Corporate Governance in Financial Distress

Peng Xu

Hosei University and RIETI

October, 2004

A big change in Japanese corporate governance

- Till the mid 1990s, on occasion a large firm's private debt restructuring initiated by main banks ended up in bankruptcies
- Since the late 1990s, Japanese bank lenders are less likely to rescue their troubled borrowing firms than they did before.

Debt restructurings' choices in late 1980s US

Gilson (1997): 51 cases of debt restructuring out of court, and 57 cases of Chapter 11

Franks and Torouts (1993): 45 private debt restructurings and 37 Chapter 11 reorganizations.

International Corporate Governance

- Similarities dominates differences, comparing the 1980s US economy with the late 1990s Japan economy
- Complementary to international comparison of the 1980s US and the 1980s Japan economies
- Bankruptcy is increasing its importance in Japan

Workouts v.s. bankruptcies

A workout defined as

(i) Required interest or principal payments on loans are reduced

(ii) The maturities of loans are extended

(iii) Loans are swapped with equities

- **Usually, workouts or out-court debt restructurings are initiated by bank lenders.**

Table 1 Selected financial characteristics for 122 financially distressed firms during the period 1997- 2003

	Bankruptcy *Liquidation firms included*			*Bankruptcy* *Liquidation firms excluded*			*Out-of-court debt restructuring*		
	Mean	Std.Dev.	Median	Mean	Std.Dev.	Median	Mean	Std.Dev.	Median
資産合計（千円）	936***	1920	231***	1010***	2060***	245	4640	3940	3410
銀行無担保融資比率	0.365***	0.318	0.300***	0.348***	0.311***	0.290	0.593	0.338	0.632
銀行無担保融資比率>90%	0.083***	0.278	0***	0.071***	0.259***	0	0.316	0.471	0
社債残高/負債合計	0.025*	0.057	0	0.021	0.049	0	0.011	0.024	0
公募社債残高/負債合計	0.019	0.049	0	0.018	0.046	0	0.010	0.025	0
新生銀融資比率	0.048*	0.125	0	0.051*	0.136	0	0.016	0.037	0
あおぞら・新生銀融資比率	0.058*	0.127	0.002	0.058*	0.135	0	0.027	0.044	0
筆頭銀行融資比率	0.365	0.184	0.336	0.382	0.184	0.355	0.361	0.166	0.348
筆頭銀行持ち株比率	0.034***	0.018	0.042**	0.037**	0.017*	0.044	0.044	0.015	0.048
EBITDA/資産合計	-0.329	1.403	-0.023	-0.390*	1.531	-0.041	-0.073	0.150	-0.017
負債比率/資産合計	1.017	0.659	0.927**	1.059	0.706*	0.931	0.998	0.176	0.955
未処理損失/資産合計	-0.467*	1.406	-0.106	-0.526*	1.532	-0.114	-0.140	0.174	-0.061
N(サンプル数)	84			70			38		

*** Differences for bankruptcy vs. out-of-court at 1% level、**5% level、* 10% level

The Sogo Shock

- 2000/04/08, Nikkei Shinbun
- Also see Tett, Gillian. (2003), Saving the Sun: A Wall Street Gamble to Rescue Japan from Its Trillion-Dollar Melt-down. New York: Harper-Collins Business.

Industrial Bank of Japan (IBJ) was orchestrating a restructuring plan of Sogo, one of the first-rated department stores in Japan with 170-year history. Like many retailers in Japan, Sogo had expanded its operation both domestic and abroad during the 1980s bubble. After 1990, it soon got financially distressed. Both main banks IBJ and LTCB had continued to rescue Sogo.

The Sogo Shock (continued)

The debt forgiveness plan

- ✓ Seventy-three banks forgiving ¥630 billion (about $6.3 billion, at an approximate exchange rate of ¥100 to the dollar) of outstanding *unsecured* loans to Sogo Group.
- ✓ IBJ and the second largest bank lender Shinsei were requested to forgive ¥180 billion ($1.8 billion), ¥98 billion ($980 million), or 94 percent and 86 percent of their *unsecured* loans respectively.
- ✓ All other banks needed to give debt forgiveness of ¥362 billion ($3.6 billion) or 49% of their *unsecured* loans.

The Sogo Shock (continued)

Shinsei's unsecured loans became secured by the Japan's government!

