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**On the (Fleeting) Existence of the Main Bank System
and Other Japanese Economic Institutions**

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Curtis J. Milhaupt*

Introduction

In the accompanying essay, Professors Miwa and Ramseyer (M&R) use economist Masahiko Aoki's book as a springboard to argue, creatively and provocatively, that most of the comparative corporate governance academy has been chasing a myth. The myth, which M&R attribute largely to Aoki's vast and influential scholarship, is the existence of the "main bank system" and the related institutions of lifetime employment and *keiretsu* groups that have figured prominently in academic and professional thinking about corporate Japan.

M&R will never be accused of pursuing a timid research agenda. They might have limited their ambitions to showing that Japanese economic institutions are ill defined or aggrandized in popular and professional usage, or that these institutions have ceased to function as they did in their heyday. But others have trodden this path.¹ Rather, at least as I read their essay, M&R seek to alter our basic understanding of postwar Japanese economic organization and behavior, by attempting to prove that the conventional wisdom is flatly untrue. The crux of their argument is summed up in the following passage (Miwa and Ramseyer, 2001: xx): "The claims about the main bank system are...false. Firms and workers did not bargain for lifetime employment. Banks neither promised to rescue defaulting debtors nor monitored debtors on behalf of their rivals. The *keiretsu* had no substance, and the government had little clout." They emphasize that the main bank system "never functioned" in Japan, and make the

fascinating assertion that the *keiretsu* “are the 1960s creation of Marxist academics and populist journalists.” All of it, we are told, is myth.

In this brief essay, I will provide an alternative perspective on the institutions of Japanese corporate governance. Although Aoki’s work has been influential in my own scholarship, I will leave to him the task of responding directly to M&R’s critique of the book. I view my role as providing some additional context—historical, institutional, and empirical—for the claims of Miwa and Ramseyer. To state my conclusion at the outset, the conventional wisdom, heavily influenced by Aoki’s work, is a more or less accurate picture of Japanese corporate governance in its heyday, which is rapidly receding from memory. Professors Miwa and Ramseyer, have not, as they profess, given us “better facts,” but a theory of perfect competition and information for Japanese firms. While their data probes the structural soundness of the theoretical edifice that Aoki has helped to construct, in the end, that edifice survives largely intact.

At stake is more than a narrow academic squabble over an arcane corner of corporate law. Like much of the important work of these scholars, the M&R essay prompts reevaluation of “settled” academic views of Japanese business and financial practices. While M&R’s efforts to rid the academy of groundless stereotypes about Japan are a service to all, in this case, they miss the mark. By tethering their critique of Aoki to the basic assertion that it is unnecessary, M&R implicitly cast the central question as whether standard economic principles apply to Japanese corporate behavior, or whether the country has a distinctive economic landscape requiring novel theoretical analysis. In fact, both are true: standard economic theory explains much of what happens in Japan, but Japan is distinctive in its particular constellation of economic, social, and political

institutions—in the same way that the United States, France, or Egypt is distinctive. Far from leading us astray, the “middle of the road” approach of Aoki and other prominent theorists such as Nobel laureate Douglass North, which combines standard economic analysis with investigation of the development and evolution of country-specific institutions, has proved a powerful tool for explaining economic history and change in Japan and elsewhere (see, e.g., North, 1981, 1990).

I. Academics and The Japanese Firm

The essay by M&R nicely crystallizes the controversial research agenda pursued by these talented and iconoclastic scholars over the past several years. Since their aim is to shatter the conventional wisdom, I will briefly outline several formative developments in academic thinking about Japanese corporate governance.

