"Bankruptcies" in Japan

By Robert J. Ballon

Though figures on domestic corporate failures are published monthly in Japan, they leave the foreign reader with unanswered questions. For instance:

(1) The number of reported failures is relatively small. Over the last 10 years, thousands of annual insolvencies in major countries has fluctuated widely with Japan and Germany recording significantly fewer: Japan 6 to 17; Germany 8 to 14; the United States 60 to 71; the United Kingdom 21 to 47, and France 26 to 60 (BOJ 1995b: 138).

(2) Generally, the behavior of Japanese businesses is viewed as idiosyncratic, confusing economic and social considerations. For example, in Japan, business failures are not viewed as part of a desirable process to eliminate inefficient firms. On the contrary, the liquidation of any enterprise appears detrimental since it puts so much at stake.

(3) The relational nature of Japanese contracts is pervasive. This prevalence is most apparent in that business transactions are overwhelmingly settled by promissory notes (*yakusoku tegata*), which creates a breeding ground for insolvency especially among smaller enterprises.

(4) The English translation of the Japanese term for bankruptcy is ambiguous. Official statistics and the mass media report on several forms of "bankruptcy" (*tosan*), but the legal process of bankruptcy (*hasan*) represents less than 10% of this total.

This report briefly reviews reported bankruptcy (tosan), starting with the suspension of bank transactions that usually triggers one of the five types of legal procedures or, more commonly, some form of voluntary arrangement among creditors.

Bankruptcies

Two private agencies (Teikoku Databank and Tokyo Shoko Research) publish monthly reports and an annual compilation of bankruptcies (tosan). The daily press uses the information to obtain a better understanding of the day-to-day economy.

A bankruptcy (tosan; in the rest of this article, we shall translate tosan as corporate failure) is reported whenever liabilities amount to ¥10 million or more. Data is broken down by type of insolvency, by the nature of the enterprise (whether incorporated or unincorporated, the former by capitalization), and by industry. The various factors contributing to insolvencies are identified and tracked over longer or shorter periods (Table 1). The data is further refined by analyses of representative cases and trends. For example, the number of failures and total liabilities attributed to the bursting of the economic bubble were, respectively, 9.6% and 48.6% in 1992, 7.0% and 36.8% in 1993, 5.7% and 31.4% in 1994.

The following figure puts the figures in perspective by comparing the annual totals, between 1991 and 1994, of approximately 13,000 corporate failures with the total number of private businesses.

Figure 1

	Out of	Failed
Number of establishments	6.5 million	13,000
Unincorporated	4 million	3,000
Incorporated	2.5 million	10,000
Large companies	32,000	<100
Small/midsize companies	2.47 million	9,900
Capitalized at <¥10 million	1.7 million	7,000
In construction	600,000	3,000
In manufacturing	850,000	2,500
In wholesale and retail	3 million	5,000
In services	1.7 million	1,500

With few exceptions, businesses are incorporated either as stock company (*kabushiki kaisha*, with a minimum capitalization of ¥350,000 raised to ¥10 million in 1990) or as limited liability corporation (*yugen kaisha* with a minimum capitalization of ¥100,000 raised to ¥3 million in 1990). Large companies are defined as having a capitalization of at least ¥100 million. Total liabilities (minimum ¥10 million per case) reached ¥2,000 billion in 1990, exploded to ¥8,000 billion and ¥7,500 billion in 1991 and 1992 respectively, and started to decline to ¥6,700 billion in 1993 and ¥5,500 billion in 1994. Given that the overwhelming majority of failed enterprises were small firms, the relative number of employees affected was low, at about 100,000 annually out of a total 45 million "regular" employees.

Corporate failures are broken down into one of seven types: five require legal intervention (two of these for liquidation procedures and three for reorganization), and the remaining two are of a private nature, voluntary arrangements and the suspension of bank transactions.

Suspension of bank transactions

A suspension of bank transactions (*ginko torihiki teishi shobun*) is the main cause of reported corporate failures with at least ¥10 million in liabilities. The practice was inaugurated by the Federation of Bankers Associations in the mid-1960s. As pointedly noted by a foreign law expert: "Japanese banks have in effect substituted a purely contractual mechanism for enforcement for a legal one"(Haley

1991: 183).