- ✓ Shinsei used to be LTCB,which collapsed in 1998. It was renamed Shinsei or "new birth", after it was sold to Ripplewood, a US private equity fund.
- ✓ "Cancellation right" or *kashi-tampo:* in first three years the purchaser could hand any bad loans back to the government if they lost more than 20 percent of their value.
- ✓ Not surprisingly, Shinsei refused to extend debt forgiveness and informed to exercise the put option *kashi-tampo*.

Workouts and lending banks' incentives

Bank lenders forgive troubled borrowing firms in *unsecured* loans only.

If the bank management extends debt forgiveness in secured loans

- ✓ Shareholders may sue the management
- ✓ The management can be guilty for a breach of trust

This is because the recovery rates for secured claims are as high as 100% in bankruptcy resolutions, as shown in Table 6.

Secured and unsecured loans to Haseko: 1985-2002

	May-85	......	Mar-89	Mar-90	......	Mar-99	Mar-00	Mar-01	Mar-02
Short-term	85468		1760	1373		3295	240	68	68
Long-term	73717		1396	1203	0	292	6634	4889	4846
Total	159185		3157	2576		3586	6874	4957	4914
Secured loans									
short-term	44029		232	135		7	10	10	12
long-term	6146		97	62		4	0	0	0
Fraction of secured	31.52%		7.33%	5.23%		0.19%	0.15%	0.21%	0.24%

Why ever-green lending policy

Hoshi and Kashyap (2004): zombie firm problem

- ✓ In May 1999, thirty-two banks extended ¥350 billion ($3.5 billion) debt forgiveness
- ✓ Three years later, Haseko’s three main banks, Daiwa Bank, Chuo Mitsui Trust bank and IBJ to swap ¥150 billion ($1.5 billion) debt to equity
- ✓ Third time debt forgiveness if there is no recovery of construction industry in the future!
- ✓ Diamond and Rajan (2000, 2001): banks’ unsecured claims are less likely to be repaid in the extreme case

Why ever-green lending policy (continued)

- ✓ Japan’s banks had extended too huge unsecured loans during the 1980s bubble so that banks can neither withdraw loans nor charge high interest rates.
- ✓ Japan’s banks probably continue ever-green policy, unless their excess unsecured loans become secured like Shinsei.
- ✓ The insolvency legal reform seems irrelevant.
- ✓ Policy implication: collateral is important!

Table 2 Time series of bankruptcy filings in 1987-2002

Year	Number of Reorganization	Number of Rehabilitation	Number of Liquidation	Total
1987-1996	10	-	0	10
1997	6	-	0	6
1998	4	-	3	7
1999	2	-	0	2
2000	3	7	1	11
2001	3	12	1	15
2002	8	14	5	27

Banks, security companies, housing loan companies and insurance companies are excluded

In Japan,

Before April 1 2000,

(1) Corporate Reorganization Law (cf. Chapter 11)

(2) Liquidation Law (cf. Chapter 7)

A big difference b/w Japanese Reorganization Law & US Chapter 11

→ A court-appointed receiver operates the firm and works out a Reorganization plan in practice and all managers depart after commencement.

As a result

The debtor’s managers: have strong incentives to resist Liquidation or Reorganization as long as possible.

→ High bankruptcy costs for Liquidation & Reorganization procedures in terms of ex ante bankruptcy costs in White(1983).

The legal reform in 2000

After Apr. 1. 2000, Civil Rehabilitation Law took effect.

→ It is the first explicit DIP procedure for large firms in practice.

→ Potentially, the debtor's managers may continue to control the firm: reduce personal costs for the debtor management and thus provide an incentive to file for bankruptcy not too late

→ Facilitate a faster conclusion of bankruptcy

Table 3 Main differences: Reorganization vs. Rehabilitation

Corporate Reorganization	Civil Rehabilitation
The firm continues as a going concern	The firm continues as a going concern
A court-appointed receiver in reorganization takes the control, while the debtor management departs the firm	The debtor management continues to take the control (debtor in possession), unless the debtor management is incompetent, for instance, management frauds. And the court may appoint receivers in case of the incompetence of the debtor management based on an application of an interest party
A court order stay to protect the firm from creditor harassment	The court may order a discontinuance of exercise of a security right existing on properties. And in a case where collateral are indispensable for

	continuation of business, the rehabilitation debtor may make an application to the court for an approval of extinguishing all the security rights on the properties, by paying money equivalent to the market value
A reorganization plan should be approved by secured creditors, unsecured creditors and shareholders. But shareholders cannot have the right of vote in case where the company fails to fully satisfy its obligations with its properties.	Unsecured creditors approve a rehabilitation plan. Generally, secured creditors may exercise their rights without following the rehabilitation proceedings. And capital may be reduced without shareholders' approval in case where the rehabilitation company fails to fully satisfy its obligations with its properties.