The stage for modern comparative corporate law scholarship was unwittingly set in 1932 by the publication of Adolf Berle and Gardiner Means’ classic work, *The Modern Corporation and Private Property*. In the book, Berle and Means advance a straightforward and powerfully compelling theory rooted, as they put it, in “the traditional logic of property”: to fulfill the need for vast pools of capital, firms issue shares to large numbers of dispersed shareholders; scattered ownership allows control to concentrate in the hands of managers. Thus, in the eyes of Berle and Means, the emergence of the modern firm results in a lamentable separation of ownership and control in which the economic interests of individual shareholders are subjected to the whims of management. Berle and Means saw law as a solution to this problem. They explicitly call for courts to enforce fiduciary rules against managerial self dealing, and

somewhat more obliquely, suggest that better regulation could enhance the operation of the capital markets, which provide protections for shareholders in the form of valuation and liquidity (ibid: 219-285). Corporate governance in this universe is about aligning the interests of shareholder “owners” who provide the capital, and corporate managers who actually run the firm. In the ensuing half century, much scholarly attention was devoted to understanding how such phenomena as hostile takeovers and legal regulation of voting and capital market transactions might alleviate this central agency problem.

Some sixty years after this influential work, however, the success of the Japanese and German economies led legal scholars and economists to remove the “Berle and Means blinders” and to see that this logic overlooks a crucial fact: in some economies, large financial intermediaries take the place of organized stock exchanges as the chief mechanism for raising capital (e.g. Roe, 1994). In these economies, banks with equity stakes may have the information and incentives to monitor firms, and the agency problem between shareholders and managers around which half a century of American corporate law and finance theory was built fades in importance.

This is where Aoki’s contributions loom large. Building upon the work of many others, Aoki provides a formal and integrated theoretical framework for understanding the economic rationale for Japan’s system of corporate finance and governance, a system in which banks have played a leading role. Aoki and other prominent theorists such as Milgrom and Roberts (1994) linked the separate components of Japanese firm structure and industrial organization into a coherent whole by revealing the complementarities at work among bank monitoring, lifetime employment, cross-shareholding, and other features of the economic landscape. Not surprisingly given the success of the Japanese

economy, many observers looked to this system as a potentially more appropriate model for developing economies, which typically lack highly organized and efficient capital markets.

But things economic (and academic) tend to move in cycles. By the end of Japan's "lost decade" of recession and stagnation in the 1990s, many analysts were ready to relegate Japan's distinctive institutions to the junk heap of economic history. A line of scholarship now questions the quality of bank-oriented corporate governance (e.g., Morck and Nakamura, 1999) and the governance of the banks themselves (e.g. Anderson and Campbell, 2000, Hanazaki and Horiuchi, 1998).

Policymakers, as M&R indicate, now seek to re-engineer the legal and regulatory landscape to improve the quality of Japanese corporate governance, particularly by incorporating features associated with the Anglo-American model of capital market oriented finance and governance. M&R go a step further, arguing, in effect, that the main bank and other institutions of Japanese corporate governance never existed in the first place. According to M&R, Japanese firms have always found their own way in highly competitive markets for capital, products, labor, and information, oblivious to constraints imposed by the state, society or history. Thus, there is nothing to unwind, undo, or address through legal reform.

With this background out of the way, let's turn to what M&R want to discuss, the facts.

II. A Brief Look at History, Institutions, and Empirics

M&R's critique rests principally on three factual claims: (1) mutual shareholding and trading ties among the *keiretsu* firms are insignificant, (2) lifetime employment is a legal requirement for large firms, not an implicit contract, and (3) there is no empirical foundation for claims that Japanese banks play a special role in monitoring or rescuing borrowers. In each area, M&R make useful contributions by providing data that may challenge certain stylized facts of Japanese corporate organization and governance. Yet in each area, it is not difficult to find other data that contradict or at least obscure the significance of the data that M&R present. Let's take the claims in turn.

