: Where Did It Come From and How Will It End?*, 14 NBER MACROECON. ANN. 129, 140 (1999) (providing a detailed list of bond-market deregulatory events).

¹¹² *Bank Monitoring and Investment*, *supra* note 4, at 109.

¹¹³ *Id.*

¹¹⁴ In fact, a handful of Japanese firms raised capital via Euromarket bond offerings in the early 1970s, but because of the permission requirements imposed prior to 1980 under the Foreign Exchange Law, few were able to tap the Euromarket for bond issues prior to deregulation. See Grouse, *supra* note 24, at 592.

detachable from the underlying debt instrument in 1985.¹¹⁵ Warrant bonds, like convertible bonds, proved popular and the Ministry of Finance estimated in 1986 that warrant bond issues accounted for over 20% of all new capital raised.¹¹⁶

Finally, in 1983, the government announced the first move in the most significant deregulation yet: the relaxation of standards for the issuance of unsecured corporate bonds.¹¹⁷ Prior to 1983, only two Japanese firms, Toyota Automotive and Matsushita Electric, were deemed sufficiently credit-worthy to issue completely unsecured bonds.¹¹⁸ In January 1983, an additional nine firms were permitted to issue unsecured straight bonds and twenty-three firms were permitted to issue unsecured convertible bonds.¹¹⁹ This privilege was steadily expanded to greater numbers of firms throughout the 1980s. By 1987, 180 firms were permitted to issue unsecured straight bonds and 330 firms were authorized to issue unsecured convertible bonds.¹²⁰ While previous liberalizations of convertible and warrant bonds had increased the domestic market for Japanese corporate debt, outstanding security requirements on the issuance of this debt had restricted the issuance of this debt to the size of the firm's unsecured assets.

Despite this progressive deregulation of the domestic straight bond market, the biggest growth throughout the 1980s remained in unsecured convertible and warrant bonds, accounting for 77.9% of all corporate bond issuances in 1989.¹²¹ First, it is important to note that while many large firms were capable of issuing unsecured straight bonds by the late 1980s, this was not true throughout much of the decade. Second, there was considerable resistance to the liberalization of the unsecured straight bond market from the Japanese commercial banks that served as corporate bond trustees under the Secured Corporate Bond Trustee Law.¹²² Under that law, Japanese banks were appointed as trustees over the collateral against which the bond was secured, and were able to charge substantial fees for their maintenance services.¹²³ It was customary in the Japanese corporate debt market for trustee banks to bear the risk of loss in place of other bondholders, buying back bonds in default and then recovering their losses against the secured corporate debt through private negotiations or formal

¹¹⁵ *Bank Monitoring and Investment*, *supra* note 4, at 109.

¹¹⁶ *Id.*

¹¹⁷ Grouse, *supra* note 24, at 593.

¹¹⁸ *Id.*

¹¹⁹ *Bank Monitoring and Investment*, *supra* note 4, at 109.

¹²⁰ *Id.*

¹²¹ *Id.* at 588.

¹²² *Id.* at 593.

¹²³ *Id.*

insolvency proceedings.¹²⁴ In this way, informal securities market practices concentrated claims in the hands of a small number of bank creditors, reducing the cost of private negotiations. These arrangements also enabled banks to influence the terms and conditions of bond issuance, since they were understood by the domestic market to be the ultimate risk-bearers of risk on default.¹²⁵

Unsecured straight bonds enabled firms to raise capital without being subject to collateralization and fee requirements. Banks understood, however, that unsecured bond issuance coupled with traditional trusteeship practices threatened to expose them to buyback risk without the provision of either the maintenance fee cushion or the right to foreclose against collateral as secured claimholders in case of the default of the issuer upon its outstanding bonds. Accordingly, banks used their dual powers as trustees and large lenders to restrict the issuance of unsecured domestic straight bonds.¹²⁶ In 1989, at the peak of the “bubble economy,” Japanese firms issued only \$250 million in domestic unsecured straight bonds, which amounted to only one-twentieth of the amount of foreign-currency denominated unsecured straight bonds issued by Japanese firms in overseas capital markets.¹²⁷

B. *Consequences of Deregulation for Banks*

As the account above suggests, the deregulation of Japan’s capital markets in the 1980s resulted in changes to the capital structure and creditor composition of large Japanese firms. Japanese firms capable of issuing bonds diversified their sources of debt capital and issued bonds in domestic and overseas capital markets.¹²⁸ Deregulation of corporate bond markets opened the door for large-scale bond issuances, and foreign investors in particular demonstrated a strong appetite for Japanese bonds. Moreover, the issuance of large numbers of convertible and warrant bonds in domestic and overseas debt markets may have eased a great deal of equity into the hands of domestic and foreign investors; while many more convertible bonds than straight bonds were issued during the 1980s, the slow growth of convertible

¹²⁴ *Id.* at 594.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.* at 589.

¹²⁸ PUBLIC AND PRIVATE DEBT, *supra* note 23, at 14 (the trend by firms away from intermediated finance accelerated in 1983, before leveling off in 1990 at a ratio of approximately 50%).

bonds as a proportion of liabilities suggests that conversion rights were often exercised.¹²⁹

The deregulation of Japan's capital markets also had consequences for Japanese banks. While banks continued to lend to large Japanese firms, the growth of non-bank bondholders diversified the creditor composition of large firms.¹³⁰ Banks were accustomed to facilitating negotiations when firms entered financial distress, but negotiated resolution became more complex as the number and diversity of creditors increased. Additionally, banks' equity stakes in their borrowers may have been diluted by the release of equity into the market through the exercise of convertible and warrant bonds.¹³¹

As bond trustees, banks stabilized the corporate bond market in case of issuer default through bond buybacks, but such buybacks posed significant risks without pre-default collection of maintenance fees and post-purchase security rights against the issuers. Japanese bond investors were unused to pricing default risk into corporate bond purchases, since issuers and trustee banks shared the costs of default, and investors received low interest rates in return for their low risk exposure.¹³² Bond buybacks by Japanese banks did not just stabilize bond markets but also protected the credibility and reputation of Japanese financial intermediaries, to the extent that even if trustee banks were denied maintenance fees and secured claims against assets of the issuer, it was difficult for banks to refuse bond buybacks.¹³³

¹²⁹ Anderson & Makhija, *supra* note 23, at 314.

