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The Problem of Bank Rescues: A Comment on Miwa and Ramseyer

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The main finding that arises from Miwa & Ramseyer's intriguing paper[1] is that there is no evidence to support the claim put forth in earlier literature that, in Japan, a firm's main bank implicitly promises to rescue the firm when it is in distress. This is as opposed to the West, the claim goes, where firms often enter costly bankruptcy proceedings because, due to collective action problems and monitoring problems, amongst others, no main creditor has incentive to step in and rescue the firms. Their data supporting this finding are very convincing. However, this comment seeks to suggest a different story that may be consistent with the Miwa & Ramseyer findings. I propose that perhaps main banks in Japan *do* implicitly promise to rescue firms in distress worth saving, but this promise is contingent upon management or controlling shareholders' cooperation — and, often this cooperation is not forthcoming due to a conflict of interest that emerges from the Miwa & Ramseyer data: between the firm's managers and/or controlling shareholders and the firm. It is well-documented in the hostile takeover literature that incumbent managers and controlling shareholders may want to block a hostile takeover, even when the takeover is in the firm's best interest.

Suppose that, contrary to Miwa & Ramseyer's conclusions, banks in Japan do implicitly promise to save firms in distress; when a bank is called upon to act on that promise, it will want to have a say as to how the managers and/or controlling shareholders will run the firm. However, they would naturally be reluctant to cooperate with such intervention, for reasons similar to those that induce them to block hostile takeovers. To begin with,

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1 Yoshiro Miwa & J. Mark Ramseyer, *Conflicts of Interest in Japanese Insolvencies: The Problem of Bank Rescues*, 6 Theoretical Inquiries L. 301 (2005).

they would be concerned that their private benefits from control would be diminished. Although they would realize that thwarting the bank's efforts might increase the probability of bankruptcy and thereby reduce the size of the firm's pie, they might still prefer not to forego full control, so as to maximize their share of the firm's existing pie. Furthermore, particularly when a firm is in distress, managers and controlling shareholders tend to engage in the classic activities for improving the position of shareholders at the expense of the firm's creditors and the firm itself.

There are a number of such activities. First, managers or controlling shareholders may involve the firm in relatively risky projects (even if, from the firm's perspective, the return on these projects does not justify the additional risk), for if such a project fails, the firm's shareholders will have little to lose, on the assumption that since the firm is in distress, it barely covers its debt anyway, whereas if the project succeeds, the shareholders will enjoy the entire extra surplus. A second classic tactic is when managers or controlling shareholders induce the firm to take more loans (even if the additional debt increases the probability of bankruptcy to the point that it is not in the firm's best interest), the reason being that the extra funds enable them to involve the firm in new projects. Similar to the preceding tactic, if these projects fail, the firm's (many) creditors — particularly the unsecured ones — and not the shareholders, will bear much of the loss and, if the projects succeed, the shareholders will garner the entire extra surplus the projects generate. Third, controlling shareholders or managers can try to slip assets out of the firm and into their pockets. Although this increases the probability of the firm's bankruptcy, these assets are more certain to find their way into the hands of the controlling shareholders or managers this way than if they were to remain in the firm, which must use its assets first to pay back debts.

Naturally, when a main bank proposes to rescue a firm, it will likely precondition the intervention on the firm's ceasing all such activities. The controlling shareholder(s) and manager(s) in the firm will, for their part, naturally prefer not to abandon these tactics. Indeed, in many of the examples presented in the Miwa & Ramseyer article, the main bank tried to help the firm in distress, but the managers refused to cooperate. It could be argued that were the implicit promise theory false, the banks would not have tried to help in the first place. Thus, as the authors stress in their Mazda example, the Sumitomo Bank wanted to send personnel, loan money, reposition the product line, and enforce austerity, but management "fought the bank at every turn."[2] In this instance, the firm was eventually rescued, but this was in spite of management's refusal to cooperate.

In the Hanasaki example, the bank asked management to devise a consolidated rationalization plan and rebuilding plan, but it refused to do so.[3] Here, the firm eventually was not saved, but not necessarily due to the absence of an implicit promise to rescue on the part of the main bank, but, rather, because management refused to cooperate. In the case of Hayashi Spinning, the firm ultimately entered reorganization proceedings, but as the result of a battle for control between management and the firm's main bank.[4] Here we see again that the bank was inclined to keep the firm's operations intact, whereas management refused to cooperate, and hence a fight for control of the firm determined which of the two would prevail. In the Mitsumi Electrical instance, too, the firm's main bank tried to intervene, but management rejected the intervention, tried to rescue the firm on its own, and ultimately failed.[5]

Interestingly, one of the Miwa & Ramseyer findings is that troubled firms include disproportionately many firms with a dominant shareholder (i.e., a shareholder with at least 25% of the firm's stock). This finding may support my claims. Firms with dominant shareholders are much harder to take over or influence, whether by mere appointment of minority directors or any other measure. Accordingly, assuming Japanese main banks do, indeed, implicitly undertake to rescue firms in distress, it is all the more difficult for these banks to act on their promise precisely in respect of these firms, because many of the dominant shareholders might refuse to cooperate and block the "mini-takeover" entailed in rescuing the firm.