Reorganization, Rehabilitation, Liquidation

Corporate debtors seem to prefer civil rehabilitation filings: a rush of civil rehabilitation filings soon after April 1 2000. Cf. Table 1.

The relationship between Corporate Reorganization, Civil Rehabilitation and liquidation

--- ex. Mycal's conversion

Table 4 Management turnover

Table 4. Intended positions/occupations reported in Nikkei of replaced presidents. Management changes tracked for four years, starting four years, starting four years before he year of bankruptcy filing.

Panel A: Corporation Reorganization filings	
	Number of managers holding specified positions/occupations
Chairman	3
Vice president	2
Advisory with directorship	2
Part-time director	1
Consultant	5
No i positions/occupations	3

Panel B: Civil Rehabilitation filings	
	Number of managers holding specified positions/occupations
Director and Chairman	3
Advisor with directorship	1
Director but no other titles	5
Consultant	3
Managing director of other group firm	2
No positions/occupations	15

Findings for management turnover

Most Civil Rehabilitation firms experience president turn-over around bankruptcy filings

Nevertheless, thirteen presidents remain after commencement of Rehabilitation, comparing with that all presidents depart after commencement of Reorganization

Large firms prefer Rehabilitation to Reorganization

Table 6. Summary of claims resolution for 22 public traded firms filing Reorganization in January 1997 - August 2002

	Percentage or description of claim paid		
Firm name	Secured creditors	Unsecured creditors	Shareholders
Priority violated for secured creditors only			
YAOHAN JAPAN	90%	3%	0
DAI-ICHI HOTEL	90%	4%	0
SASAKI GLASS	90%-100%	3% - 8%	0
Priority held			
KYOTARU	100%	20%	0
TOKAI KOGYO	100%	8%-2%	0
TADA	100%	13%	0
DAITO KOGYO 8%	100%	8%	0
TOSHOKU	100%	8%	0
MITSUI WHARF	100%	36.9%－100%	0

ASAKAWAGUMI	100%	5% - 10%	0
LONGCHAMP	100%	9%	0
JDC	100%	9% - 10%	0
NIKKO ELECTRIC INDUSTRY	100%	10%	0
KOKOKU STEEL WIRE	100%	6.50%	0
NAGASAKIYA	100%	0.50%	0
LIFE	100%	47.72%	0
JAPAN METALS & CHEMICALS	100%	?	0
SATO KOGYO	100%	4%	0
NISSAN CONSTRUCTION	100%	7%—100%	0
KEISHIN WAREHOUSE	100%	8%	0
HOKO FISHING	100%	23%—100%	0
HOKUBU	100%	25%	0

Table 7. Summary of claims resolution for 24 public traded firms filing Rehabilitation in April 2000 – August 2002

	Percentage or description of claim paid	
Firm name	Unsecured creditors	Shareholders
	Priority held	
TOYO STEEL	NA	0
AKAI	NA	0
SOGO	5%	0
FUJII	50%	0
MARUTOMI GROUP	15%	0
FUJI CAR MFG.	8%-10%	0
IKEGAI	1.59%	0
FOOTWORK INTERNATIONAL	NA	0
BETTER LIFE	10%	0
OHKURA	1.50%	0
ELECTRIC	NA	0
ERGOTECH	NA	0

AOKI	2%	0
KOTOBUKIYA	0.70%	0
SHOKUSAN JUTAKU SOGO	NA	0
KITANOKAZOKU	6%	0
SOGO DENKI	NA	0
NAKAMICHI	NA	0
IZUMI INDUSTRIES	NA	0
ISEKI POLY-TECH	NA	0
DAI NIPPON CONSTRUCTION	2%	0
Priority violated for unsecured creditors only		
NICHIBOSHIN	4.14%	1%
KAWADEN	22.43%	21%
HAKUSUI TECH	NA	10%
FUJIKI KOMUTEN	5% - 100%	100%

Findings for priority violation

Priority is less likely to be violated in Japan than in US not only for secured creditors but also for unsecured creditors

The priority violation for secured creditors is 6% (3/46) in Japan and 8% (34/37) in US.