¹³⁰ See SCHAEDE, *supra* note 24, at 104 (figure 5.6(a) depicts flow data for corporate financing between 1960-2004 for large firms, illustrating that bank lending continued throughout the mid- to late-1980s at its high-growth era levels, although it was eclipsed by stock and bond-market financing). As some large borrowers stopped borrowing from banks during the 1980s, banks sought out new borrowers among SMEs, continuing to secure loans against collateral—largely real estate. *Id.* at 102-03. Banks throughout the 1980s sought to maintain high volumes of loans and overlooked borrower default risks in order to preserve their business model. *Id.* at 103.

¹³¹ See Anderson & Makhija, *supra* note 15, at 314. Long-term loans as a proportion of liabilities on firm balance sheets fell from 14.7% to 7.0% between 1980 and 1992, but bank loan volumes were consistent with their 1970s levels. *Id.*

¹³² Grouse, *supra* note 24, at 598 (arguing that “[i]n light of this sudden liberalization of the Japanese bond market, and the resulting boom in debt financing . . . it is little wonder that the general appreciation of risk on the part of the average Japanese investor is poorly developed”).

¹³³ *Id.* (individual bond investors did not bear heavy losses on Japanese bond defaults prior to the 2001 collapse of Mycal, the Japanese retailer).

C. *Implications of Deregulation for the Private Resolution of Business Failure*

The deregulation of Japan's capital markets enabled large Japanese firms to raise increasing proportions of their debt capital in domestic and foreign bond markets, resulting in the diversification of their capital structures and the composition of their creditors.¹³⁴ As new sources of capital emerged, bank debt and trade credit became somewhat less significant sources of external capital, although banks continued to lend heavily throughout the 1980s.¹³⁵ Diversification of creditor composition may have also had consequences for negotiating dynamics during the private resolution of business failure, as banks were joined by classes of bondholders with potentially divergent interests. These developments occurred during a period of financial exuberance, and the implications of diversified capital structures and creditor compositions may not have been readily apparent to banks and borrowers during the 1980s.

In Part IV, this article discusses the challenges that arose during Japan's prolonged recession in the 1990s, during which time banks provided ongoing loan support to distressed borrowers to prevent their insolvency. Part VI seeks to explain this behavior in light of the barriers to negotiated resolution of business failure that arose from the diversification of creditor composition, as well as the existing substantive and procedural defects in Japan's insolvency laws.

VI. THE FAILURE OF MARKET METHODS AND LEGAL PROCESS IN THE RECESSIONARY 1990S

As the 1990s began, Japan entered a prolonged, deep recession, triggering sharp declines in asset values, including equities and commercial real estate investment, while liabilities maintained their bubble-era values.¹³⁶ This had significant implications for Japanese firms and their creditors.

As explained below, changes in capital structure and creditor composition raised barriers to negotiated resolution of business failure, and legal process remained burdensome and costly. Thus, neither market methods nor legal process provided adequate remedies for creditors seeking

¹³⁴ Anderson & Makhija, *supra* note 15, at 314.

¹³⁵ Banks may have suffered from an adverse selection problem during this period, however, in that demand for loans may have been highest among borrowers that were less capable of raising capital in the capital markets. SCHAEDE, *supra* note 15, at 103.

¹³⁶ RICHARD KOO, THE HOLY GRAIL OF MACROECONOMICS: LESSONS FROM JAPAN'S GREAT RECESSION 13-16 (2008).

to resolve the near-insolvency of many distressed borrowers. In response, Japanese banks provided ongoing loan support to distressed borrowers in order to stave off their insolvency. This Part argues that, despite the seeming irrationality of continuous bank lending to non-performing borrowers, the simultaneous failure of market methods and legal process suggests a rational explanation for this behavior of Japanese banks.

A. *Japanese Banks Provided Loan Support to Distressed Borrowers*

Japanese banks were particularly vulnerable to the declining values of their borrowers' assets. While bank debt was relatively less important in the capital structure of Japanese firms, Japanese banks had continued to increase their loan exposure to Japanese firms throughout the 1980s. Loans were either explicitly secured against firm assets or were at least made in the knowledge of the financial health of the borrower.¹³⁷ As firms struggled to satisfy their outstanding debt obligations to Japanese banks, the volume of nonperforming loans ("NPLs") in banks' lending portfolios increased.¹³⁸ The proliferation of NPLs raised questions as to the adequacy of bank capital reserve ratios to meet the default risks of their borrowers.¹³⁹

Empirical evidence suggests, however, that Japanese banks continued lending to non-performing borrowers, supplying credit throughout the 1990s to firms that would otherwise have defaulted on their debt obligations and forced private or legal resolution of their business failure.¹⁴⁰ Japanese banks pursued seemingly irrational lending strategies: increasing the volume of lending to their most troubled borrowers without increasing the volume of lending to financially healthy borrowers, and declining to charge risk premiums on loans to their most troubled borrowers.¹⁴¹

These lending practices had two effects. First, they appeared to decrease NPLs by enabling Japanese firms to satisfy short-term debt obligations. Second, they allowed Japanese firms to misrepresent their capital levels in order to give the appearance of financial health.¹⁴² Banks themselves did not have endless capital to commit to lending to nonperforming borrowers, and banks were only capable of engaging in this

¹³⁷ *Id.* at 40 (ex. 2-1 illustrates rising bank lending to the corporate sector throughout the 1980s as a percentage of nominal GDP, peaking at 85% during the late 1980s).

¹³⁸ SCHAEDE, *supra* note 15, at 36.

¹³⁹ Dan W. Puchniak, *Perverse Main Bank Rescue in the Lost Decade: Proof That Unique Institutional Incentives Drive Japanese Corporate Governance*, 16 PAC. RIM L. & POL'Y J. 13, 44 (2007).

¹⁴⁰ Joe Peek & Eric S. Rosengren, *Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan*, 95 AM. ECON. REV. 1144, 1165 (2005).

¹⁴¹ Puchniak, *supra* note 139, at 36.

¹⁴² *Id.* at 44.

lending scheme because of low borrowing costs from the Bank of Japan.¹⁴³ Banks could continue “evergreening” their loans so long as the repayment of their outstanding credit obligations was more valuable than the costs incurred by central bank borrowing.¹⁴⁴ I describe these bank lending practices as “loan support,” to avoid the negative connotations of “evergreening.”