This scenario would not be surprising, since, as noted above, a dominant shareholder's more profitable strategy may well be to raise the firm's risk, induce it to take more loans, and milk its assets — actions that would be immediately vetoed by a rescuing bank. The above-mentioned distorted incentives of managers and controlling shareholders to take these actions are even more acute when there is a dominant shareholder, because he or she benefits directly from these activities as a shareholder in the firm. When there is no dominant shareholder, the incentive for managers to take the noted actions for the shareholders' benefit (and against the firm's interest) is less obvious.

Considered in conjunction with my proposal, that what Miwa &

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2 *Id.* at 310.

3 *Id.* at 314.

4 *Id.*

5 *Id.* at 315.

Ramseyer's data might be picking up on is the fact that managers and controlling shareholders often block banks' efforts to rescue firms, the abundance of distressed firms with dominant shareholders can explain another interesting finding in their article, namely, that there was no observable relation between the number of potential main bank representatives on a firm's board and the odds of that firm surviving. With firms with dominant shareholders, even when the bank has representatives on the board of directors, those representatives may have no decisive power without the cooperation of the controlling shareholders.

Another interesting finding presented in the article is that the most troubled firms often switch main banks. Miwa & Ramseyer suggest that this finding also undermines the claim that main banks implicitly promise to rescue firms, since such a promise can be likened to an insurance contract: just as an insurance company would not give an eighty-year-old life insurance at the same terms as a thirty-five-year old, so no bank would want to step in to rescue a firm already in distress. The firm will have paid the implicit insurance premiums in exchange for an implicit promise of rescue to its previous main bank, during the period that the firm was healthy. Accordingly, Miwa & Ramseyer argue, if an implicit promise to rescue were to exist, so many troubled firms would not switch main banks. I propose, however, that this finding notwithstanding, main banks might nonetheless be implicitly promising to rescue firms. Miwa & Ramseyer assume that this promise is made *to the firm*. Under this assumption, it is indeed puzzling that firms in distress have a stronger tendency to switch main banks. I submit that this promise is not made to the firm but, rather, *to other banks*.

But why would banks in Japan want to implicitly promise one another to rescue firms? One of the conventional wisdoms Miwa & Ramseyer challenge in their article is that the main banks are the substitute to the mechanism of firm reorganization via the courts in the West and that this adds overall value to the firms (due to the rescuing of viable investments and saving of the costs of the reorganization proceedings, including delay, uncertainty, other firms' reluctance to do business with a firm undergoing such a proceedings, etc.). But suppose that the implicit promise by banks to rescue firms does, indeed, add overall value to the firm. There may be something about the structure of the banking industry in Japan that facilitates the following long-term reputation mechanism among banks: If we assume that there are only a few large banks and many of them lend to many of the same firms, then bank *A* is the main bank for firm *X* and bank *B* a smaller creditor, while for firm *Y* bank *B* is the main bank and bank *A* a smaller creditor, and so on and so forth. Thus, a repeated interaction among the players can plausibly reach an equilibrium of the banks taking turns rescuing firms, to the ultimate benefit of all banks and all firms.

To be sure, this equilibrium might not always be a stable one, since it is a collusive equilibrium resting on reputation. But it nonetheless could hold for certain periods (contingent, of course, on the cooperation of management, as stressed earlier). Under such an equilibrium, a bank that, at a certain point, bears a lighter burden of distressed firms relative to its counterparts (either because it is the main bank of fewer firms in distress or because the firms are in less distress relative to the firms borne by other banks) will be willing to take over part of the rescuing burden of an overcommitted main bank (whether because it carries relatively more distressed firms or greater distress than its counterparts), at no charge to the firm that is the object of the switch in banks.

Thus, my proposition fits well with the Miwa & Ramseyer finding that healthier firms switch main banks less often than distressed firms do. When a firm is healthy, the banks do not need to redistribute their burdens with regard to this firm. Under the proposed reputation mechanism, the need to redistribute burdens arises only when the firm in question is in distress.

Indeed, one might ask why, as Miwa & Ramseyer find, a bank often steps in as a firm's new main bank when the firm is already in distress. There seems to be no rational explanation for such a move, whether or not we accept the implicit promise theory. The existence of a reputation mechanism among banks could explain this apparent puzzle.

Finally, the proposition that banks implicitly promise *one another* to rescue firms in distress (contingent upon management cooperation) introduces some rationality into the implicit promise hypothesis. It is consistent with Miwa & Ramseyer's assertion that banks in Japan are not much different than banks in the West, in the sense that they are all driven by profit-maximizing incentives. Thus, my proposition is consistent with Miwa & Ramseyer's critique of the claim in the literature that Japanese banks are driven by sociological or cultural biases, rather than by profit considerations.