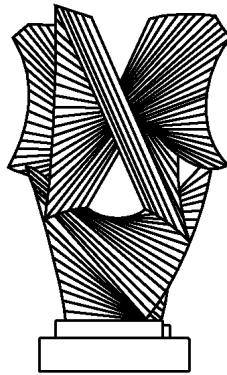


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The Legal Logic to the Japanese
Main Bank System

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Introduction

If the firm is a nexus of contracts, the stylized Japanese main bank system is a nexus of implicit contracts.¹ Of the many characteristics commentators often ascribe to it, take four:

1. The main bank monitors its debtors more intensively than the amount of its loans would suggest;
2. It insures its clients against business failure;
3. It loans its clients large sums, both long- and short-term; and
4. It makes arrangements (1) and (2) implicitly.²

These characteristics raise two quite different inquiries: (1) through (3) lead readers to ask *why* these phenomena occur; (4) should lead them to ask *whether* (1) and (2) occur.

Implicit main bank contracts are not promises that chain-smoking CEOs make in ornate conference rooms. Neither are they promises made in dimly-lit Akasaka restaurants while sipping Scotch and flirting with hostesses. Instead, implicit contracts are promises they never made, for had they made them, they would not be implicit. Make no mistake. It may be a simple definitional matter, but it is a basic one. An agreement is not “implicit” just because it may be unwritten or incomplete. Even if oral and incompletely specified, it will still be an explicit and (generally) court-enforceable contract. Judges may prefer written and complete agreements, but they know how to handle swearing contests over who promised what to

¹Or, as Aoki, Patrick, and Sheard (1994) nicely put it, “a nexus of relationships.”

²Many discussions add a further characteristic: the main bank buys stock in its clients. For an explanation of this phenomenon based on insider trading, see Ramseyer (1993).

whom.³ Instead, in most cases a contract is implicit if but only if no one explicitly made it. That Japanese main bank contracts are implicit thus implies that few Akasaka hostesses have ever seen a bank officer agree either to monitor debtors disproportionately or to insure them against failure. Most scholars of Japanese main banks—whether in this volume or elsewhere—ask why banks and debtors tacitly cut these bizarrely unspoken deals.⁴ In this chapter, I ask whether they cut them at all.

In comparing the American and Japanese legal regimes, I suggest three discrete hypotheses. First, Japanese firms borrow more heavily from banks than American firms in part because of regulatory structures (section 1). During the late 1970s and early 1980s, regulated interest rates more closely tracked market rates in Japan than in the United States; during most of the post-World War II decades, regulation made the bond market a less cost-effective source of funds in Japan than in the United States. For both reasons, firms in Japan had less incentive to avoid the bank loan market.

Second, given the size and character of banking transactions, rational bankers and borrowers will generally negotiate their contracts explicitly (section 2). If they do not draft contracts about issue X explicitly, one should not conclude they draft them implicitly. One should conclude they draft no contracts about X at all.

Third, Japanese banks may rescue borrowers when they do because the legal system keeps them from committing themselves to jettisoning them (section 3). By punishing banks that intervene in their borrowers' affairs, perhaps American judges enable banks more credibly to commit to letting troubled firms die. Because Japanese judges do not punish such banks, perhaps they do not let them commit. Even though Japanese banks would prefer to commit to jettisoning troubled borrowers, perhaps they cannot.

³Japanese law has no general statute of frauds requiring contracts to be in writing, though various exceptions exist (Suekawa, 1–6). On the requirements for insurance contracts, see Egashira (335–62); *Shoho* [Commercial Code], law no. 48 of 1899, § 629.

⁴Notable exceptions include Miwa (1990, 1991, 1993: 178–89); Horiuchi, Packer, and Fukuda; and Horiuchi.

*1. The Heavy Japanese Reliance on Bank Debt**1.1. Differential reliance*

Most scholars claim Japanese firms rely more heavily on bank debt than do American firms.⁵ Although they all find idiosyncratic ways of measuring the reliance and although much depends on accounting definitions, they usually conclude the same: Japanese firms borrow a bigger share of the money they need from banks than do American firms. The Bank of Japan, for example, found that in 1982 American firms borrowed 85 cents from banks for every dollar they borrowed on the securities markets. French firms showed a ratio of 2.65, British firms of 4.08, German firms of 4.20, and Japanese firms of 5.33. During the three preceding years, American firms borrowed 1.69 times as much from banks as through securities, and Japanese firms borrowed 5.33 times as much (Kitahara, 17, 115). Whether in the United States or Japan, most small firms cannot issue bonds.⁶ Were one to examine the debt patterns only of the bigger firms, the cross-national differences would loom larger still.

Much of this difference stems from two sources. First, some of it stems from the heavy disintermediation that occurred in the United States in the late 1970s and early 1980s; accordingly, section 1.2 outlines the interest-rate regulations that contributed to that phenomenon. Second, some of it stems from aspects of the Japanese securities market that raised the costs of securitized finance; section 1.3 traces the source of those costs.

1.2. Interest-rate policy

American policy. During the half-century before the mid-1980s, American bureaucrats limited the interest banks could pay their depositors.⁷ In the late 1970s, however, they let inflation drive market

⁵The only exception I located was Royama, who found a largely similar dependence on bank loans by American and Japanese firms until the mid-1970s.

⁶For example, from 1971 to 1985 Japanese firms with paid-in capital of under one billion yen consistently raised less than one percent of their funds in the bond market (Kamochi, 63).

⁷Banking Act of 1933, 48 Stat. 181, codified as 12 U.S.C. §§ 371a, 371b (Federal Reserve Board member banks); 12 U.S.C. § 1828(g) (FRB nonmember banks); former Regulation Q, 12 C.F.R. § 217, revoked by 51 Fed. Reg. 9767

interest rates high. While the prime rate neared 20 percent, individual savings accounts paid 6 percent interest or less, and corporate and checking accounts paid 0 percent. By early 1980 the difference between the treasury bill yield and the regulated rate on one-year time deposits (pegged at 6 percent) reached 7.46 percent. By mid-1981, it topped 9 percent (see table 1). The difference between the T-bill rate and the pass-book savings rate (pegged at various rates from 5 percent to 5.5 percent) hit 9.84 percent (Board, tab. 1.16).

Effectively, the divergence between the market and regulated rates created a rent. To be sure, the banks may have competed some of it away. If they did not, however, depositors and borrowers could avoid it by circumventing the banks and transacting directly. Increasingly, they did. While market rates stayed low, corporate treasurers could cite convenience to justify keeping cash in zero-interest demand accounts. When market rates rose, so did the opportunity cost of keeping their cash there. Increasingly, they chose not to incur that cost.

Instead, treasurers with money to park placed their money in the commercial paper (CP) market—the market for short-term unsecured corporate obligations.⁸ Other treasurers turned to the market to borrow. In 1959, firms had raised \$3.7 billion in the CP market. By 1976, they had raised \$52.6 billion and by 1989, \$493 billion.⁹

(1986); 1937 Fed. Res. Bull. 1073 (interpreting definition of savings account in Reg. Q to exclude corporate accounts), reproduced in *CCH Federal Banking Law Reporter* § 19, 304.16.

⁸Note that American banks did offer market returns to their largest customers. Since 1961, they had sold negotiable certificates of deposit (CDs). Although the Federal Reserve Board had initially applied Regulation Q to the certificates, by 1973 it exempted them entirely (Loring and Brundy, 349). Hence, during the late 1970s American corporate treasurers could earn market rates by buying these CDs. Because they could always liquidate their investment at the discounted present value of the certificate pay-out, the CDs gave them both market returns and liquidity.