[Japan] has a unique transaction suspension system, whereby banks belonging to a clearing house impose a two-year freeze on current account transactions of any individual or corporation that issues a dishonored check or bill twice within six months. There is also an agreement between the member banks not to make new loans to such a party. This system is effective in maintaining the trustworthiness of checks and bills. (Federation of Bankers Associations of Japan 1994: 101)

Such "suspension" is the most common reason for the failure of small/mid-size enterprises, usually triggered by the inability to make payment on a bank loan or by default on a promissory note (yakusoku tegata). Issuing a promissory note is the most common method used by firms to settle accounts, particularly for inventory purchases. Such notes usually mature in a 60-90 day period. The note is sent to the supplier upon receipt of his/her statement; s/he can then discount the note at his bank. However, and this is when the note may hide a time-bomb, s/he can endorse it to a third party, or, even more dangerously, use it as collateral for further financing. A dishonored note means that the issuer did not have sufficient funds in his/her settlement account (*toza yokin*) for payment on the due date.

Annually at all clearing houses, dishonored checks and bills amount to about 0.15% in number and 0.02% in value (Table 2). A dishonored debt may then lead to the suspension of bank transactions which is frequently lethal for the firm involved.

In 1994, two-thirds of the 10,000 incorporated firms suspended (with total liabilities of ¥2,700 billion) were capitalized at between ¥1 and ¥10 million; in addition, almost 4,000 unincorporated enterprises suffered a suspension of their bank transactions (Table 3).

A high proportion of dishonored notes have been notes issued to loan sharks (*kori-gashi*) by small entrepreneurs in urgent need of funds. They may obtain immediate funds by issuing a note with a 10-day maturity at usurious rates. The lender will hold the note instead of turning it in for redemption at the issuer's bank on the promise that it will be refunded in cash. Meanwhile, the issuer hopes to obtain proper financing. If he fails, a new short maturity note may be written often under threat. If the loan shark cashes the note, the issuer's fate is sealed.

"Business failure is the standard hard luck of small companies that do not have the necessary leverage on banks or others to bail them out. It is often caused by a chain reaction: when a parent company fails, some of its subsidiaries and subcontractors share its fate. Unlike the small firms left to fend on their own, most large companies are tightly involved with an industrial grouping. They may find themselves in a shaky financial position, but it is expected that well before anything as dangerous as dishonoring a bill could happen, the main bank, if not the entire group, will move to the rescue. (Ballon and Tomita 1988: 73-4)"

Table 1. Corporate Failures (Tosan) by Capitalization and Industry, 1991-94

	1991	1992	1993	1994
Total	10,723	14,167	14,041	13,963
(Liabilities in ¥billion)	(7,970)	(7,563)	(6,714)	(5,500)
Unincorporated	2,448	2,995	2,918	2,907
Incorporated (capital: ¥million):				
< One	242	297	280	312
1-10	5,493	7,328	7,190	7,074
10-50	2,281	3,181	3,301	3,357
50-100	188	258	225	223
100 and more	71	108	127	90
By industry:				
Construction	2,125	2,845	2,868	3,206
Manufacturing	1,477	2,308	2,591	2,740
Wholesale & retail	4,479	5,558	5,287	5,157
Transport & Communications	254	453	518	502
Services	1,133	1,550	1,695	1,537
Others	1,255	1,453	1,082	821
By cause of insolvency:				
Stagnant sales	2,913	5,219	6,707	7,164
Deterioration of bills collection	691	895	955	865
Reckless management	4,178	4,306	3,082	2,785
Failure in business planning	976	1,138	962	910
Others	1,965	2,609	2,335	2,239

Sources: Statistics Bureau 1995: 208, and for 1994, Teikoku Databank 1995a.

As indicated above, the bankrupt firm may then go to court or attempt to reach some "voluntary arrangement" among their creditors.