These lending choices, which scholars have described derisively as “unnatural selection” or “perverse incentives,” arguably prolonged the depth and severity of Japan’s recession by preventing otherwise insolvent firms from defaulting and by delaying structural adjustment.¹⁴⁵ Instead, lending volumes remained large and expanded to nonperforming sectors of the Japanese economy, which could not be revived to financial health even by extraordinary fiscal and monetary stimulus.¹⁴⁶ Puchniak argues that banks throughout this period were motivated in large part by the need to meet minimal capital requirements under Basel I rather than the desire to enhance profitability.¹⁴⁷ The government of Japan helped banks to nominally meet their Basel-mandated risk-based capital ratios by allowing firms to employ accounting gimmicks to disguise the true health of their borrowers, prohibiting banks from disclosing their loan support for distressed

¹⁴³ Jun Nagayasu, *The Term Structure of Interest Rates and Monetary Policy During a Zero Interest Rate Period*, 22 MONETARY & ECON. STUD. 19, 22 (2004). The official discount rate declined from 6.0% to 0.5% between July 1991 and September 1995. *Id.* Rates stayed low, between 0.5% and 0.25%, from 1995 to 1998. *Id.* The Bank of Japan brought short-term interest rates near zero in February 1999 and kept rates at such levels until June 2006. See Masaru Yoshitomi, *Comments on: “Japanese Monetary Policy: 1998-2005 and Beyond” by Takatoshi Ito* (BIS Papers No. 31, 2006), available at <http://www.bis.org/publ/bppdf/bispap31k.pdf>.

¹⁴⁴ Puchniak suggests that loan support was likely unprofitable for banks, despite very low borrowing costs, and that banks were incentivized to take losses by implicit government rescue promises and regulatory forbearance, and by subsidizing banks through the purchase of subordinate debt at below-market levels. Puchniak, *supra* note 139, at 53-56. The implicit rescue hypothesis appears questionable in light of the failure of Hokkaido Takushoku Bank and the mergers between many other banks during the period. *Id.* at 54. As a counter-argument, I propose that loan support practices suggested that banks were less concerned by profitability than with lowering default risk. Peek and Rosengren discuss the “balance sheet cosmetics” hypothesis, which suggests that “the incentive for a bank to make additional credit available to troubled firms to which the bank already has loans outstanding increases as the bank’s reported risk-based capital ratio nears its required capital ratio.” Peek & Rosengren, *supra* note 140, at 1150.

¹⁴⁵ Both negative appellations were taken from the title of Peek and Rosengren’s 2005 article.

¹⁴⁶ Puchniak, *supra* note 139, at 35-36 (finding that industries most heavily affected by the bursting of the bubble economy, such as real estate and construction, were among the largest loan recipients throughout the 1990s and increases in loan amounts to troubled borrowers in these industries should be viewed within a broader portrait of declining lending throughout the 1990s, as corporate borrowing declined throughout the 1990s). Koo attributes declines in lending to corporate borrower’s lack of demand for funds, rather than to banks’ unwillingness to lend. KOO, *supra* note 136, at 46-47.

¹⁴⁷ Puchniak, *supra* note 139, at 45, 47-48 (“Japanese banks found themselves in the unique position where government regulations and incentives, coupled with their battered balance sheets, made evergreening, rather than cutting risk loans, a more effective strategy” for meeting their risk-based capital ratios).

borrowers, providing reassurance that ongoing loan support would not result in bankruptcy, and lending capital to financial institutions at below-market interest rates.¹⁴⁸

Peek and Rosengren find that the main bank system, which declined in significance during the 1980s, re-emerged in the 1990s as a significant source of loan support to distressed firms.¹⁴⁹ Main banks were more likely than secondary lenders to provide additional loans to troubled borrowers, and this tendency increased if the primary lender and the troubled firm were members of the same business group.¹⁵⁰ Moreover, the authors' empirical findings suggest that government policy identified main banks rather than other lenders as the appropriate providers of loan support to distressed borrowers.¹⁵¹ Finally, Peek and Rosengren's studies suggest that government lenders provided direct support to distressed firms with troubled main banks.¹⁵² Thus, government lending policy addressed the problem of financial distress from the perspectives of both lender and borrower, since the failure of either the borrower or the lender was likely to trigger a string of defaults among related parties.¹⁵³

These studies indicate significant levels of institutional intervention in the performance of financially distressed Japanese firms in the 1990s by both major commercial lenders and the Bank of Japan. This institutional intervention, while preventing or prolonging the occurrence of actual default by distressed borrowers, has been heavily criticized for creating "zombie banks" and "zombie firms" which survived throughout the 1990s only by virtue of nontransparent accounting standards and the flow of lending enabled by near-zero interest rates and loose monetary and fiscal policies.¹⁵⁴

¹⁴⁸ *Id.* at 49-50.

¹⁴⁹ Peek & Rosengren, *supra* note 140, at 1148 (finding that "the shift to bond finance and away from bank finance by Japanese firms did not continue during the 1990s even as the bad loan problems at banks intensified").

¹⁵⁰ *Id.* at 1161.

¹⁵¹ See Puchniak, *supra* note 139, at 58 (citing Peek & Rosengren and interpreting their analysis to "find that government lenders were more likely to increase loans to firms that had troubled main banks . . . [suggesting] that the government attempted to aid unhealthy main banks that were keeping their promise to evergreen").

¹⁵² *Id.* at 1162.

¹⁵³ See Packer & Ryser's findings on the significant number of insolvencies triggered by the insolvency of related firms. PACKER & RYSER, *supra* note 53, at 20.

¹⁵⁴ See Ricardo J. Caballero, Takeo Hoshi, & Anil K. Kashyap, *Zombie Lending and Depressed Restructuring in Japan*, 98 AM. ECON. REV. 1943 (2008) (for the argument that loan support to "zombie firms" delayed restructuring by preventing competitive forces from forcing troubled firms to fire workers and lose market share).