⁹Litt, Macey, Miller, and Rubin (378); Kohn (215); Stigum (48, 1024). Note that much of what is thought to be disintermediation in the United States is instead intermediated finance through the nonbank sector. Although the amount of commercial paper outstanding (generally cited as an index of disintermediation) in the American market in 1987 was \$353 billion, \$275 billion of

Table 1. The Interest-Rate Gap

Year-quarter	Japan			United States		
	Market Rate ^a	Reg'd Rate ^b	MR - RR ^c	Market Rate ^d	Reg'd Rate ^e	MR - RR ^c
1984-4	6.42	5.5	0.92	8.97	no limit	0
1984-3	6.95	5.5	1.45	10.34	n.l.	0
1984-2	7.02	5.5	1.52	9.84	n.l.	0
1984-1	6.83	5.5	1.33	9.13	n.l.	0
1983-4	7.08	5.75	1.33	8.79	n.l.	0
1983-3	7.47	5.75	1.72	9.19	6.0	3.19
1983-2	7.52	5.75	1.77	8.42	6.0	2.42
1983-1	7.61	5.75	1.86	8.08	6.0	2.08
1982-4	8.02	5.75	2.27	7.93	6.0	1.93
1982-3	8.38	5.75	2.63	9.71	6.0	3.71
1982-2	8.05	5.75	2.30	12.36	6.0	6.36
1982-1	7.76	5.75	2.01	12.89	6.0	6.89
1981-4	8.31	6.25	2.06	12.02	6.0	6.02
1981-3	9.03	6.25	2.78	15.09	6.0	9.09
1981-2	8.67	6.25	2.42	14.83	6.0	8.83
1981-1	8.63	7.0	1.63	14.37	6.0	8.37
1980-4	9.31	7.0	2.31	13.71	6.0	7.71
1980-3	9.06	7.75	1.31	9.24	6.0	3.24
1980-2	9.22	7.75	1.47	10.05	6.0	4.05
1980-1	9.27	7.0	2.27	13.46	6.0	7.46

that amount was issued by such financial intermediaries as finance companies (e.g., GMAC). Kohn (216-18); Stigum (1027, 1060).

Table 1. The Interest-Rate Gap

Year-quarter	Japan			United States		
	Market Rate ^a	Reg'd Rate ^b	MR - RR ^c	Market Rate ^d	Reg'd Rate ^e	MR - RR ^c
1979-4	8.60	6.0	2.60	11.80	6.0	5.80
1979-3	7.84	6.0	1.84	9.63	6.0	3.63
1979-2	7.83	5.25	2.58	9.38	6.0	3.38
1979-1	6.48	4.5	1.98	9.36	6.0	3.36
1978-4	6.08	4.5	1.58	8.68	6.0	3.68
1978-3	6.15	4.5	1.65	7.32	6.0	1.32
1978-2	6.01	4.5	1.51	6.48	6.0	0.48
1978-1	6.12	5.25	0.87	6.41	6.0	0.41

Notes and sources:

^aGovernment bond yield, as given in International Monetary Fund, *International Financial Statistics* (Washington, D.C.: International Monetary Fund, various months).

^bBank of Japan "guideline" interest rate applicable to one-year time deposits, in effect at the end of each quarter. See Nihon ginko chosa tokei kyoku, *Keizai tokei geppo* [Economic Statistics Monthly] tab. 60 (Tokyo: Nihon ginko, various months).

^cDifference between market rate and regulated rate.

^dThree-month treasury bill yield, as given in International Monetary Fund, *International Financial Statistics* (Washington, D.C.: International Monetary Fund, various months).

^eMaximum legal interest rate applicable to one-year time deposits, in effect at the end of each quarter. See Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin* tab. 1.16 (Washington, D.C.: Federal Reserve Board, various months).

Individual depositors abandoned banks too. Securities firms had offered mutual funds for decades. Now they offered open-end funds investing in the money market. There, depositors found a close substitute for checking accounts and earned 10 to 20 percent interest to boot. Faced with these options, depositors fled the banks. Faced with their flight, regulators abandoned the restrictions on almost all rates.¹⁰ By 1989, however, investors had already moved \$338 billion to money market funds (Stigum, 15).

Japanese policy. Although Japanese bureaucrats fixed interest rates, too, they more effectively limited inflation and more closely let those rates track market rates. Granted, they banned interest on corporate demand deposits. Yet they allowed near-market rates on a variety of savings accounts.¹¹ Precisely because they let those rates track market rates so closely (see table 1), Japanese investors had less reason to avoid banks.¹² For most of the time between 1978 and 1984, Japanese bureaucrats kept the difference between the market rate and the regulated rate on one-year time deposits under 2 percent. They never let it exceed 3 percent.¹³ They did let the difference between the market rate and the pass-book savings rate (pegged at various rates from 1.75 percent to 4.0 percent) hit 6.03 percent in the third quarter of 1981. Otherwise, they kept it under 6 percent

¹⁰See generally, Depository Institutions Deregulation Act of 1980, Pub. L. No. 96-221, 94 Stat. 132, codified in 12 U.S.C. § 3501; Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469, codified in 12 U.S.C.S. § 3503 note (mandating acceleration of deregulation). For the revocation of Reg. Q, see 51 Fed. Reg. 9767 (1986).

¹¹Pursuant to Okurasho kokushi [Ministry of Finance Orders] issued under the *Rinji kinri chousei ho* [Temporary Financial Interest Adjustment Act], Law No. 181 of 1947, § 2.

¹²Hugh Patrick suggests in correspondence that the treasury bill rate is a short-term rate while the Japanese government bond rate is a long-term rate, and that under most theories the long-term rate will be higher than the short-term rates. Accordingly, he notes, this table may *understate* the contrast between Japan and the United States.

¹³In 1980, 51.8 percent of the financial assets in the personal sector were in time deposits (Suzuki 1987: 28).

(Nihon, tab. 60). On anything other than demand accounts, they let corporate depositors earn interest like anyone else.¹⁴

Although Japanese investors still earned positive rents by avoiding regulated bank accounts, they earned lower rents than in the United States. And because they earned lower rents, so did the entrepreneurs who created the institutions necessary to let them avoid the banks. Institutions are not free. With smaller incentives to create the institutions that would facilitate disintermediation, those entrepreneurs did less to facilitate disintermediation in Japan than in the United States.

1.3. *The securitized loan market*

Not only did Japanese investors and borrowers find bank terms more advantageous than their American peers, they also had fewer options. American corporate borrowers could raise funds in the bond and CP markets. American investors could obligingly park their money there. Before the mid-1980s, however, most Japanese firms had almost no cost-effective nonbank sources for funds, and most

¹⁴Suzuki (1987: 74-83). Only demand deposits (*toza yokin*) paid no interest. Overall, 47.2 percent of the deposits at the Japanese city banks were held by corporate depositors in 1984 (Akane).

Japanese bureaucrats gave the largest depositors significant market-rate options. For example, in 1979 Japanese bureaucrats let banks sell negotiable CDs. Initially, they set a 500-million-yen minimum to the accounts. In 1984 they lowered that amount to 300 million yen, in 1985 to 100 million, and in 1988 to 50 million. Second, in 1985 bureaucrats let banks offer floating interest money-market certificates. Initially, they set a 50-million-yen deposit minimum, and let banks pay a rate that floated at 0.75 percent under the weekly Bank of Japan rate for CDs. Soon, they lowered the minimum—to 30 million yen in 1986, and 20 million and then 10 million yen in 1987. By 1989, they let banks offer a new small-deposit money-market certificate. They originally required a 3-million-yen deposit, but then lowered that floor to 1 million yen, to 500,000 yen, and by 1992 eliminated the floor entirely. Third, in 1985 bureaucrats let banks pay market interest on deposits of at least 1 billion yen. Again, they have since lowered the minimum—in steps (as with the other accounts), by 1991 to 3 million.