The percentage of violation of priority of claims for unsecured creditors is as high as 70% (26/37) in US but it is 4/46 in Japan.

Findings for priority violation (continued)

In sum, strict priority of claims in 39 cases (85%) held among a sample of 46 firms that filed for Corporate Reorganization or Civil Rehabilitation, comparing with 8 (22%) cases of maintenance of priority among the 37 cases in Weiss (1990).

Figure 1. Stay time: Rehabilitation versus Reorganization

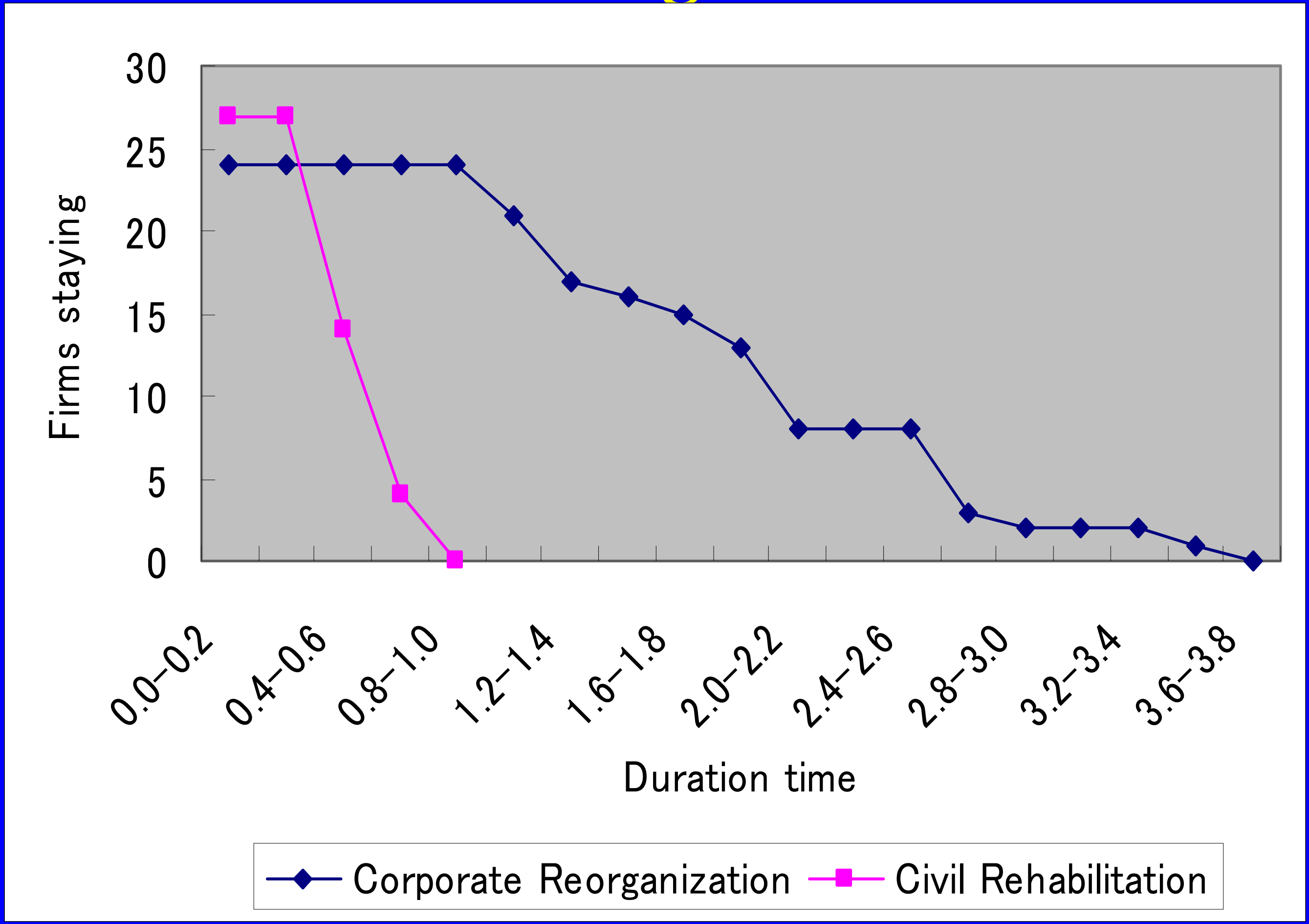
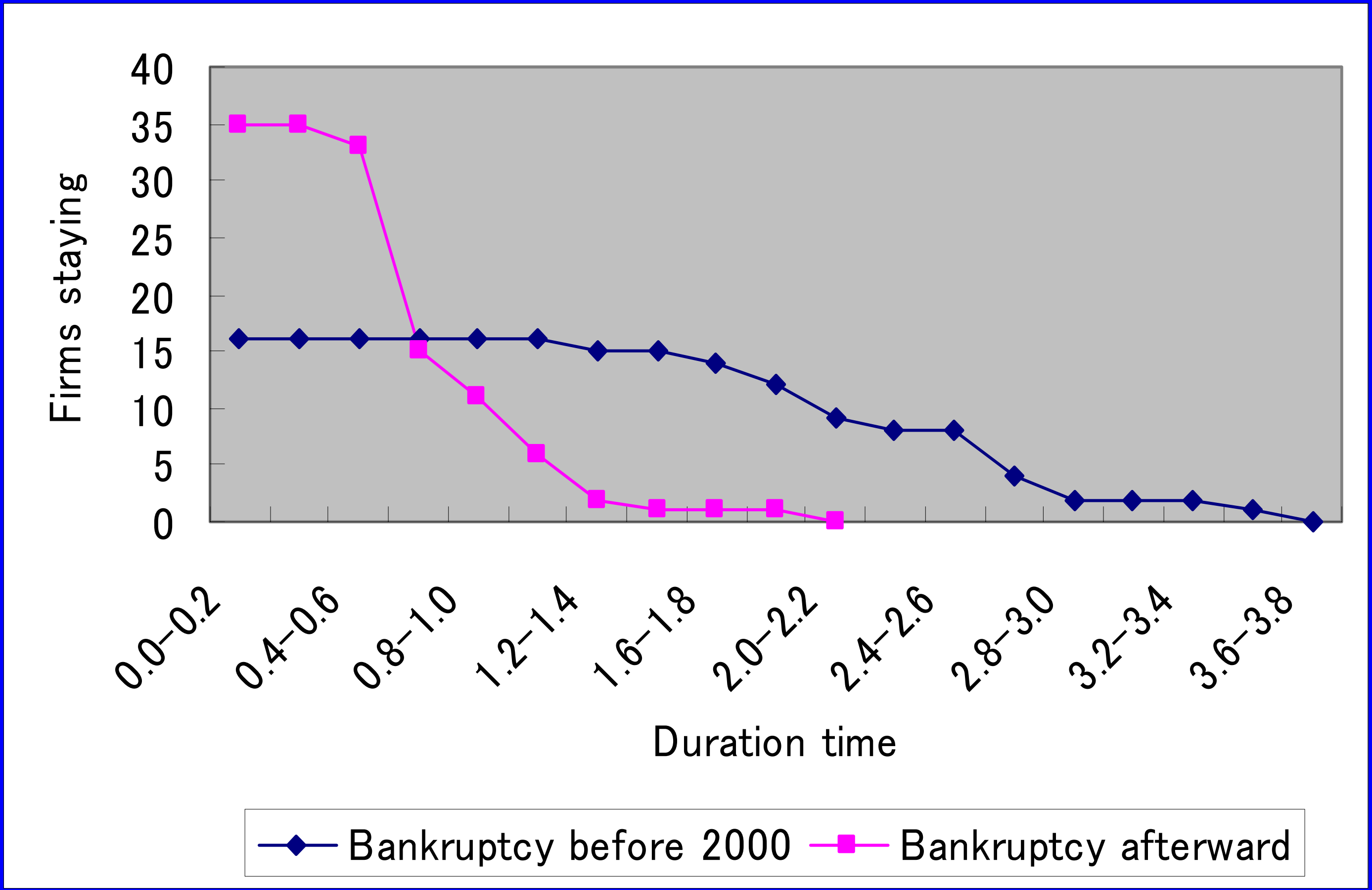


Figure 2.