B. Loan Support Can Be Explained By the Failure of Market Methods and Legal Processes.

It seems plausible that the Bank of Japan and Japanese commercial banks coordinated their policy to provide liquidity to distressed firms and avoid or postpone the incidence of widespread insolvency. These goals seem consistent with earlier bank behavior, particularly in light of the liquidity and cash-flow enhancing effects of bank supervision of distressed firms.¹⁵⁵ It is possible to explain loan support, however, without finding that Japanese banks operated as implicit rescuers. As Miwa and Ramseyer have observed, the implicit rescue hypothesis is largely myth and ignores the influence of rational incentives on the behavior of banks and borrowers.¹⁵⁶

In fact, bank behavior was rational under the circumstances. These circumstances included near-zero interest rates and loose monetary policy, the failure of market methods to resolve business failure where changes in capital structure had raised the costs of private negotiations, and substantive and procedural deficiencies in Japan's insolvency laws that limited their utility.

1. Low Interest Rates and Loose Monetary Policies Enabled Loan Support

The Bank of Japan's monetary policies throughout the 1990s kept interest rates close to zero, enabling commercial banks to borrow from the central bank at very low cost. The banks providing loan support were usually major lenders, if not primary lenders, of the distressed firms. It is likely that these banks had major loan exposure to the distressed firms receiving loan support, including debt obligations nearing maturity.¹⁵⁷ Default upon such short-term debt obligations would require banks to take major writedowns on their balance sheets, calling into question the adequacy of their capital reserves and threatening to throw banks into insolvency.¹⁵⁸

¹⁵⁵ Morck & Nakamura, *supra* note 10, at 336.

¹⁵⁶ See Yoshiro Miwa & J. Mark Ramseyer, *Does Relationship Banking Matter? The Myth of the Japanese Main Bank*, 2 J. EMPIRICAL LEGAL STUD. 261, 298 (2005) [hereinafter *Does Relationship Banking Matter?*].

¹⁵⁷ Indeed, Peek and Rosengren suggest that the rationale for providing loan support was precisely to prevent firms from defaulting on short-term debts owed to the financial institution providing the loan support. This was done to prevent borrower default, which in turn shielded the bank's reported risk-based capital ratio from declining. Peek & Rosengren, *supra* note 140, at 1165.

¹⁵⁸ *Id.* This phenomenon occurred in 1997, when the failure of Sanyo Securities triggered the collapse of Hokkaido Takushoku Bank, and ultimately the failure of Yamaichi Securities. See Mitsuhiro Fukao, *Recapitalizing Japan's Banks: The Functions and Problems of Financial Revitalization Act and Bank Recapitalization Act*, 38 KEIO BUS. REV. 1 (2000).

The provision of loan support to distressed borrowers was rational for banks with significant loan exposure to non-performing borrowers, so long as the costs of capital from the Bank of Japan were less than the expected value of debt repayment by the troubled borrower. This mechanism allowed commercial banks to borrow cheaply, lend this money out to debtors at a higher rate, and receive some of that loan capital back in return as repayment of interest and principal on debt obligations nearing maturity. A portion of this money would go to paying interest rates on the sum borrowed from the central bank, and a portion might go towards bank expenses or reinvestment. Loan support provided banks with interest income they would not otherwise have, and allowed banks to avoid writedowns that might reveal the extent of their bad debt exposure.

Loan support to distressed firms may have allocated capital inefficiently to firms that could not make good use of the capital, but this is precisely the sort of moral hazard invited by ultra-low interest rates and loose monetary policies.¹⁵⁹ Although loan support was highly susceptible to abuse, the policy was not without its theoretical merits. If banks reinvested their earnings from loan repayments in higher-return assets that allowed them to cover residual losses from the NPLs in their loan portfolios, such policies over time might eventually permit banks to sever their ties with troubled borrowers once their balance sheets were sufficiently recovered to bear the losses.¹⁶⁰

2. *Loan Support Was Not Provided to All Distressed Borrowers*

The existence of loan support did not prevent many financially distressed firms from entering insolvency in the 1990s. Until the 1990s, the annual rate of all insolvency filings, including corporate and personal liquidations and reorganizations, was only 2,254 per year.¹⁶¹ There was a surge in corporate and personal insolvency filings in the early 1990s, which led courts to adapt their procedures to accommodate the increased volume of insolvency filings.¹⁶² These internal reforms prompted a second wave of

¹⁵⁹ See Adam S. Posen, *The Political Economy of Deflationary Monetary Policy, in JAPAN'S FINANCIAL CRISIS AND ITS PARALLELS TO U.S. EXPERIENCE* 194, 206 (Ryoichi Mikitani & Adam S. Posen eds., 2000), available at: http://www.piie.com/publications/chapters_preview/319/9iie289X.pdf (Bank of Japan Governor Hayami Masaru spoke frequently of the moral hazards posed by Japan's zero interest rate policy).

¹⁶⁰ This view is consistent with Miwa and Ramseyer's argument that Japanese bankers reduced loan exposure to troubled borrowers where they could, and provided continued loan support only when banks decide that continued support will enhance the prospects of repayment. See Miwa & Ramseyer, *supra* note 11, at 338.

¹⁶¹ Anderson, *supra* note 2, at 3.

¹⁶² *Id.* at 4.

corporate and personal filings in the mid-1990s.¹⁶³ Part IV suggests that Japanese creditors historically relied on market methods to resolve business failure because the costs of private negotiation were lower than the costs of legal proceedings, and that the high costs associated with formal insolvency proceedings in Japan gave incentives to creditors and distressed firms alike to resolve failure through private negotiations.

Accordingly, while further empirical work must be done in this area, it seems reasonable to predict that many more firms were privately reorganized or liquidated throughout the 1990s than were reorganized or liquidated through court procedures. A sharp increase in bankruptcy filings likely represented only a small fraction of total business failures during the decade. These findings suggest that Japanese banks did not provide lending support indiscriminately but continued to distinguish firms that possessed sound prospects for recovery but needed time to reduce debt from firms that required either reorganization or liquidation. Alternatively, banks might have targeted lending support to firms to which they had large loan exposures and allowed firms that posed less risk to banks' balance-sheet health to fail. Either explanation is consistent with the claim that the application of loan support was guided by rational incentives.