In 1985, 9.8 percent of the deposited amount at the city banks paid unregulated interest; by 1990, that amount was 57.9 percent (Sadaki et al., 100).

Japanese investors had no cost-effective nonbank places to park their savings.

American bond markets. Large American borrowers have long been able to obtain funds through the bond market. Although the Securities and Exchange Commission (SEC) has regulated most sectors of that market, it has not (except with junk bonds) killed any sector. In several ways, it has even relaxed the regulatory framework. Through some of these changes, it has significantly cut the cost of securitized finance. As but one example, take “shelf registration.” Beginning in 1982, the SEC offered it as an alternative to the traditional registration procedure. Borrowers must usually file elaborate disclosure statements to issue long-term (over nine months) public debt. Under the new shelf-registration regime, they can reduce the cost of the process by filing a blanket statement covering future issues.¹⁵ Rather than register each time they needed extra cash, they can now issue their bonds “off the shelf.” On a typical \$90-million issue of fifteen-year, 12-percent-coupon bonds in the early 1980s, they saved \$2.3 million.¹⁶

Japanese bond markets. Until the late 1980s, most Japanese issuers—even many of the safest firms—found the bond markets either closed or prohibitively expensive. The reason lay in part in the political power of the banks. In order to protect the spread they earned on the difference between the rates they paid on deposits and earned on loans,¹⁷ the banks had to control the securitized loan

¹⁵Rule 415, 17 C.F.R. § 230.415; see Clark (1986: 751–52).

¹⁶Present-valued aggregate savings. See Kidwell and Thompson (192); Bhagat, Marr, and Thompson. Although Japanese regulators now permit shelf-registration too, they have done so only since the fall of 1988. *Shoken torihiki ho* [Securities Exchange Act], Law No. 25 of 1948, §§ 23-3 through 23-12, as amended by Law No. 75 of 1988; Okura sho rei No. 41 of Sept. 20, 1988 (Yamakawa 1988a, 1988b).

¹⁷The spread was smaller than in the United States, but larger than a market spread. The banks did not maximize the spread between the rates. Rather, they maximized the *politically maintainable* spread. The much larger American spread quickly disintegrated as Americans developed alternatives to banks.

market (bonds and CP).¹⁸ After all, if large firms could freely turn to a securitized market, they could easily circumvent the bank-loan cartel. Corporate treasurers and individual investors could transact directly or through mutual funds;¹⁹ corporate borrowers could issue bonds or CP. Together, they could split the regulatory rents banks would otherwise sometimes earn.

The banks did not disable the bond market entirely. Instead, they levied a toll charge on firms that used it. Any rational monopolist would have done the same. Although bank loans often do economize on transactional and informational costs (Horiuchi and Okazaki; Hoshi, Kashyap, and Scharfstein 1991), they do not always do so. Sometimes, securitized loans are cheaper. When they are, a borrowing firm and a monopolistic lender can both gain if the firm (*a*) borrows its funds in the securitized market and (*b*) pays the monopolist an access charge. The lenders will set that access charge approximately equal to the difference between (*i*) the (effectively unregulated) rates they can charge their borrowers and (*ii*) the (artificially low) rates they pay their depositors.

Granted, no given bank would directly have lost monopoly rents if one of its borrowers had issued bonds and used the proceeds to repay its bank loan. After all, the banks loaned their funds at market rates. Collectively, however, the banks would have lost money. Necessarily, whenever a bank borrower moved to the securitized market, it took with it depositors who would otherwise have invested at the artificially low interest rates. Necessarily, every time a firm issued bonds, the banks collectively lost low-interest deposits.²⁰

The banks collected their toll charge by managing the collateral to the bond issues. The story begins in 1933, when the major banks (who were then also underwriters) collectively agreed to underwrite only secured bonds (Kuroda, 112). When the Americans bifurcated

¹⁸They also, of course, had to limit access to the equity market—a subject beyond the scope of this chapter. Note that legally CP is not a security in Japan. On Japanese financial markets generally, see Rosenbluth.

¹⁹For a sophisticated analysis of the regulation of mutual funds in Japan, see Miwa (1993: 277–89).

²⁰They may not have lost quite as much as it appears, since the banks themselves bought many of the bonds.

Japanese commercial and investment banking in the 1940s,²¹ the banks expanded their group (eventually known as the Bond Committee, the *kisaikai*) to include the securities firms. The ban on unsecured bonds, however, they retained.²²

According to the law, only banks could manage collateral.²³ By requiring bond issuers to post collateral, the Bond Committee thus could force them to pay banks a fee for using the securities markets (Horiuchi and Sakurai, 106; Aoki and Patrick). By pricing those collateral-management fees strategically, it then could preserve the banks' monopoly pricing scheme. By all odds, it did set the price high. According to one survey (of Tokyo Stock Exchange-listed firms that had recently issued bonds abroad or made large private placements domestically), 85.7 percent of the firms gave Japanese bank commissions as a reason for selling bonds abroad (Miwa 1992: 313). On a typical 10-billion-yen bond in the Euromarket, banks earned commission fees of 3.5 million yen. In Japan they earned 53 million yen.²⁴

In exchange for cooperating with the banking cartel, the securities firms shared the regulatory rents. In order to obtain their acqui-

²¹*Shoken torihiki ho* [Securities Exchange Act], Law No. 25 of 1948, § 65.

²²For an introduction to the Bond Committee system, see Minaguchi; on the lack of a legal basis (or antitrust exemption) for the Committee, see Negishi (28–29), Takeuchi (6).

²³*Tampo tsuki shasai shintaku ho* [The Secured Bond Trust Act], Law No. 52 of 1905, § 6.

²⁴Frankel and Morgan (587). The “collateral management” services may have been largely a sham. If so, then the collateralization requirement itself may have been largely a wealth transfer from issuers to banks. Evidence of the sham nature of the arrangement appears in the security interests themselves. Many of the bonds were secured by a “mortgage” on the firm itself under the *Kigyo tampo ho* [Enterprise Security Law], Law No. 106 of 1958. Such a “security interest” is not a security interest at all—but simply an unsecured priority claim.

Teranishi (146–47) interprets matters very differently. According to him, the bond issues were part of a successful government attempt to target credit subsidies to favored firms. Under this theory, the city banks bought the bonds at supramarket prices and in exchange received submarket loans from the Bank of Japan.

escence, the banks priced their collateral management services strategically: they priced them in ways that shared with the securities firms (who collectively set underwriting fees) the monopoly rents they as banks earned.²⁵

All this occurred with Ministry of Finance (MOF) approval. A telling example of MOF's role occurred in mid-1991. As underwriters to the issuing firms, the securities firms had been selling at a discount the bonds they had just underwritten. They were reselling bonds from new issues, in short, at prices below those they had paid the issuer. Effectively, they were cheating on their own cartel. Having quoted supracompetitive underwriting fees, they were then discounting those fees by underwriting the bonds themselves at above-market prices. Once it noticed the practice, the MOF—acting as “cartel cop”—intervened. Using its general police powers under § 54 of the Securities Exchange Act, it ordered the firms immediately to stop their price competition (Miwa 1992: 324-27, 1993: 71-74; Anon. 1992: 87).

In effect, the firms in the financial services industry (the banks and the securities firms) had together cartelized the entire industry. Whether a borrower tried to raise its money in the bank-loan market or on the securities market, they collected a monopoly rent. Precisely because they controlled both markets, a borrower could not avoid the monopoly rents in one market by raising funds in the other.