Shareholding and trading: For M&R, the *keiretsu* are a "convenient fiction" having "no substance," whose genesis lies in the postwar machinations of Marxists and misguided journalists. Curiously, M&R make little attempt to reconcile these bold claims with two highly problematic facts: First, three of the postwar *keiretsu*—Mitsui, Mitsubishi and Sumitomo—are direct descendents of prewar *zaibatsu* conglomerates. Logically, M&R must either narrow their claims to the groups lacking a prewar provenance or demonstrate the "nonexistence" of the *zaibatsu* as well. Second, business groups of one form or another exist in numerous economies around the world, including Korea, Chile, and India (e.g., Khanna, 1999). To the extent that M&R aim to demolish an icon of zealous Japanologists, the phenomenon they attack is by no means unique to Japan. If it exists widely in some form outside Japan, why is it so improbable within?

Even if M&R could finesse the obstacles posed by Japanese history and similar business practices elsewhere, the data they present, while interesting, is of uncertain significance in the face of widespread contradictory data. For example, according to data

reported in OECD (1996: 153), 30.7 percent of the “large” shareholders of Japanese firms are parent companies or companies in the same group (the corresponding figure for the U.S. is 1.9 percent), 35.6 percent are financial institutions with business relationships (1.9 percent for the U.S.), and 9.4 percent are non-financial institutions with business relationships (1.9 percent for the U.S.). These data are from a questionnaire sent to large manufacturing companies in the two countries, and are not likely tainted by Marxist influence on compilations of *keiretsu* groupings. In a 1990 survey reported in OECD (1996: 154), 6.6 percent of the responding Japanese firms reported that mutual shareholdings represented 50-60 percent of their outstanding stock; 9.3 percent reported that 40-50 percent of their stock was mutually held, and 17.6 percent reported a figure of 30-40 percent.

A 1994 Fair Trade Commission survey reported in OECD (1996: 156) found that intra-group shareholding for the six major groups (whose share in the total economy is between 17 and 19 percent in terms of capital, assets, sales and profits) averaged 22.2 percent (varying from 14.2 to 38.2 percent among the groups). Reciprocal shareholding by group members averaged 14.5 percent (varying from 8.2 to 22.9 percent). The average mutually held stake was 1.2 percent of the outstanding stock.

Concentrating on the size of individual stakes, M&R assert that reciprocal shareholdings are too small in practice to be significant. But under the Commercial Code, most significant corporate decisions require the approval of holders of two-thirds of the outstanding stock. Thus, 33.3 percent is a crucial “blocking stake” in a Japanese firm. If, on average, 14.5 percent of a group firm’s stock is held in hostage-like reciprocal fashion, and another 7 percent is held unilaterally by other group affiliates, it is

highly unlikely that any unaffiliated shareholder will hold a stake large enough to influence management. While the average individual stake among group members is small, it is not the average individual stake that matters.

M&R also cite data suggesting that intra-group relational trading ties are less substantial than commonly assumed. However, they only provide data on trading ties among manufacturing firms, excluding financial and service ties among all group firms. When all intragroup business relations are included, the figures on intragroup relations as a percentage of total business (for 1992) are as follows: Mitsui 44.2, Mitsubishi 51.7, Sumitomo 60.8, Fuyo 29.3, Sanwa 27.6 and Dai Ichi Kangyo 32.8. M&R also do not discuss intra-group personnel relations, which by all accounts are substantial. As with much of the other data presented by M&R, if the point is to probe the conventional wisdom, they are helpful. But viewed in context, the data do not bear up under the strain of supporting the assertion that there are no relational ties within these groups.

Lifetime employment: M&R are not alone in arguing that the Japanese courts have played a significant role in shaping the employment practices of large firms. Indeed, this argument is pursued in detail by Araki (1994); Foote (1996) and Milhaupt (1996). Judicial precedent does place substantial constraints on an employer's ability to terminate workers, even where layoffs are motivated by economic necessity. Conversely, the legal doctrine supports adjustment of work rules and ambiguous demarcation of job requirements, providing firms with flexibility in worker assignments and transfers to soften the rigidities imposed by restrictions on layoffs.