3. *Loan Support Did Not Prevent Japanese Firms from Raising Debt Capital in the Domestic Bond Market*

Despite allegations of perverse incentives, loan support likely did not prevent healthier firms from raising debt capital. Rather, the domestic bond market remained relatively robust throughout the 1990s, following commercial law reforms that relaxed debt issuance restrictions and removed the trustee bank barriers to the issuance of domestic straight unsecured bonds.¹⁶⁴

Under the pre-1993 Commercial Code, Japanese firms were restricted from issuing public debt beyond either a firm's capital, cash reserves, or net assets according to its final balance sheet.¹⁶⁵ As Japanese firms faced declining asset values, restrictive debt issuance laws threatened to shut many leveraged firms out of domestic capital markets, forcing Japanese firms to rely more heavily on overseas capital markets.¹⁶⁶ The 1993 Commercial Code Reform abolished bond issuance restrictions and reformed the

¹⁶³ *Id.*

¹⁶⁴ Grouse, *supra* note 24, at 589.

¹⁶⁵ *Id.* at 594.

¹⁶⁶ *Id.* at 595.

corporate bond trustee system, lowering barriers to the issuance of domestic corporate bonds.¹⁶⁷ Trustees were replaced by Corporate Bond Management Companies, which were more limited in the scope of their managerial powers, enabling securities companies to play a larger role in structuring bond offerings and reducing bond issuance fees and maintenance fees.¹⁶⁸

Following the 1993 Commercial Code Reform, new bond offerings were largely unsecured straight bonds without implicit buyback guarantees. While unsecured straight bonds had comprised only 9% of the Japanese bond market in 1989, they swelled to a whopping 93.2% of the market by 1997.¹⁶⁹ The volume of domestic bonds issued also increased significantly. In 1997, \$57 billion worth of domestic straight bonds were issued, which was 190 times greater than the value of such bonds issued in 1989 and six times greater than the value of all overseas straight bonds issued in 1997.¹⁷⁰ The robust domestic market for Japanese bonds suggested that many market participants, including institutional investors, believed that the repayment prospects for Japanese corporate debt were sufficiently good to buy unsecured bonds without conversion or warrant rights.¹⁷¹

An alternative explanation for the growth in the domestic corporate bond market that is consistent with the unnatural selection or perverse incentives hypotheses is that the incentives of Japanese banks were so skewed by policies favoring the bailout of financially distressed firms that healthy borrowers could not get bank loans on attractive terms.¹⁷² This explanation has persuasive force, although firms' preference for bond finance over bank debt was also manifest during the 1980s, prior to the recession and the implementation of loan support. Additionally, while empirical research is needed, it seems plausible that Japanese banks preferred to diversify their portfolios by buying bonds issued by non-distressed firms, since bonds provided greater liquidity than loans and could be sold in the market when necessary. The increased issuance of domestic corporate bonds seems to point to both slackening overseas demand for

¹⁶⁷ *Id.* at 596.

¹⁶⁸ *Id.* at 597.

¹⁶⁹ *Id.* at 588.

¹⁷⁰ *Id.* at 589 (noting that domestic unsecured straight corporate bonds accounted for 62% of the Japanese bond market).

¹⁷¹ This latter element may have been more reflective of poor equities performance than the confidence of bond investors.

¹⁷² Puchniak, *supra* note 139, at 37 (arguing that loan share increased throughout the 1990s to the worst-performing sectors of the Japanese economy and decreased to Japan's healthy, export-driven manufacturing sector). *But see* KOO, *supra* note 136, at 46-47 (arguing that this was not due to banks' lack of willingness to lend, but to decreased demand by borrowers for loans and increased levels of corporate savings and debt repayment).

Japanese corporate debt and relatively less favorable terms of bank debt than bond finance for non-distressed firms. However, it does not appear that loan support skewed capital allocation such that large, non-distressed firms were unable to raise debt capital.

4. *Creditor and Stakeholder Composition Continued to Diversify Throughout the 1990s, Potentially Raising Barriers to the Negotiated Resolution of Business Failure*

The continued diversification of creditors and shareholders of the Japanese firm throughout the 1990s, including the growth of foreign institutional investors, may have raised barriers to the negotiated resolution of business failure, discouraging Japanese banks from making use of market methods. As discussed below, foreign institutional investors brought new perspectives that frequently placed them in tension with both firm management and Japanese banks.

Ahmadjian and Robbins characterize the rising influence of foreign institutional investors in the Japanese equity market during the 1990s as a conflict between the stakeholder and shareholder governance.¹⁷³ As Western institutional investors, including pension funds and mutual funds, took portfolio stakes in Japanese firms, they favored downsizing and asset divestiture to constrain bloated cost structures, often placing them in conflict with incumbent management.¹⁷⁴

Japanese business leaders had long focused on diversification and corporate growth, prioritizing growth over profitability and demonstrating relatively little interest in maximizing share price for the benefit of investors.¹⁷⁵ Long-term cross-shareholdings, declined in the 1980s as the exercise of convertible and warrant bonds diluted the value of such shareholdings, and continued to diminish in the 1990s as banks sold off their cross-shareholdings to streamline their stock portfolios. Japanese trading partners in cross-shareholdings also sold equity stakes.¹⁷⁶ As banks and trading partners liquidated their positions, traditionally passive shareholders were replaced by foreign institutional investors seeking bargains in depressed Japanese stocks who demanded that firm management deliver higher returns on capital.¹⁷⁷

¹⁷³ Christina L. Ahmadjian & Gregory E. Robbins, *A Clash of Capitalisms: Foreign Shareholders and Corporate Restructuring in 1990s Japan*, 70 AM. SOC. REV. 451, 452 (2005).

¹⁷⁴ *Id.* at 453, 457.

¹⁷⁵ *Id.* at 454.

¹⁷⁶ *Id.* at 457.

¹⁷⁷ *Id.*

Foreign shareholders exercised influence not just by increasing their stakes in Japanese firms, but by actively participating in shareholder governance, attending annual meetings and demanding that management listen to their ideas.¹⁷⁸ Moreover, foreign investors exercised their right to exit, trading actively and influencing share prices.¹⁷⁹ While foreign investors held only 10% of publicly traded shares, they executed 30% of stock trades, a figure that further increased to nearly 40% in 1999, and Japanese institutional investors often followed trading patterns initiated by foreign shareholders.¹⁸⁰

In addition to being confronted by foreign shareholders, firm managers were confronted by domestic and foreign bondholders, including municipal governments, institutional funds, and individual investors. Like foreign shareholders, these large and diverse classes of creditors had varying interests and appetites for risk. These new classes of bondholders and shareholders were different from the relatively concentrated and homogenous bank creditors whose sophistication, aligned interests, and similar concern for reputational costs facilitated private negotiation.