Recent changes. Only recently did Japanese firms begin to borrow significant funds in the domestic bond market. Although for decades they operated a market in government bond repurchase contracts (known as *gensaki*), that market was small for many years and never gave banks much competition. In it, those firms that needed short-term working capital sold their portfolio of government bonds, together with a promise to repurchase them (at a price

²⁵Miwa (1992: 324-27). Obviously, in any given industry (like the financial services industry) there can only be one monopoly rent. Having cartels among both collateral management firms (banks) and underwriting firms (securities firms) thus would not have increased the total monopoly rent extracted. The contest between the banks and securities firms instead would have been over the distribution of that rent.

reflecting an implicit interest charge) within a few months (generally one or two). Those with excess cash then earned market returns by buying those bonds with the repurchase agreements attached. Essentially, the bond constituted collateral for what was a short-term loan. Because one could not profitably sell government bonds that one did not own, the market worked as a fund-raising device only for firms that already owned them.²⁶

As table 2 shows, the domestic industrial bond market stayed small at least until the mid-1970s. By the MOF's own calculations, in the first half of that decade the largest firms raised 6 percent of their total funding through bonds, and 10.3 percent of their borrowed funds through bonds.²⁷ For the smaller firms, the market was simply not an option (Kamochi, 63).

Japanese firms did eventually develop a large bond market, but only because of events overseas. Primarily for reasons exogenous to the banking industry, the Japanese government eased foreign exchange controls in the early 1980s. European firms had maintained an active market in foreign-currency corporate bonds, and these new foreign exchange rules now let large Japanese firms tap that market. In it, they could issue unsecured bonds. Effectively, they could avoid the banks' toll charge and a host of regulatory requirements besides. When the government revised the foreign exchange rules effective late 1980,²⁸ Japanese firms increased the money they raised abroad from 680 billion yen in 1980 to 1.1 trillion yen in 1981. When it liberalized those rules further in early 1984, they increased the amount raised abroad from 1.9 trillion yen in 1983 to 2.7 trillion yen in 1984. By 1989, Japanese firms borrowed 11 trillion yen abroad.²⁹

²⁶The market is known as the *gensaki* market. See generally Tsujimura (38–39); Litt, Macey, Miller, and Rubin (382).

²⁷Large being defined as firms with one billion yen or more in paid-in capital (Ishikawa, 40–41; Kamochi, 53).

²⁸Amendments by Law No. 65 of 1979 to *Gaikoku kawase oyobi gaikoku boeki kanri ho* [The Foreign Exchange and Foreign Trade Management Act], Law No. 228 of 1949.

²⁹Kuroda (1987: 114); Okura (1988: 56). Due to the domestic recession, bond issues have fallen since 1989.

Table 2. Bond issues by Japanese industrial companies
(billion ¥)

Year	Domestic	Overseas
1965	391	
1970	723	16
1975	1,835	475
1976	1,222	368
1977	1,403	368
1978	1,590	555
1979	1,652	735
1980	1,091	683
1981	1,815	1,118
1982	1,513	1,374
1983	1,561	1,919
1984	2,335	2,795
1985	2,585	3,253
1986	4,552	4,117
1987	5,970	5,340
1988	7,744	6,892
1989	9,284	11,129

Notes: Includes convertible issues and issues with warrants attached.

Sources: Okura sho shoken kyoku (ed.), *Okura sho shoken kyoku nempo* [Annual Report of the Ministry of Finance Securities Bureau] (Tokyo: Kin'yu zaisei jijo kenkyu kai, various years); Koshasai hikiuke kyokai (ed.), *Koshasai nenkan* [Bond Annual] (Tokyo: Koshasai hikiuke kyokai, various years).

Once the large firms could issue bonds in the Euromarket, Japanese banks had little choice but to ease the terms they offered those firms. First, they let them issue unsecured bonds within Japan.

Given that the large firms would raise their funds overseas unless they let them avoid the toll charge, they let them avoid it (Kuroda, 136–37). Firms issued their first unsecured domestic bonds in the 1970s, and by 1984 the Bond Committee had lowered its standards to the point where sixteen firms qualified. By 1991 four hundred companies qualified, and the banks cut their collateral management fees even on issues that remained secured.³⁰

Second, the banks acquiesced to a CP market. Because of the gap between market and regulated interest rates, American firms had been paying banks regulatory rents that they could avoid if they could learn to borrow from investors directly. Through the CP market, they came to do just that.³¹ Japanese firms had not turned to a CP market because they had had none, and they had not created a CP market because of the political power of the banks. Although the law did not explicitly ban CP (Takeuchi, 7), it did not clearly permit it either. With its status ambiguous, banks could threaten to use their power within the MOF (power that stemmed from their ties to the ruling Liberal Democratic Party, the LDP; see Ramseyer and Rosenbluth) to interpret the ambiguity into a ban.³² Given that risk, Japanese firms bargained first. Because of the competitive pressure from the Euromarket, they did eventually negotiate a CP market. Their politically charged negotiations took time, however, and they did not obtain their CP market until late 1987.³³ Once they

³⁰See, e.g., “Zoshi hakusho” [Capital Increase White Paper] (1987: 95) (October 1985 liberalization), (1988: 114) (July 1987 liberalization), (1991: 30, 85) (November 1990 liberalization), and (1992: 94–95) (management fees). Under pressure from the Japanese Fair Trade Commission, the Bond Committee has also been forced to abandon its uniform pricing schedule. Henceforth, collateral management fees are to be determined on the basis of individualized negotiations between an issuer and its bank. Anon. (1992: 94–95); Negishi (30).

³¹Commercial paper is generally exempt from the registration requirements of the 1933 Securities Act by either 15 U.S.C. § 77c(a)(3) (short-term debt), § 77d(2) (privately placed debt), or § 77c(a)(2) (line-of-credit debt). On its exemption in Japan, see Litt, Macey, Miller, and Rubin.

³²For nice summaries of the politics and ambiguities involved, see Litt, Macey, Miller, and Rubin; Schaede.

³³Tsujimura (21). CP was defined as short-term notes (two weeks to nine months) of 100 million yen or more.

obtained it, they used it. Within a year, the market passed the Euro-CP market. By December 1990, it hit 15.7 trillion yen (Stigum, 108; Nihon, tab. 67).

2. *Explicit and Implicit Deals*

2.1. *Legally enforceable claims*

Basic to *any* banking system is a legal regime that lets people enforce and transfer rights to assets. The ordinary bank loan is itself no more than one such set of (explicit) contracts. One party (the lender) transfers to another party (the borrower) assets to which it has a legally enforceable claim (cash). The borrower agrees to return the cash after a stated time, together with a fee for using it (interest). The lender makes at least the risk-adjusted return it would earn on the cash elsewhere; the borrower pays no more than the risk-adjusted return it will earn on the cash. Such are the usual gains from trade.

Absent enforceable claims, many of these gains disappear. Most lenders will not lend unless the borrower gives them the right to sue if it does not return the cash. Many lenders will not lend unless the borrower also agrees to repay them before it pays anyone else. Often, such agreements lower the price a lender would otherwise charge for the funds. Usually, they increase the supply of funds a lender will provide. Either way, they increase social welfare.

2.2. *Alternative enforcement schemes*

Not that the banking industry would collapse without courts. Lenders and borrowers can usually protect their claims in other ways. For instance, they can hire private armies. Whether in New York or Tokyo, they sometimes do. And whether here or there, the problems are obvious. Private debt collection work may have made the Corleone family thrice a box-office smash. It imposes large externalities on everyone else.

Lenders and debtors sometimes also keep their word just because they hope to repeat the transaction. Assume a firm earns a higher return on some kinds of deals than on others. The firm will try hard to repeat such deals. If it must keep its word to ensure repetition, it may even keep its word. The key, however, is the assumption: that it

expect to earn supramarket returns by repeating these deals in the future. Absent such future rents from repetition, rational firms may renege.³⁴

2.3. *Enforcement schemes in Japan*

Although many differences in Japanese and American banking patterns derive from differences in the legal regimes, consider first some basic commonalities. Both countries have capitalist economies and both countries maintain sophisticated courts. In both countries, those courts protect most rights to private property and enforce most consensual bargains.