At the same time, however, it is unlikely that the threat of legal sanction was the primary motivation of Japanese firms in entering into long-term, open-ended employment

relationships with key workers. While some cases on “abusive” dismissal of employees predate the widespread emergence of lifetime employment practices, the Supreme Court did not affirm the standards developed in the lower courts until 1975. Furthermore, as M&R themselves note, many of the important cases restricting layoffs arose out of the two oil crises of the 1970s, long after lifetime employment practices were firmly entrenched. Even more importantly, the judicial standards for dismissal apply to a much larger universe of employees than those covered by lifetime employment (Araki, 1994), indicating that promises of career-long employment security—implicit or explicit—are not the only available response to the legal requirements. Thus, legal analysis itself makes it problematic to explain the practice of lifetime employment as entirely legally driven.

Other facts, moreover, suggest quite forcefully that compliance with law is not the whole story behind lifetime employment practices. For example, differences in Japanese tenure and wage patterns between large and small firms are highly consistent with economically motivated approaches to worker training and incentives (Hashimoto and Raisian, 1985). Indeed, M&R would have to navigate a broad landscape of economic theory and empirical evidence well beyond the scope of Aoki’s work in order to sustain the burden of showing that “only law matters” to lifetime employment practices.

Far more plausible is the conclusion that lifetime employment arose out of a larger social, economic, and political pact to bring stability to postwar Japan, a pact that was reinforced by the courts. Indeed, the origins of lifetime employment are echoed in the judicial standards on abusive dismissal, under which layoffs must be “objectively reasonable and socially appropriate.”² Viewed in this light, lifetime employment is a

(under certain circumstances, economically rational) norm that has been sanctioned and diffused by the state.

Whatever the contribution of the law to the development of lifetime employment, the practice served as an important complement to other facets of Japanese corporate governance in its heyday, such as the absence of an external market for corporate control (e.g., Milgrom and Roberts, 1994). That the legal system contributed to the development of these institutional complementarities³ is a useful refinement of Aoki's theoretical framework, but not grounds for refuting the economic motivations behind this practice.

Main banks: M&R raise several empirical objections to the functioning of the main bank system. First, M&R dispute the conventional understanding that the main bank both serves as a “delegated monitor” of the firms to which it lends, and rescues those firms when they experience financial trouble. The data reported, however, are less supportive of this claim than the authors suggest. For example, M&R present evidence that main banks do not maintain ironclad relationships with firms experiencing losses. But the same data could be cited to illustrate the *strength* of main bank ties in Japan. Imagine the passage at page ___ of the essay⁴ were rewritten as follows: “In Japan, the loyalty of bankers to their borrowers is noteworthy. A majority of firms experiencing consecutive annual losses—even for as long as five years--maintain their relationship with their main bank. A whopping 70% of firms with four consecutive years of losses maintain their relationship with the main bank.” More importantly, however characterized, these data are difficult to interpret. In the absence of comparative data, it is impossible to determine whether these figures are high or low. Even more problematically, firms experiencing a loss may still be servicing most of their fixed

obligations, particularly their debt to major commercial bank lenders. If the loans are being repaid on schedule, there is little economic reason (and possibly no legal grounds) for a bank to abandon its borrower. At the very least, we need additional information to evaluate the significance of the data M&R have provided.

At the same time, M&R's claims in this area are consistent in spirit with a growing body of literature calling into question the "specialness" of main bank-borrower ties. For example, Hall & Weinstein (2000) report that firms without main banks receive as much loan assistance from the top lending bank and from all bank lenders as firms with ties to main banks. They conclude that their "results are not supportive of the notion that a relationship with a main bank confers significant benefits on firms. Indeed, our results represent a challenge to that view" (ibid.: 79). The same study finds, however, that concentrated debt holders do tend to give greater assistance to firms in distress. They conclude that the "main benefit of the Japanese main bank system may be the fostering of concentrated debt-holding, not the creation of special, 'group' relationships between banks and firms" (ibid.).