Five forms of legal resolution

Firms in default or burdened by excessive debts due to business failure, or those that are having difficulty continuing business operations may resort to one of the five types of legal recourse to be filed with a District Court. The forms of legal resolution include legal bankruptcy, special liquidation, commercial-code arrangement, composition and reorganization. In total, 1,595 cases in 1993, and 1,684 cases in 1994, slightly over 10% or reported corporate failures, resorted to one of these forms of litigation (Table 4).

(1) Petition for bankruptcy (hasan)

Hasan (bankruptcy) comes under the Bankruptcy Law of 1992, which is

based on the German Bankruptcy Law of 1877, amended in 1952 to conform to the U.S. legal system introduced after World War II. About 90% of the cases that go to court adopt this procedure. Two-thirds of these are enterprises capitalized at less than ¥10 million. Hasan effectively discharges all the obligations of a bankruptcy by distributing assets. A court-appointed receiver (*kanzai-nin*) with the power to void fraudulent or preferential transfers made by debtor s takes over control of the firm's assets. Bankruptcy is declared if the obligor is found to be insolvent. Bankruptcy proceedings are often sought by small to midsize creditors to protect themselves against large creditors' unilateral settlement with the debtor. Bankruptcy petition can be withdrawn or converted to "composition" (see below).

(2) Special liquidation

Only stock companies already in the process of voluntary liquidation have recourse to special liquidation (*tokubetsu seisan*) under the provision of Article 431 of the commercial code. Where circumstances might seriously impede liquidation, the court can order or accept application for special liquidation. Control remains with the liquidator (usually a representative of the company under liquidation). All creditors, even dissenters, are bound by the settlement. Failure to reach or to execute the agreement sets bankruptcy proceedings into motion.

(3) Procedures under the provisions of Article 381 of the commercial code

If in danger of insolvency, small and privately owned companies often resort to procedures under Article 381 of the commercial code (*shoho seiri*). These are based on a reorganization plan prepared by the company and approved by all its creditors while the court is given wide discretionary power to assist with the reorganization.

(4) Procedures under the Composition Law

The Composition Law of 1992 allows a debtor on his own initiative to file an application for composition (*wagi*) with the court by providing a plan for settlement. The plan is implemented after obtaining approval from the court and three-quarters by value of the creditors. If approval is not obtained, the procedure is converted into a bankruptcy proceeding. Before World War II, this was

Table 2. Checks and Bills Clearing (All Clearing Houses) 1985-94

	1985	1990	1993	1994
Checks and bills				
Number (1,000)	413,305	383,745	327,866	318,083
Value (¥billion)	2,693,034	4,797,291	3,262,382	2,769,857
Dishonored checks and bills				
Number (1,000)	1,176	309	517	491
Value (¥billion)	1,321	1,188	1,340	1,130

Note: 1990 was the peak year in clearing value.
Source: BOJ 1995a: 255-6.

Table 3. Suspension of Bank Transactions by Capitalization, 1990-4

	1990	1991	1992	1993	1994
Total	5,292	9,066	10,728	10,352	10,246
(Liabilities in billion yen)	(1,000)	(4,198)	(4,322)	(3,108)	(2,725)
Capitalized (¥ million)					
1-<10	4,102	6,616	7,723	7,351	7,230
10-<50	1,027	2,025	2,420	2,440	2,506
50-<100	24	90	113	90	89
100 and more	139	335	472	471	421
Memo					
Capitalized at < ¥1 million	262	381	413	365	413
Unincorporated enterprises	3,299	4,598	5,169	4,588	3,895
Individuals	1,148	1,168	1,229	1,015	793

Source: BOJ 1995a: 257.

the most common form of company reorganization; today it is less frequent, particularly within the jurisdiction of the Tokyo District Court.

(5) Protection under the Company Reorganization Law

Kaisha kosei (corporate reorganization) comes under the Company Reorganization Law of 1952 adapted from the U.S. Bankruptcy Law, later extensively amended and now similar to the bankruptcy procedure in the U.S. known as "Chapter 11."