That Japanese courts do all this suggests Japanese firms may not use implicit agreements as often as usually argued. If courts will indeed enforce explicit contracts, rational parties will seldom leave large deals to implicit terms. By definition, implicit contracts are not contracts. Not being contracts, courts will not enforce them. Not being enforceable, rational parties will keep them only if they expect to earn supracompetitive rents by continuing the relationship into the future. Parties will comply with implicit contractual terms, in other words, only if the future repeated transactions earn them an expected return larger than the return they can expect to earn elsewhere.

In deciding whether to negotiate the terms of a deal explicitly, rational parties thus face a tradeoff. They will use implicit rather than explicit contracts if but only if (a) the future rents (present-valued, of course) necessary to induce compliance voluntarily (the minimum compliance-inducing rents)³⁵ are less than (b) the costs of

³⁴Klein and Leffler; Ramseyer (1991); Shapiro; Telser. Some observers may suggest that hostage mechanisms (Williamson) could support self-enforcement in Japan. Although possible in theory, the point is unlikely to apply to Japanese bank-borrower relations in practice. The most likely hostage would be the cross-shareholdings, but because stock does not have relationship-specific value, it does not work as a hostage. See Ramseyer (1993).

³⁵Readers will note that some rents will accrue simply from the mutual investments in relationship-specific information. Unless these exceed the one-shot gains from renegeing, however, these rents will not suffice to make the deal self-enforcing. Moreover, readers should note that the same rents accrue to

drafting the contract explicitly and enforcing it in court (the contracting costs).³⁶ Whenever the compliance-inducing rents exceed the contracting costs, they will draft contracts.³⁷

In the banking industry, this tradeoff overwhelmingly militates against implicit contracts. The reason: the minimum compliance-inducing rents vary with the size of the transaction, while contracting costs are largely independent of it. In the financial services industry, a firm that reneges on a deal will generally pocket the cash advanced it. Accordingly, for it not to renege it must anticipate rents with a discounted present value greater than the cash advanced. The bigger the deal, the bigger will be the minimum compliance-inducing rents.

By contrast, legal fees are largely independent of the size of the deal. There are obvious exceptions—e.g., the larger the deal, the greater the incentive to find higher-priced lawyers. Yet the costs of negotiating and drafting a contract depend primarily on attorney hours, which in turn depend on the complexities and idiosyncrasies of the deal. They depend only tangentially on the money at stake. Typically, therefore, once the size of a deal reaches a certain threshold, the compliance-inducing rent will exceed contracting costs. At that point, rational firms will negotiate all contracts explicitly.

Recall the contexts where scholars first developed the theories of implicit self-enforcing contracts. First, many scholars found the theories helpful in understanding labor markets. Where factory

the parties even if they draft explicit contracts—the parties do not abandon the relationship-specific rents by drafting court-enforceable agreements.

³⁶Readers who complain that court enforcement is expensive largely miss the fact that most rational parties settle outside of court *by reference to* the expected legal outcome (Ramseyer and Nakazato). Because the vast majority of contract disputes in both the United States and Japan are settled outside of court, the relevant enforcement costs for explicit contracts are not (the relatively high) litigation costs, but rather (the much lower) settlement costs. Note, however, that the higher the costs of litigation, (*a*) the more likely the parties are to settle, and (*b*) the greater the variance in settlements.

³⁷Note that the calculus does not change if rephrased in terms of the effect that renegeing has on the bank's reputational capital and ability to deal implicitly with *other* borrowers. Whether the bank earns a return of z on one contract or a return of nz on n contracts, the calculus is the same.

workers could easily shirk and managers could not cheaply monitor, employers could save resources by paying workers a supramarket wage (i.e., efficiency wages) (Shapiro and Stiglitz). Second, scholars found that the theories helped explain how markets worked where buyers could not cheaply confirm product quality *ex ante*. Where buyers could not check quality before buying, they saved money by paying a higher price to an established seller. Rather than risk a fake from a peddler outside Ueno station, they bought their Rolexes from Ginza jewelers (Klein and Leffler). Last, scholars used the models where courts could not reach the parties involved. Unable to use courts, medieval international traders relied on reputations and trading clubs (Greif; Milgrom, North, and Weingast)

None of these situations remotely resembles the Japanese banking industry. First and most obviously, courts exist and work. The parties involved are not peripatetic medieval merchants, wandering from jurisdiction to jurisdiction. Second, the stakes are high. Explicit contracts may not efficiently prevent factory workers from shirking or street vendors from peddling fake watches. But these are not factory workers earning thirty dollars an hour or street vendors selling three thousand-dollar watches. These are firms with legally trained staffs, law-firms within easy reach, and millions of dollars at stake. Modern scholars use implicit contracts to explain why these firms behave as they do on million-dollar deals. They need first to explain why the firms reject straightforward court-enforceable contracts.

In response to this, some fans of implicit contract theory may cite problems of verification: parties will prefer implicit contracts, they will argue, where the deal depends on information courts cannot verify. Although hard to verify promises exist (e.g., to cherish and obey, till death do us part), the putative main bank contracts (e.g., to insure against business failure) are not among them. Creative lawyers can easily suggest a wide variety of verifiable indices of business trouble, and can easily list just as many verifiable bank responses. They regularly (and explicitly) draft contracts that insure fashion models' legs, football players' arms, and singers' voices.

Writing an insurance contract against business failure they will find boringly mundane.³⁸

If insurance agreements seem unlikely candidates for implicit contracts, consider whether disproportionate monitoring agreements are any more likely.³⁹ In Japan, implicit contract theorists argue, the main bank implicitly agrees with other banks both (a) to monitor the debtor disproportionately and (b) to bear losses disproportionately. The Mitsubishi Bank, for example, may *explicitly* agree to lend Iroha Sushi, K.K., 30 percent of the bank loans Iroha needs. At the time it does so, it may also *implicitly* agree to bear 80 percent of the costs of monitoring Iroha and to absorb 80 percent of any losses should Iroha fail.

It is hard to imagine a less likely implicit contract than this Mitsubishi-Iroha arrangement, for it is hard to imagine a more needlessly complicated agreement. If Iroha's creditors collectively find it efficient for Mitsubishi to bear 80 percent of the monitoring costs, the straightforward way to reach that result is to have Mitsubishi lend 80 percent of the money.⁴⁰ It will then have a greater incentive to monitor (even if not precisely 80 percent) and will absorb exactly 80 percent of any resulting losses (provided all loans have equal priority). Because the total loans outstanding will not change, this explicit alternative will not raise any bank's capital requirements. And because Mitsubishi bears 80 percent of Iroha's default risk under either scheme, neither does it reduce Mitsubishi's diversification.⁴¹

³⁸Note that *if* verification by a court is problematic, reliance on the bank's reputational capital will not solve the problem either, since verification by the bank's *other* partners will be equally problematic. If third parties cannot verify a bank's performance, then the value of the bank's reputational capital will not accurately reflect the bank's performance.

³⁹See, e.g., Sheard (1991) for a particularly insightful discussion of the model.

⁴⁰Sheard (1991) raises—and rejects—this possibility.

⁴¹Sheard (1991: 25) argues, however, that the *borrower* may prefer to deal with several banks.

3. *Insurance Contracts*

3.1. *Initial doubts*

According to the traditional stylized facts, Japanese main banks more often rescue ailing borrowers than American banks do. When times are bad, the main bank cuts the interest rate it charges. When firms start to fail, it decides whether they have any future prospects. If they do, it loans them extra money and gives them extra expertise. Through such moves, it insures its borrowers against business failure.⁴² Many observers consider all this an implicit insurance contract.⁴³ Over the past decade, they have published several brilliant studies exploring the phenomenon. Within this volume, they include several more. Nonetheless, it is clear neither that Japanese firms would want this insurance, nor that they buy it. Consider each point in turn.