As further evidence that the main bank has no substance, M&R also cite 1994 data indicating that about as many firms fail in Japan as in other major industrial economies. Yet a comparison of the Japan Statistical Yearbook and the Congressional Information Service (both published in 2000) indicates that each year far more businesses fail annually in the United States than in Japan, even after controlling for differences in the size of the two economies. This bare fact, of course, does not tell us much about the operation of the main bank system, since no knowledgeable observer has ever claimed that the main bank system is a complete substitute for bankruptcy in Japan. Among other

reasons, small and start-up firms in Japan, as elsewhere, often lack capital and fail in large numbers. In order to assess whether main banks protect some clients from bankruptcy, we need comparative data on the number of *large* firms that resort to bankruptcy, holding constant macro-economic variables. Unfortunately, M&R do not provide this data. We do know, however, that in Japan, only 2 percent of all business bankruptcies from 1980-1990 were of firms with more than 100 million yen (about \$1 million) of capital.⁵ In the United States, however, 9 percent of the businesses filing for bankruptcy in 1994 had assets of \$1 million or more (Warren and Westbrook, 1999: 520). Any number of possible explanations can be given for the existence of relatively more and larger bankruptcies in the United States than in Japan, and more research into this question is welcome. Such data as currently exist, however, are not inconsistent with the view that the main bank system absorbed some large cases that would otherwise have been resolved through formal bankruptcy proceedings.

Finally, M&R seek to undermine one of Aoki's explanations for bank intervention—the desire to acquire additional branches--by claiming that branches are unprofitable. They also suggest that banks need not heed the direction of bureaucrats to absorb failing firms because “the government had little clout.” Yet it is widely known, well outside the confines of Aoki's work, that acquiring branch networks is a common enticement for banks and that the Ministry of Finance applied informal pressure to prevent bank and corporate failures.⁶ Indeed, there is considerable evidence that bureaucratic arm-twisting of banks to prop up the social safety net continues to this day.⁷ It also bears noting that M&R's claims here are in tension: if, as they state, large banks

opened only about one branch per year due to government policy favoring small banks, it indicates that governmental financial policy has bite among the private sector.

Ultimately, M&R's denial of the existence of many key institutions of Japanese economic organization appears to rest on the ground that no actual practice possesses all of the features commonly found in the stylized accounts. As we have come to expect from these scholars, their work forces commentators to be cautious about misleading generalizations and stereotyping, tendencies that seem particularly prevalent in works on Japan. In the essay at hand and in the larger research agenda to which it relates, however, this contribution is at times obscured by the tendency to characterize data which might valuably *refine* the understanding of how institutions operate as proof that the institutions are utterly devoid of substance.

In order to succeed at this level of ambition—demolishing the perceived icons of Japanese economic organization--M&R need to summon all of their formidable skills and be more exacting in the specification and testing of their own claims. For example, what does it mean to say of the main bank, an institution that is widely acknowledged to exist by those most closely associated with it,⁸ that it “has no basis in real economic behavior”? (Miwa and Ramseyer, 2000a) Do M&R mean that it fails to conform to neoclassical economic theory? Is it a claim that the stylization is over or under inclusive? That practitioners working within the institution suffer from cognitive dissonance or behavioral biases? Is use of the term “real” economic behavior designed to distinguish it from politically or socially motivated behavior?

III. Japanese Corporate Governance, We Hardly Knew Ye

In Milhaupt (2001), I examined the role that norms play in Japanese corporate governance. Norms are simply nonlegal rules--rules that are not promulgated by an official source nor enforced through formal sanctions, yet are regularly complied with (Posner, 1997). I argued that there are four central features of postwar Japanese corporate governance in the stylized account: the main bank system, the concomitant absence of an external market for corporate control, employee-dominated boards that focus on day-to-day management rather than monitoring, and the lifetime employment system. I showed how each of these features is shaped and supported by social norms. The point was not to deny the importance of law; rather, it was to highlight the complex interplay between formal and informal institutions in the operation of Japanese firms.