Protection under this statute is available only to joint stock companies to allow the continuation of large-scale operations. Based on considerations beyond the enforcement of legal obligations the emphasis here is on maintaining the assets in order to continue the enterprise. A major aim is the continuation of employee contracts. The law stipulates that the court must hear the opinion of the employees before it decides on the reorganization plan submitted by the custodian.

Corporate reorganization usually follows an attempt at "voluntary arrangement" under the aegis of a company's main bank that now decides to curtail its involvement (see below) Applicants are immediately eligible to undertake measures aimed at preserving the integrity of the company, including the effective stay of creditors' claims. Control of the firm and the reorganization process are transferred to a court-appointed trustee often proposed by the main bank.

The outcome is as follows: major secured creditors become shareholders, capitalization is reduced, and new management takes over, or a merger or takeover is arranged with another company. Several years may elapse but if the procedure remains unsuccessful, corporate assets are sold and the proceeds distributed to creditors based upon seniority of debt; any remaining amounts are distributed to shareholders. Once corporate reorganization has begun, bankruptcy proceedings are suspended and will be terminated when the court approves reorganization.

Table 4. Number of Corporate Failures (*Tosan*), 1993 and 1994

	1993	1994
Total	14,041	13,963
Legal resolution:	1,595	1,684
Hasan (bankruptcy)	1,289	1,459
Tokubetsu seisan (special liquidation)	25	32
Shoho seiri (commercial-code arrangement)	22	20
Wagi (composition)	225	161
Kaisha kosei (corporate reorganization)	34	12

Source: Teikoku Databank 1995a.

Voluntary arrangements

Ninety percent of reported corporate failures do not involve the courts, as creditors and debtors may agree, at least at first, to handle the matter themselves. An informal settlement of claims in the event of insolvency is most usual, aimed at either the total liquidation of the debtor's business or, more likely, at reorganization. The procedure consists of so-called voluntary arrangements (*nin'i seiri*) whereby the decision to liquidate or reorganize is made public by convening a meeting of creditors. In 1994, 15 of the top 50 corporate failures (by amount of liabilities) were handled through voluntary arrangements.

The procedure differs depending on general business conditions and the particular business. In the case of a large company, the initiative is almost always taken by the debtor's main bank, which is usually a major lender to the firm and/or has a cross-shareholding relationship. Among small firms, for whom trade credit is vital, trade creditors may take the initiative.

Large companies

The mediating role of the main bank in the case of insolvency has been compared to the oversight of a court or the appointment of a receiver with the additional and crucial benefit of having already accumulated much specific information on the debtor's prospects (Sheard 1994). Belonging to an industrial group around a core bank facilitates intervention on behalf of the company in distress. Such intervention, however, is not necessarily limited to the members of an industrial grouping. The strategy is three-pronged.

(1) Debt restructuring—Refinancing is arranged as a package with the main bank assuming the largest burden of debt. Debt principal repayments are frozen and interest payments are deferred or forgiven. Bridge financing may be provided by the main band itself or in cooperation with other banks involved. In major cases, close communication with the financial authorities is maintained.

(2) New management–Top management is changed temporarily or definitively. Generally, the founder/owner (or, as is often the case, the long-time president) and other senior officers are demoted or replaced. Directors may have been previously dispatched by the bank, but new executive directors are introduced, if not a team of managers charged with implementing the recovery plan.

(3) Recovery plan—A rationalization plan (*saiken keikaku*) is presented to debtor and creditors. Assets are disposed and the workforce is reduced as needed. Stable shareholdings are transferred to other stable shareholders. It is expected that the main bank will absorb the largest portion of residual risks. The final outcome is often a merger with or a takeover by another large company. Throughout, the bank is careful to maintain trade credit, which means including the trading companies in the reorganization process.

Smaller firms

Smaller firms usually cultivate a working relationship with a particular bank in their neighborhood while diversifying sources of funding and services with other small banks, credit associations and public financial institutions,. Subsidiaries and subcontractors usually allow their parent company to determine the nature of these relationships, since the parent may also guarantee some loans. When several promissory notes fall due at the same time, threatening to undermine a firm's credit, the relationship is called upon to provide some bridge financing. The bank's major incentive is to maintain its local reputation although it always faces the risk that some unsavory dealings may be involved.