Would firms want it? If a bank offered insurance against firm failure, it would invite classic problems of adverse selection. Unless the bank had perfect information, the least credit-worthy firms would disproportionately apply for the insurance. Because the bank cannot distinguish risk levels perfectly, the higher risk level in the pool would cause the bank to raise the insurance premium it charged. The safest firms in the pool would then decline the insurance contract, and the average risk level would rise further. The bank would raise the premium still higher, still more firms would decline the contract, and so forth. The process would continue re-

⁴²Some observers describe the implicit insurance contract as something close to a mixed strategy: the main bank agrees to rescue the firm with probability x , where x is positive but less than 1. Despite some suggestions to the contrary, it is not clear why this would eliminate either moral hazard or adverse selection, so long as the main bank has less than perfect information about the debtor's strategy.

⁴³This is a fundamentally different theory from Hoshi, Kashyap, and Sharfstein's (1991) argument that the main bank lowers the cost of financial distress. They do not argue that the main bank necessarily offers an implicit insurance contract. Rather, they argue that its presence reduces the transactions costs of reorganizing distressed firms.

lently—until the market for the insurance disappeared (Akerlof).⁴⁴

The bank would face equally severe problems of moral hazard. Just as Barbara Stanwyck (sort of) played a nice kid before buying her husband accident insurance with a double indemnity clause, rational firms would pretend to invest in low-risk projects in order to buy their implicit insurance against failure more cheaply. Just as Stanwyck then (sort of) tossed her husband off the train, rational firms would then hike the risk level of the projects they undertook.

Some implicit insurance theorists argue that main banks can prevent this moral hazard by punishing the incumbent managers in the firms they rescue. Unfortunately, the gain to the firm's shareholders from the moral hazard will often exceed the loss to the few fired managers.⁴⁵ As a result, rational shareholders can compensate their managers *ex ante* for any punishment the managers will incur if the bank later intervenes and punishes them. To do so, they need simply to pay the managers a supramarket salary. So long as they pay them wages that include a premium equal to the risk-adjusted loss the managers suffer if the firm fails and the main bank intervenes, both the shareholders and the managers gain.

Do banks sell it? Whatever the logic to implicit contracts, to date no one has shown that banks actually offer them. Indeed, no one has shown that Japanese banks more regularly rescue debtors than American banks. Consider several bits of evidence. First, large numbers of Japanese firms fail regularly. From 1981 to 1985, a mean of 18,700 firms with debt of over 10 million yen went out of business every year (Chusho). Granted, most of the failing firms were small. Yet that fact itself suggests the first caveat: banks do not insure small firms. In turn, the caveat suggests the first problem: why not insure small firms? Banks should find it no harder to monitor small firms than large. Small firms should want the insurance as badly as large. If (as seems likely) small firms generally run less diversified opera-

⁴⁴These problems of adverse selection and moral hazard would disappear if main banks had perfect information. For arguments that main banks have good information, see Hoshi, Kashyap, and Sharfstein (1990: 69); Sheard (1989).

⁴⁵Note that the main bank will own no more than 5 percent of the firm's stock. See Ramseyer (1993).

tions than large, they may even want the insurance more. If banks and large firms can negotiate mutually advantageous implicit insurance, so should banks and small firms.⁴⁶ And if banks and small firms do not find implicit insurance mutually advantageous, perhaps something else better explains the apparent bank rescues of large firms.

Second, several scholars who have tried to locate empirical evidence of the insurance have not found it. Horiuchi, Packer, and Fukuda, for example, used data from the chemical industry to ask whether main banks lowered interest charges to troubled firms. They found no evidence that they did. Miwa (1990: chap. 6) asked whether main banks increased their percentage of a firm's loans when the firm fell into distress. He too found no evidence.

Last, no one has ever found any evidence that firms pay for this insurance (Miwa 1991: 16)—and absent that payment one would not expect banks to offer the insurance. Some scholars suggest that those firms which want the insurance pay a higher interest rate on loans from their main bank than on loans from other banks. No one has found any evidence that this occurs. Others suggest, more promisingly, that those firms which want the insurance route their main bank a greater share of their fee-based business. Since all firms need the fee-based services, however, this effectively suggests that *all* firms might receive the insurance. To be sure, some firms use more such services than others. Given a single industry, large firms will typically buy more foreign exchange than small; given a single firm size, export-oriented firms will buy more foreign exchange than others. Nonetheless, the firm's need for these fee-based services will seldom correlate with its riskiness. If so, the bank cannot be pricing its insurance very efficiently. And if banks are not pricing it carefully, the best conclusion about the implicit insurance contracts may be that banks do not sell them.

⁴⁶Note (a) that the per-asset-value premium on the insurance could be higher for small firms if they systematically have inferior management, (b) that the premium could also be higher for small firms if there are economies of scale to monitoring, and (c) that the insurance might be unavailable entirely if owner-managers presented more serious moral-hazard problems.

3.2. *Equitable subordination and bank rescues*

Consider, however, another possibility: perhaps Japanese banks do rehabilitate large borrowers more than American banks, but do so because they cannot credibly threaten to let them fail. Given that Japanese courts will let a bank rescue a borrower without jeopardizing its rights in bankruptcy, perhaps Japanese banks find some rescues profitable *ex post*. By contrast, perhaps American banks abandon borrowers because they cannot cheaply save them. Given that American courts sometimes punish a bank for intervening in its debtors' affairs, perhaps American banks find rescues more often unprofitable even *ex post*.

The ex post incentive. All else equal, creditors sometimes (not always) have an incentive *ex post* to intervene and rescue debtors who threaten default.⁴⁷ Many firms find themselves in trouble at least partly because they lack adequate cash—they find themselves illiquid even when not insolvent. A bank that has lent such a firm large amounts will sometimes find that lending it extra funds, even short-term, pays. If it refuses to lend those funds, the firm will fail. If it has secured its past loans, it may then receive a share of the liquidation proceeds—but its share will likely fall short of its outstanding claim. If it lent its money unsecured, it will receive even less. Simply by advancing such a firm cash, the bank can sometimes recover its principal and interest in full. As a result, all else equal, American and Japanese banks will sometimes be tempted *ex post* to save their failing debtors.

The ex ante logic. If a bank would find it profitable to rescue a troubled firm *ex post*, it faces serious problems *ex ante*. Most basically, it will find it hard credibly to threaten to punish a borrower that defaults. As the punishment will be unprofitable *ex post*, the threat to punish will be incredible *ex ante*. Unable to threaten *ex ante*, the bank can now sell only bundled credit-insurance contracts. In turn, to the extent it cannot constrain its debtors, those debtors will exploit the bundled contract by increasing the risk level of their

⁴⁷See Bulow and Shoven. Explicit contracts are unlikely to help much here. Even if the bank explicitly stated *ex ante* that it would not help a debtor in distress, it might still have an incentive to break that statement and defer repayment. Obviously, the borrower will not complain if the bank does so.

projects. The bank will anticipate this, of course, and raise the price it charges. The inability to commit *ex ante*, in other words, will create incentives *ex post* that in turn will generate adverse selection and moral hazard *ex ante*. Disintermediation will ensue: firms that would prefer to undertake lower risk projects will leave the bank-loan market entirely.

With small borrowers, a bank may yet be able to make its threat credible by combining precommitment strategies with a concern for its reputation. BCCI notwithstanding, for most banks the credit business is an iterated game. Precisely because of the moral-hazard and adverse-selection problems that bundled credit-insurance contracts aggravate, a bank may hope to cultivate a ruthless reputation for *not* insuring its borrowers. If it lends money often enough and discounts the future at a rate low enough, with small borrowers such a reputation-based strategy may work (Kreps et al.; Rasmusen, § 5.4).