Just as Japanese managers were unaccustomed to being confronted by activist shareholders seeking board representation or influence over the business activities of the firm, Japanese commercial banks were unaccustomed to the participation of large and unruly classes of creditors or share sell-offs by institutional investors as firms approached financial distress. Bank creditors were accustomed to negotiating with each other over the fate of distressed debtors and may have had reputational incentives not to block a compromise lest they suffer a similar fate when their major borrower was financially distressed. In contrast, bondholders had no incentive to cooperate with bank creditors and strong incentives to force secured bank creditors to accept losses on their claims. Foreign institutional investors were more willing than Japanese shareholders to engage in cross-shareholdings to sell their stakes in distressed firms, trading sufficient volumes to force Japanese institutional investors to sell off their holdings as well.¹⁸¹

To Japanese banks concerned with facilitating private negotiations, increasingly expensive and difficult creditor negotiations and opportunistic foreign shareholders may have provided powerful incentive to prevent their major borrowers from entering financial distress by providing loan support.

¹⁷⁸ *Id.* at 458.

¹⁷⁹ *Id.* at 457.

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

Loan support would not necessarily save distressed borrowers, but it could postpone default indefinitely and provide a distressed firm with breathing room and a chance to reverse its fortunes. Using loan support to postpone private resolution of business failure resulted in financing costs for banks and borrowers alike, but these costs could plausibly be tolerable if creditor negotiations were anticipated to yield even greater costs for banks and firm management.

Since creditors could push failing negotiations into insolvency proceedings, the costs of negotiating the resolution of business failure were unpredictable. It is thus unsurprising that banks might sometimes choose to incur the predictable financing costs of loan support, rather than incur the uncertain costs of negotiation with large and diverse classes of creditors. It is equally unsurprising that management of distressed firms might sometimes accept loan support, rather than brave unpredictable negotiations and the possibility of dismissal if creditors tired of negotiations and pushed the firm into involuntary bankruptcy.

It appears that Japanese banks used loan support as a postponement tactic, the desirability of which arose from banks' concerns that private negotiations would diminish their prospects of debt repayment, as bondholders demanded at least partial recovery of their loss. Where banks could no longer reliably control negotiation outcomes, banks used loan support to allow distressed borrowers to stay in business and pay down their outstanding debts. For banks, loan support was rational and maximized their repayment prospects. The financing costs of providing loan support were low throughout the 1990s, while the barriers to achieving their repayment goals in private negotiations were higher than before.

As discussed above, low interest rates and loose monetary policies enabled Japanese banks to borrow cheaply from the Bank of Japan and provide loan support to distressed borrowers. The simultaneous failure of market methods and legal processes gave banks rational incentives to do so, rather than bear the uncertainty and costs of negotiated resolution or formal insolvency proceedings.

In order to change banks' incentives, however, the central bank had to raise borrowing costs for banks until loan support became too costly to prolong, or until the conditions causing either market failure or legal failure were resolved. In Part VII, I argue that major reforms in Japanese bankruptcy laws addressed substantive and procedural defects in Japan's insolvency laws and provided Japanese creditors with a streamlined and less costly alternative to private negotiations, enabling Japanese creditors to use formal legal proceedings to resolve many business failures between 2000

and 2003. Legal reforms reduced the expected costs of insolvency proceedings relative to the costs of loan support or private negotiation such that creditors and debtors demonstrated a growing preference for legal processes over the market methods available to them.

VII. INSOLVENCY LAW REFORM IN THE 21ST CENTURY

Despite an initial wave of insolvency filings in the early 1990s, Japanese courts and legal scholars recognized that the existing insolvency laws were costly, procedurally inefficient, and impeded the timely resolution of business failure.¹⁸² As discussed in this Part, the Japanese legal community—including judges, academics, and practitioners—undertook significant reforms of Japan’s insolvency law and court procedures in order to remove substantive and procedural barriers to the use of formal insolvency proceedings. Post-reform filing statistics suggest that these reforms removed significant barriers to the use of legal process to resolve business failure.

A. *Development and Implementation of Insolvency Law Reforms*

Japanese judges first implemented an internal reform of court procedures in the mid-1990s, which resulted in a second wave of insolvency filings as Japanese creditors sought to work through another group of deeply distressed borrowers.¹⁸³ However, some of the most significant obstacles to the use of legal process, including the gatekeeping mechanisms and trusteeship reorganization requirements, remained in place.¹⁸⁴

Despite initial procedural reforms, use of insolvency proceedings remained somewhat tepid. As discussed previously, loan support might account in part for creditors’ reluctance to rely on legal process. Banks had strong incentives to use loan support to slowly ease bad debt off their books, and many distressed firms likely postponed restructuring or liquidation given the availability of loan support.¹⁸⁵ Periodic waves of insolvency filings may have reflected creditors’ interest in formally resolving business failure, but the transience of such waves suggested that creditors’ disappointment with legal process led them to fall back on either loan support or market methods.

¹⁸² Anderson, *supra* note 2, at 4.

¹⁸³ *Id.*

¹⁸⁴ *Id.* at 11-12.

¹⁸⁵ *Id.* at 4. This was described in the Japanese press as the “bad debt problem” (*furyō saiken mondai*) and was attributed in part to the inefficiencies and costs associated with insolvency proceedings. *Id.*

In the face of these structural barriers to the use of legal process, voices within the Japanese legal community advocated for insolvency law reform in order to reduce the costs associated with insolvency proceedings and give creditors incentives to use the courts.¹⁸⁶ The government of Japan formed an insolvency reform subcommittee of the Judicial System Deliberative Council, comprised largely of legal academics and practitioners.¹⁸⁷ This subcommittee set a goal of reforming and consolidating Japan's insolvency laws into three procedures: Civil Rehabilitation, Corporate Reorganization, and Bankruptcy.¹⁸⁸

The subcommittee focused its attention first upon Civil Rehabilitation, which was previously known as Composition (*wagi*). The Civil Rehabilitation Act was enacted on April 1, 2000, and retained many of the core components of the Composition procedure. It was a reorganization procedure that applied to both personal and corporate insolvency, it left the debtor partially in control, and it did not extend to secured interests.¹⁸⁹

The Civil Rehabilitation Act made several major alterations to the pre-existing Composition procedure. First, the pre-application screening of the debtor by the court, previously a strict gatekeeping mechanism that threatened to push many debtor-in-possession reorganizations into trusteeship proceedings, was reduced to a nominal review by the court.¹⁹⁰ This change mitigated the debtor firm's incentives to gamble with the assets of the firm or take on additional debt to prevent entering insolvency, since Civil Rehabilitation would not necessarily result in the immediate dismissal of firm management.