For the smaller firm, however, trade creditors are more important than bank creditors. The smaller firm may benefit from a relationship with a large trading company that can provide some cushion in time of distress since the latter is both debtor and creditor and has a mutual stake in the continuity of their business relations. Groupings are common, generally around a local business cooperative officially recognized and supported. The major risk for smaller firms is a chain reaction of insolvencies triggered by the ubiquity of promissory notes and their use, commonly, as collateral. The reason for over 10% of the reported corporate failures in recent years has been such chain-reaction insolvencies. The recent case of Nishiki Finance is enlightening (*see below*).

Conclusion

In Japan, as in other countries, a firm in financial distress faces the difficulty of debt renegotiation with creditors. Social considerations are unavoidable: on a personal level, relationships and loyalties take a beating as the default of one may reflect badly on others. An old Japanese adage about social behavior is that "conflict should not occur." The sad fact is that it does occur.

As in so many other instances of economic life in Japan, business transactions are not so much ruled by explicit reference to legal provisions and contractual stipulations as by relational dynamics among involved parties. The importance of staying in business (vitally more important than doing business) results from the mutual stake of a limited number of actors who generally prefer to avoid bankruptcy courts, at least at first, and try to work out some voluntary arrangement among themselves, because they know each other rather well and participate in a close network of interdependencies. The task of supporting a large company is commonly entrusted to the debtor's main bank in particular when the failing company belongs to an industrial grouping. Such arrangements may not exclude opportunistic or fraudulent behavior (neither does legislation nor a contract), but they are part and parcel of an economic and social system. On the other hand, the government has assumed a prime responsibility for the survival of smaller firms through specialized financial institutions and the promotion of cooperatives. Apparently, it all stands Japan to good since, as expected, "life goes on."

Nishiki Finance, a money lender, was established in 1972 and capitalized at ¥200 million. In 1994, it operated a network of 23 branches and revenue was ¥6.27 billion. It was declared bankrupt (hasan) in August 1995, liabilities amounting to ¥18.5 billion. The chain reaction was traced to a record of 243 instances, including 110 individuals. Liabilities were distributed as follows (¥million):

Less than 50	83 cases	50 to < 100	100 cases
100 to < 500	59 cases	500 to < 1 billion	1 case.

Creditors (besides individuals) were enterprises capitalized as follows (¥million):

Less than one	2 cases	One to < 10	111 cases
10 to < 30	18 cases	30 to < 50	2 cases.

Among the eight major creditors (all with 20 or less employees), two went bankrupt (hasan) and six had entered "voluntary arrangement" (Teikoku Data Bank 1995b).

REFERENCES

Ballon, Robert J. and Iwao Tomita (1988). *The Financial Behavior of Japanese Corporations.* Tokyo: Kodansha International.

BOJ (Bank of Japan) (1995a). *Economic Statistics Annual 1994.*

—(1995b). *Comparative Economic and Financial Statistics: Japan and Other Major Countries 1995.*

Federation of Bankers Associations of Japan (1994) *The Banking System in Japan.* Tokyo.

Haley, John Owen (1991). *Authority without Power: Law and the Japanese Paradox.* New York: Oxford University Press.

Sheard, Paul (1994). *"Main Banks and the Governance of Financial Distress."* In Masahiko Aoki and Hugh Patrick (eds). *The Japanese Main Bank System. Its Relevance for Developing and Transforming Economies.* New York: Oxford University Press, pp.188-230.

Statistics Bureau (1995). *Japan Statistical Yearbook, 1995.* Tokyo.

Teikoku Databank (1995a). *Zenkoku Kigyo Tosan Tokei, 1994.* Tokyo.

—(1995b) *Teikoku News.* August.

Robert J. Ballon is professor emeritus of Sophia University (Tokyo) and director of the International Management Seminars held at the university. He first came to Japan in 1948, and has authored several books on Japanese business such as Foreign Competition in Japan: Human Resource Strategies *published in 1992.*