40
35
30
25
20
15
10
5
0
Firms staying
0.0-0.2
0.4-0.6
0.8-1.0
1.2-1.4
1.6-1.8
2.0-2.2
2.4-2.6
2.8-3.0
3.2-3.4
3.6-3.8
Duration time
Bankruptcy before 2000
Bankruptcy afterward

Table 8. Mean time from bankruptcy petition to resolution: US versus Japan

JAPAN (current paper)			
Corporate Reorganization		2.2 years	24 firms
Civil Rehabilitation		.57 years	27 firms
Whole		1.2 years	51 firms
	Before 2000	2.2	16 firms
	Afterward	.71	35 firms
U.S.A. (Franks and Torouts (1989))			
Before 1979		4.5 years	16 firms
Afterward		2.7 years	14 firms
U.S.A. (Weiss (1990))			
After 1979		2.5 years	37 firms

Table 5. Descriptive Statistics for 25 publicly traded firms filing for Corporate Reorganization in 1997- August 2002 and 27 publicly traded firms filing *Civil Rehabilitation* in April 2000 - August 2002.

	Mean	Med.	Std.Dev.	Cases
Reorganization firms				
ASSET (millions of yen)	204.60	114.90	309.08	25
PUBLIC BONDS/LIABILITY	0.0370377	0	0.08173	25
LEVERAGE	0.891696	0.924708	0.112048	25
COLLATERAL/ASSET	0.310112	0.274631	0.221833	25
Rehabilitation firms				
	Mean	Med.	Std.Dev.	Cases
ASSET (millions of yen)	54.54	22.71	90.47	27
PUBLIC BONDS/LIABILITY	0.0124753	0	0.027838	27
LEVERAGE	1.29515	0.933156	1.08802	27
COLLATERAL/ASSET	0.315463	0.28956	0.178389	27

Table 11. A Log-logistic duration model estimates for *Reorganization* (Observations = 25, Sample Period = January 1997 - August 2002)

	1	2	3	4
	Coeff.	Coeff.	Coeff.	Coeff.
Intercept	0.705486 (11.6998)	-0.0223176 (-0.0328258)	0.990461 (1.96033)	0.771971 (7.30856)
LOGASSET		0.0401323 (1.09195)		
LEVERAGE			-0.322699 (-0.58478)	
PUBLIC BONDS/ LIABILITY	1.4701 (2.5805)	1.29372 (2.21183)	1.32855 (1.84759)	1.35662 (2.37226)
COLLATEA/ ASSET				-0.207777 (-0.866803)
POST 2000	-0.589809 (-5.12935)	-0.599946 (-5.76521)	-0.567918 (-4.88233)	-0.591076 (-5.36098)
Log likelihood	-1.561122	-1.000966	-1.343801	-1.143118

Table 12. A Log-logistic duration model estimates for *Rehabilitation*
Observations = 27, Sample Period = April 2000 - August 2002)

	1	2	3
	Coeff.	Coeff.	Coeff.
Intercept	-0.806931 (-9.30073)	-0.507509 (-0.425925)	-0.807226 (-8.27132)
LOGASSET		-0.0167208 (-0.236265)	
LEVERAGE	0.0769746 (2.54459)	0.0741412 (2.10828)	0.0770385 (2.48213)
PUBLIC BONDS/LIABILITY			0.0119631 (0.00834607)
COLLATERAL/ASSET	0.347913 (1.66904)	0.32633 (1.45694)	0.34815 (1.62838)
Log likelihood	4.854069	4.965625	4.854102

Findings for bankruptcy duration

(1) Bondholder holdouts delay the Corporate Reorganization process.

(2) Leverage has no significant effect on duration in Corporate Reorganization.

(3) Asset size is not significant in any estimates for duration in either Corporate Reorganization or Civil Rehabilitation.

(4) High leveraged Civil Rehabilitation firms spend more time in bankruptcy.

Conclusion

Rehabilitation firm spends in bankruptcy substantially shorter than a Reorganization firm

A bankrupt firm in Japan exits faster than a U.S. firm filing for Chapter 11

Rehabilitation Law may provide an incentive to firms in economic difficulties to file for bankruptcy not too late.

Conclusion

Orderly insolvency resolutions strongly suggest that corporate governance works well in Japan.

In the last decade, many economically inefficient firms are being forced to exit or to restructure.