The Civil Rehabilitation procedure also allowed the court upon application to impose a stay over secured creditors and even authorized the court to strip creditors of their security interests.¹⁹¹ The stay provisions may have altered the negotiation dynamics between secured and unsecured creditors when an insolvency filing was considered, preventing secured creditors from foreclosing on collateral and raiding the firm's assets while unsecured creditors negotiated the terms of the reorganization. The imposition of the stay gave unsecured creditors a greater voice in

¹⁸⁶ *Id.* at 4-5.

¹⁸⁷ *Id.* at 5.

¹⁸⁸ *Id.* at 6. See also Shinjiro Takagi, *Restructuring in Japan*, 12 INT'L INSOLVENCY REV. 1 (2003).

¹⁸⁹ Anderson, *supra* note 2, at 7. Minji saisei ho [Civil Rehabilitation Act], Law No. 225 of 1999 (Japan).

¹⁹⁰ Anderson, *supra* note 2, at 7.

¹⁹¹ Takagi, *supra* note 188, at 4 (while a secured creditor can enforce its secured rights, a debtor is eligible a temporary stay order prohibiting enforcement of that secured right for a certain period; also, secured rights cannot be extinguished without the consent of the secured creditor unless the debt has been paid in full).

reorganization proceedings and more closely aligned the incentives of secured and unsecured creditors, encouraging them to reach a mutually satisfactory compromise. This was particularly significant where bank creditors held security interests in the assets of the distressed firm and bondholders were almost entirely unsecured.¹⁹²

In addition to these substantive reforms, the Civil Rehabilitation Act furthered internal reforms made by courts throughout the 1990s in enhancing procedural efficiency, lowering time and costs associated with filing.¹⁹³ Anderson argues that these procedural reforms had a major impact on the success of formal reorganization proceedings, accelerating the pace of reform and reducing the ability of creditor and the debtor management to engage in holdup tactics that might deplete firm value and result in the loss of valuable opportunities for reform.¹⁹⁴ Creditor-imposed delays could not only raise the costs of insolvency procedures, but could also prevent distressed firms from raising capital, making investments, and retaining market position, which potentially diminished the firms' prospects for recovery.¹⁹⁵

Most importantly, the Civil Rehabilitation Act galvanized creditors and debtors to file for insolvency at record-breaking levels. While annual corporate insolvency filings in the 1990s numbered in the hundreds, there were 10,000 filings in 2002 alone, and nearly all of these filings were under the Civil Rehabilitation Act.¹⁹⁶ While the Civil Rehabilitation Act was intended to facilitate reorganizations for small and medium-sized enterprises, large firms also made use of the law.¹⁹⁷ Despite the exclusion of secured creditors from court proceedings, large corporate debtors and their creditors valued the reduced scrutiny and quick resolution of insolvency and became primary users of the Civil Rehabilitation procedure.¹⁹⁸

¹⁹² *Id.* Takagi addresses other changes in the Civil Rehabilitation Act, including mitigation of the majority requirement, court permits for sale of the debtor's business, and the reduction of capital without shareholders' resolutions. *Id.* A reorganization plan may only alter the rights of unsecured creditors if it is accepted by a simple majority of creditors holding more than half of the total amount of unsecured claims outstanding. *Id.* Government and state-owned financial institutions, which usually have large numbers of claims, are reluctant to accept plans that alter their claims. *Id.* The consent standards for the alteration of secured creditors' claims are still very high but were reduced to a bare majority level for unsecured claims. *Id.* Under the revised Civil Rehabilitation Act, courts can permit the sale of all or part of a firm's business without a shareholder's resolution, and can reduce an insolvent firm's capital without a shareholder's resolution. *Id.* A shareholder's resolution is still required, however, to raise capital. *Id.*

¹⁹³ Anderson, *supra* note 2, at 7.

¹⁹⁴ *Id.*

¹⁹⁵ For further discussion of the indirect costs of bankruptcy, see Jerold B. Warner, *Bankruptcy Costs: Some Evidence*, 32 J. FIN. 337 (1977).

¹⁹⁶ Anderson, *supra* note 2, at 16.

¹⁹⁷ *Id.* at 8.

¹⁹⁸ *Id.*

Following the enactment of the Civil Rehabilitation Act, the subcommittee reformed the Corporate Reorganization Act and the Bankruptcy Act in April 2003 and January 2005, respectively.¹⁹⁹ The Corporate Reorganization Act retained all the basic features of the previous procedure. It was a trustee-driven reorganization procedure including both secured and unsecured creditors, any plan under which required a majority vote of all participating creditors.²⁰⁰ While the Corporate Reorganization Act did include some procedural innovations, such as a quick approval process for the sale of assets and lien-stripping, few cases appear to have been filed under the Corporate Reorganization Act.²⁰¹

Similarly, the revised Bankruptcy Act largely preserved existing Japanese liquidation procedures, with some refinements to enhance procedural speed and enable the consolidation of parent-subsidiary liquidations for the benefit of creditors.²⁰² As with the Corporate Reorganization Act, filings under the Bankruptcy Act appear to have been few in number.²⁰³

B. *Consequences of Insolvency Law Reform*

It appears that the most significant consequence of Japan's insolvency law reforms was the stark increase in the number of corporate filings under the Civil Rehabilitation Act. The provisions for debtor-in-possession reorganization, exclusion of secured creditors, and procedural efficiencies appear to have overcome some of the most implacable obstacles to the utilization of legal process by creditors and debtors. The possibility of retaining firm management during the reorganization process may have reduced management's incentive to avoid insolvency at any cost, even at the risk of destroying firm value and diminishing recovery for creditors of the firm.