With large debtors, a bank will find it harder to make such reputational strategies work. Even banks that can jettison small borrowers find it hard to bully firms to whom they have lent enormous amounts. College professors with southern California mortgages may find their finances dominated by their local savings and loan. But insolvent third-world strongmen with multibillion dollar loans seem sometimes to dictate terms to the great money-center banks. Models of repeated games and precommitment may explain why banks adopt strategies that otherwise do not seem credible—but they work only if the bank's one-shot loss from punishing a firm is small compared to its future reputational rents. When a firm's debt is large enough, the bank's *ex post* unprofitable strategy will make the bank's *ex ante* threat less credible. When a large enough debtor threatens to fail, even a ruthless bank may try to rescue it.

The American law of firm rescues. Effectively, Japanese banks may be selling implicit insurance contracts to the largest firms that the firms do not want. When a large firm borrows from a Japanese bank, perhaps it knows that—should it find itself in trouble—the bank may save it. Even if the firm does not want the insurance, the bank cannot credibly sell it unbundled credit. Unable credibly to threaten to let failing large debtors fail, the bank has no choice but to include insurance with its credit.

Even if American banks less often rescue their borrowers than Japanese banks do (a proposition no one has proven), that fact would not necessarily show that willing Japanese banks sell implicit insurance to willing Japanese borrowers. American banks instead may be jettisoning their clients because their bankruptcy law more readily lets them commit to doing so. The hypothesis follows.

By tradition, American judges have looked skeptically at creditors who intervene in a debtor's business. Those who do so, they reason, may try to restructure the debtor to their private advantage. Should a bank intervene, therefore, American judges sometimes subordinate its claims.⁴⁸

At stake is the doctrine of "equitable subordination": for the sake of "fairness" a judge may subordinate the claims of a creditor that intervenes before Chapter 11 in its debtor's affairs.⁴⁹ "[A]s a court of equity," Chaitman (1961) explained, a bankruptcy court "has the power to subordinate the claims of one creditor to those of other creditors where the claimant has engaged in some type of inequitable conduct which has resulted in an unfair advantage to the claimant or an injury to the other creditors." Hence, a bank can lose its priority whenever "the bank has taken control of the debtor, thus assuming the fiduciary duties of a controlling shareholder, and then breached those duties to the injury of general creditors."⁵⁰

⁴⁸Interventionist creditors have also been required to pay various debtor liabilities out of their own pockets (Douglas-Hamilton). Absent collective action problems among creditors (but *only* absent such problems), creditors could vitiate the effect of the equitable subordination doctrine by unanimously agreeing not to argue the theory in court.

⁴⁹1 U.S.C. § 510(c). See generally Chaitman; Clark (1977, 1981); DeNatale and Abram; Herzog and Zweidel; Anon.; Collier (vol. 3: § 510.05). For what is probably the first discussion of the possible role of the doctrine in U.S.-Japan comparisons, see Prowse (50).

⁵⁰Chaitman (1962). For examples of cases subordinating creditor claims under the doctrine of equitable subordination, see, e.g., *In re Osborne*, 42 B.R. 988 (D.C. W.D. Wisc. 1984) (credit association's claims subordinated to trade creditors' where association induced trade creditors to continue to make deliveries while debtor was in financial trouble, even absent control by association over debtor); *In re Sepco, Ind.*, 30 C.B.C.2d 474, 36 B.R. 279 (B.C. D.S.D. 1984) (bank claims subordinated upon finding of fraud by bank agent in nego-

At trial, banks argue that the doctrine prevents them from saving troubled clients. Nonetheless, many judges remain skeptical:

While defendant [i.e., the bank] argues that subordination will cause members of the financial community to feel they cannot give financial assistance to failing companies, but must instead foreclose on their security interests and collect debts swiftly, not leaving any chance for survival, the Court is singularly unimpressed.⁵¹

The bank in the case had restructured a troubled debtor and advanced it extra funds. When the debtor started to fail anyway, it tried to ensure that the debtor repaid its debts to the bank. The unsecured creditors complained, and the court took their side. Once in control of the debtor, the bank could not use its control to its private advantage. Having tried, it now stood last in line.

American bankers have not missed this risk of subordination. The problem “has generated much debate and fear among members of the financial community,” DeNatale and Abram (417) noted. Granted, courts do not necessarily subordinate creditors who intervene. They do so only when they think creditors intervened and misbehaved. According to the usual judicial formula, they subordinate a creditor’s claim only when: the creditor “engaged in some type of inequitable conduct,” the creditor obtained “an unfair advantage” over other creditors, and equitable subordination is not “inconsistent with the provisions of the Bankruptcy Act.”⁵² Unfortunately, the formula does not much help. Judges subordinate claims whenever

tiating with other creditor), *aff'd*, 750 F.2d 51 (8th Cir. 1984); *In re Sayman’s Inc.*, 15 B.R. 229 (B.C. N.D. Ga. 1981) (creditor’s claims subordinated where creditor cut off service in overly hasty manner); *In re American Lumber Co.*, 7 B.R. 19 (B.C. D. Minn. 1979) (where bank controlled actions of debtor and liquidated debtor in manner advantageous to itself but not to unsecured creditors, bank’s claims were subordinated), *aff'd*, 5 B.R. 470 (D.C. D. Minn. 1980); *In re Process-Manz Press, Inc.*, 236 F. Supp. 333 (N.D. Ill. 1964) (lender’s secured claim subordinated upon finding of control, domination, and fraud), *rev’d on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. den’d*, 386 U.S. 957 (1967).

⁵¹*In re American Lumber Co.*, 5 B.R. at 478.

⁵²*In re Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977).

“equity” demands it and equity, like pornography, lies in the eye of the beholder. Ultimately, American creditors restructure their debtors at their peril.⁵³

Equitable subordination does not make bank rescues impossible; it makes them more costly. When a firm hits bad times, creditors will seldom lend more money without controlling the way the firm uses it. Under American law, they can do so before a Chapter 11 filing only by gambling all: if the firm succeeds, the bank recovers its claim; if the firm fails and the other creditors convince the judge that the bank indulged its private biases, it potentially loses all. For the sake of making credible threats, perhaps that risk often suffices. Precisely because of this *ex post* risk to intervention, perhaps American banks can more credibly threaten to jettison defaulting debtors *ex ante*.⁵⁴

The Japanese law of firm rescues. Japanese judges use no doctrine analogous to equitable subordination. Granted, the proposition is impossible to prove, risky even to advance. Few things in comparative legal work are harder than proving a categorical negative, and doubly so when the issue involves a matter so entrusted to judicial whimsy. Whether in the United States or Japan, in bankruptcy cases judges wield enormous discretion. They can disallow sales, payments, and security interests, for example, sometimes even when the parties complete the transaction before anyone files for bankruptcy.⁵⁵

Moreover, even though they may phrase it differently, Japanese judges do exercise their discretion in ways that often resemble the American judicial concern for “equity.” If a bankrupt firm repays a debt to benefit one specific creditor, the judge may void the pay-

⁵³I attempt no statistical analysis of judicial behavior because reported cases never constitute a representative sample of disputes. On the impossibility of using court verdict rates to prove the direction of the law, see Priest and Klein.

⁵⁴Often, of course, there will be public debt subordinate to the bank’s loan. Because the indenture trustee cannot legally waive the default, rescues often can be made only by the bank.