The exclusion of secured creditors from the Civil Rehabilitation process was also significant, since this could plausibly reduce the risk of holdup by secured creditors and facilitate compromise among unsecured bondholders.²⁰⁴ By dividing secured and unsecured creditors and only

¹⁹⁹ *Id.* at 11-12. Kaisha kōsei hō [Corporate Reorganization Act], Law No. 172 of 1952 (Japan) (as amended by Law No. 154 of 2002); Hasan Hō [Bankruptcy Act], Law No. 71 of 1922 (Japan) (as amended by Law No. 75 of 2004).

²⁰⁰ Anderson, *supra* note 2, at 12.

²⁰¹ *Id.* at 11-12; Takagi, *supra* note 188, at 6-7 (proposing that the lack of a "debtor in possession" system was responsible for low levels of interest in using the corporate reorganization procedure).

²⁰² Anderson, *supra* note 2, at 12.

²⁰³ *Id.* at 16.

²⁰⁴ *Id.* at 7.

requiring unsecured creditors to approve the reorganization plan, the Civil Rehabilitation procedure minimized the conflicts of interest between dissimilar creditor classes that could arise in negotiated resolution.²⁰⁵ Finally, the reduced costs and expedited pace of Civil Rehabilitation proceedings likely lowered the barriers to filing and reduced the risk that distressed firms would stagnate further during lengthy insolvency proceedings.²⁰⁶

In contrast, the apparently low rates of creditor utilization of Corporate Reorganization and Bankruptcy procedures may indicate that these procedures did not align creditor and debtor interests as successfully, or that these procedures did not offer an additional value to creditors not already realized by Civil Rehabilitation procedures. Timing could also be a significant factor: the processing of tens of thousands of Civil Rehabilitation filings during the first years of the new century indicates creditors' pent-up demand for cost-effective legal process, but by the 2003 enactment of the Corporate Reorganization Act, corporate insolvency filings were already easing from their peak in 2002. While further empirical work is needed here, it seems possible that the unprecedented and prolonged surge of corporate insolvencies between 2000 and 2003 resolved a significant portion of the outstanding distressed corporate debt.

Changes in accounting standards and balance sheet consolidation under the 1998 financial reforms may have galvanized creditors to push their distressed debtors into Civil Rehabilitation, since creditors could no longer disguise their NPL exposure.²⁰⁷ Distressed firms could no longer hide asset devaluations on their books under mark-to-market accounting standards.²⁰⁸

Changes in accounting standards that increased the visibility of loan support, while reducing its effectiveness in masking bad debt, likely prompted creditors to push distressed firms into insolvency proceedings, but reforms in insolvency law likely mattered as well. Moreover, while the main providers of loan support were major bank lenders with security interests in the assets of the firm, secured creditors could be excluded altogether from Civil Rehabilitation proceedings on application, allowing the court to consider the interests of unsecured creditors.²⁰⁹

²⁰⁵ Takagi, *supra* note 188, at 5.

²⁰⁶ Anderson, *supra* note 2, at 7.

²⁰⁷ SCHAEDE, *supra* note 15, at 127 (concluding that consolidated accounting standards adopted from 2000 onwards prevented firms and banks from hiding unprofitable businesses in privately held subsidiaries, and mandatory quarterly earnings reports improved the availability of Japanese corporate information).

²⁰⁸ *Id.* (noting that mark to market valuation of corporate stockholdings also forced firms to revalue their equity portfolios at current market value, revealing the extent of post-Bubble losses on firm balance sheets).

²⁰⁹ Anderson, *supra* note 2, at 7.

Accounting changes were most likely to imperil the lending relationships between main banks and their distressed borrowers, but main banks were not the beneficiaries of Civil Rehabilitation. Rather, the Civil Rehabilitation Act may have enabled unsecured creditors to push distressed firms into insolvency without risking depletion of firm value by secured lenders.

VIII. CONCLUSION

While further empirical work is necessary in order to strengthen and validate the tentative findings of this article, this account is intended to identify possible relationships between capital structure and creditor composition on the one hand, and the choice between market methods and legal process as a means of resolving business failure on the other.

Concentrated firm capital structures and small, relatively homogenous groups of secured bank creditors appear to have produced conditions under which private negotiation of business failure was perceived as an adequate remedy and relatively more desirable than reliance on legal process. The availability of adequate market methods likely reduced the demand for legal process, obviating the need to address procedural and substantive defects in Japan's insolvency laws. The deregulation of Japan's capital markets enabled firms to reorganize their capital structures, increasing the number and diversity of creditors and likely weakening the influence of bank creditors. This article suggests that changes in capital structure and creditor composition may have created barriers to the negotiated resolution of business failure, necessitating the availability of adequate and effective legal process. Yet without reform, Japan's insolvency laws remained ill-suited to use by creditors.

The onset of a severe and prolonged recession in the 1990s revealed the challenges of resolving business failure under circumstances in which neither market methods nor legal process offered effective remedies for creditors and distressed firms. Loan support enabled banks and firms to indefinitely stave off insolvency and seemingly emerged as a rational, albeit undesirable, strategy in the 1990s for lack of better options.

Finally, the enactment of the Civil Rehabilitation Act in 2000 may have broken the deadlock imposed by the simultaneous failure of market methods and legal process. This Act resolved substantive and procedural obstacles to the use of legal process, enabling unsecured creditors disadvantaged by loan support to protect their interests and force the

resolution of business failure. In the years that followed, tens of thousands of distressed firms were restructured under the Civil Rehabilitation Act.

If a larger theme may be wrought from the limited scope of this text it is that, contrary to perceptions of stagnation and reluctance to modernize (most recently in the context of the Olympus corporate governance scandal²¹⁰), Japan's business system has demonstrated dynamism in the face of legal change, including the deregulation of Japan's capital markets in the 1980s and the reform of the country's insolvency laws at the beginning of the new century. The narrative of "Japan Inc." as a bastion of conservatism²¹¹ is dangerous when it distracts scholars and policymakers from evidence that Japanese firms are responsive to incentives and adaptive to changes in the legal environment. This Article suggests that targeted legal reform may have a significant role to play in the revitalization of Japan's economy, particularly where market methods no longer offer efficient solutions to increasingly complex problems.

²¹⁰ *Back to the Drawing Board: After the Olympus Scandal, Japan Inc. Wants Less Scrutiny*, ECONOMIST (Nov. 3, 2012), <http://www.economist.com/news/business/21565660-after-olympus-scandal-japan-inc-wants-less-scrutiny-back-drawing-board> (last visited May 12, 2013).

²¹¹ *Id.*

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