⁵⁵*Hasan ho* [Bankruptcy Act], Law No. 71 of 1923, § 72 (grounds for disallowing creditor claims); *Kaisha kosei ho* [Corporate Reorganization Act], Law No. 172 of 1952, § 78 (same). See generally Matsushita.

ment.⁵⁶ If it repays a debt knowing that it thereby harms other creditors and the payee knows that too, the judge may void the payment.⁵⁷ If it sells real estate (even at fair market value) and might squander the cash, the judge may void the sale.⁵⁸ And if a debtor grants a security interest after it has started to default on its notes, a judge may void the security interest.⁵⁹ What one does *not* see in these cases, however, is any equivalent of equitable subordination—any series of decisions where judges voided security interests to punish a major secured creditor who intervened in the debtor's affairs. Without such a doctrine, a creditor will more often find such intervention profitable *ex post*. Profitable *ex post*, its threats will be less credible *ex ante*.

The absent evidence. The question, then, is whether the absence of an equitable subordination doctrine in Japan increases the incidence of firm rescues. To answer it, we need several pieces of evidence we do not yet have. First and most basically, if the proposition is true, then (all else equal) Japanese banks should more readily rescue troubled firms than American banks. We do not know this. We know only that both Japanese and American banks rescue a few large troubled firms and jettison most others.

Second, large Japanese debtors should be at a greater disadvantage in the loan market than large American debtors. According to the hypothesis, (a) the absence of equitable subordination prevents Japanese banks from committing to jettisoning borrowers with large debts to the bank, (b) the presence of the doctrine allows American banks to make that commitment, and (c) reputational considerations

⁵⁶Ito v. Hayasaka, 25 Saihan minshu 779, 781-82 (S. Ct. July 16, 1971); Usui v. Nomura, 12 Daishin'in minshu 3043 (S. Ct. Dec. 28, 1933).

⁵⁷Yumoto v. Makara, 21 Saihan minshu 859 (S. Ct. May 2, 1967).

⁵⁸Ito v. Uno, 746 Hanrei jiho 38 (S. Ct. June 27, 1974); Nakayama v. Nonaka, 12 Daishin'in minshu 637, 663 (S. Ct. Apr. 15, 1933).

⁵⁹K.K. Yamagata ginko v. Nomura, 29 Kakyu minshu 516 (Sendai H. Ct. Aug. 8, 1978). According to Shimojima (335), *recorded* security interests cannot be voided in bankruptcy proceedings, but *unrecorded* interests can. See Ito v. Hayasaka, 25 Saihan minshu 779 (S. Ct. July 16, 1971). Even recorded security interests can be voided in reorganization proceedings. See Akagi v. K. K. Menzu roman, 861 Hanrei jiho 108 (Kobe D.C. Feb. 28, 1977).

enable both Japanese and American banks to commit to jettisoning borrowers with small debts. If so, then large American debtors should do better in the credit market relative to small American debtors than large Japanese debtors do relative to small Japanese debtors. On this too we have no evidence.

Third, Japanese debtors should try to keep their debts at any one bank small. If the hypothesis is true, then Japanese debtors will try harder than American firms do to avoid borrowing large amounts from any one bank. We do know that Japanese firms diversify their borrowings (Ramseyer 1991). Unfortunately, we do not know whether, all else equal, they do so *more* than American firms.

Last, the absence of equitable subordination in Japan should promote disintermediation. If the absence of equitable subordination prevents Japanese banks from credibly committing to jettisoning troubled clients, it necessarily forces them to bundle “implicit insurance contracts” with the credit they sell. Because moral hazard and adverse selection will raise the price banks must charge for these bundled credit-insurance contracts, low-risk firms will try to avoid the bundled package. The best way to do that is to leave the bank-loan market entirely.⁶⁰

Japanese firms *have* started to leave the bank-loan market. From 1985 to 1989, firms increased the amounts they raised through bond issues nearly fourfold (table 2). According to Hoshi, Kashyap, and Scharfstein (1991), from 1983 to 1990, firms listed on the Tokyo Stock Exchange reduced their ratio of bank debt to total debt by a third. Those able to issue bonds not guaranteed by a bank reduced it by over 40 percent. The safest firms, it seems, deserted the banks en masse. As Hoshi, Kashyap, and Scharfstein (1991) put it, firms with “good performance, valuable investment opportunities, or valuable assets” turned to the bond market. Only those with significant “scope for inefficient behavior” remained.

Ultimately, equitable subordination remains a tenuous hypothesis. Most obviously, the only evidence we have on point is that of disintermediation—and that, of course, is a phenomenon subject to

⁶⁰On some of the reasons multiple bond holders cannot as cheaply renegotiate the terms of their debt contract as a single bank can, see Roe.

an enormous variety of explanations. Yet we also do not know the aggregate effect of bankruptcy law, for equitable subordination is but a small part of the picture. Although all American courts in theory apply the doctrine, more is at stake. Some American courts treat the doctrine skeptically.⁶¹ Some American courts punish banks for *not* rescuing a firm (on the ground that the bank refused the additional credit in “bad faith”). And most American courts let a bank safely “rescue” firms so long as it waits until after they file Chapter 11 petitions. In the end, a basic empirical vacuum remains: although Japanese banks help some troubled borrowers, they jettison most; although American banks jettison most troubled borrowers, they help some. Beyond that, we cannot say.

4. Conclusion

As part of the institutional structure of an economy, legal rules shape the deals firms cut. By altering the costs of alternative forms of economic exchange, they alter the transactions firms enter. The differences between American and Japanese commercial practice form a case in point: some of the most puzzling differences may largely be artifacts of the different legal regimes in place.

The Japanese main bank system (to the extent a distinctive system exists) may be one such idiosyncratic result. Recent observers use the system to explain the large bank debts Japanese firms use and to posit aesthetically appealing models of implicit contractual arrangements: agreements where one bank agrees with the other banks to act as their delegated monitor, and agrees with the firm to insure it against business failure. It is not that these models are theoretically impossible. At stake are indefinitely repeated transactions, and we know from the game-theoretic folk theorem that in such worlds anything can be an equilibrium. It is rather that they are realistically implausible.

Any differences between the Japanese and American banking systems may derive from far more mundane reasons. Consider why Japanese firms borrow so much of their money from banks. First, during the late 1970s and early 1980s, Japanese bureaucrats caused

⁶¹Kham & Nates' Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) (Easterbrook, J.).

regulated rates to track market rates more closely than in the United States. As a result, investors and firms faced smaller incentives to devise ways of avoiding the banks. Second, for most of the postwar period Japanese banks levied a large toll charge (in the form of collateral management fees) on anyone who used the bond market. Firms thus could avoid the banks through the bond market only if they repaid much of their savings to their bank.

If Japanese banks rescue large failing clients more often than American banks rescue them (an unproven proposition), consider why they might do so. Japanese banks may rescue their clients because they cannot credibly threaten to abandon them; American banks may abandon their clients because they cannot cheaply save them. American law sometimes punishes creditors who intervene in a debtor's business; perhaps Japanese law does not. Hence, perhaps American banks can more credibly threaten to let troubled firms fail. In doing so, they avoid the moral-hazard and adverse-selection problems they might otherwise face. Because Japanese law does not penalize banks that intervene, perhaps Japanese banks often cannot credibly threaten to punish defaulting clients. Unable to threaten *ex ante*, perhaps they involuntarily sell their clients bundled credit-insurance packages. Unfortunately, we do not yet have the data to test the hypothesis.

For all their analytic elegance and mathematical sophistication (and they *are* both elegant and sophisticated), the recent models of implicit contracts raise a more basic problem: if banks and firms want these arrangements so badly, why do they not negotiate them explicitly and draft court-enforceable agreements? If they did draft an agreement insuring a firm against specified business problems, the firm could rely on the courts. Although complicated contracts seldom come cheap, for transactions this large they should come cheaper than the rents a firm would need to pay a bank to make an agreement self-enforcing. Notwithstanding those potential savings, the firms do not draft such agreements. Perhaps the reason is simple. Perhaps they do not make them at all.

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