A central argument of the paper was that these norms are postwar inventions. Contrary to many assertions, lifetime employment, distain for takeovers, and the use of banks as a partial substitute for bankruptcy proceedings are not intrinsically Japanese practices deeply rooted in Japanese history. Indeed, prewar practices shared many traits now commonly associated with the “Anglo-American” model.⁹ Equally importantly, there is substantial evidence that the norms supporting these institutions are evolving in ways that portend significant changes in Japanese corporate governance. It may be too early to proclaim the “end of history” for corporate law, as Japan and other economies embrace Anglo-American, shareholder-oriented capitalism (Hansmann & Kraakman, 2001). But it is apparent that significant norm shifts are under way in Japan: increased acceptance of the takeover as a legitimate tool of corporate strategy and monitoring, a heightened awareness of shareholders’ economic expectations, a change in managerial

mindset about its proper role in running the firm, diminished social expectations of forbearance on the part of banks and their regulators, and rising ambivalence about the benefits of seniority-based employment practices. The environment for Japanese corporate governance has changed in a manner almost unthinkable five years ago, when Aoki first published his book in Japanese.

Much of this environmental change has taken place because of changes in institutions that have reduced the transaction costs of basic corporate activities such as engaging in mergers and acquisitions, filing a derivative suit, or conducting a corporate reorganization (Milhaupt and West, 2001). I agree with M&R that some legal proposals, particularly mandating that Japanese firms maintain a certain number of independent directors, are misguided or at best meaningless. The experience of the past decade, however, strongly indicates that Japanese corporate actors respond rapidly and voraciously to legal reform, and that many of the reforms to date (e.g., in the areas of bankruptcy, mergers, holding companies, accounting) have had positive effects from the standpoint of efficiency, organizational flexibility, and managerial accountability (ibid.). The Japanese experience should temper M&R's deep-seated Coasean skepticism about the ability of new rules to change behavior.

Perhaps the system that Aoki explained in such elegant terms never functioned as well as the theory predicted. Perhaps scholars and World Bank staffers were wrong to assume that it might serve as a model for developing countries.¹⁰ But those theoretical and normative errors, if indeed that is what they are, do not support the claim that the system was all “a figment of the academic imagination.”

Conclusion

I applaud the iconoclastic spirit of the M&R essay, which highlights potential shortcomings in the conventional wisdom. And I share the principal, if unstated, normative premises of their critique: firms *should* compete for capital, banks *should* let failing borrowers fail, government regulation *should* expose banks to market competition, and law *should* provide firms with the flexibility to attain the governance mechanisms that best suit their production technologies and competitive needs. Fortunately, this appears to be precisely the direction Japanese corporate governance and regulation are heading.

Contrary to their stated intentions, however, M&R have not given us “better facts” about Japanese corporate governance—facts that cast great doubt on the power of Aoki’s theoretical construct or the (past) existence of Japan’s institutional structure. Rather, they have presented a new theory. This is entirely understandable in light of the old academic adage that “It takes a theory to beat a theory.” The theory is that Japanese firms exist in a world of perfect market competition, a world where informal relationships and institutions of all types, including governmental regulation, are irrelevant in the shadow of the invisible hand and private contracting. Though tempting in its parsimony and universality, the theory is not supported with compelling data and has little explanatory power with respect to changes in Japanese economic performance and organization over the past several decades.

Scholars, practitioners, journalists, and policy makers can rest at ease: the institutions of Japanese corporate governance that almost everyone took for granted did in fact exist. They may never have measured up in every respect to the academic

stylizations. They may not have been deeply rooted in Japanese culture. They may never have been suitable for use outside the fairly distinctive circumstances in which they developed. But exist they did, and to some extent they still do. Interested observers can now turn their attention to a more pressing issue—how best to replace them.

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¹ Scholars have long noted the ambiguity and classification problems inherent in the term “*keiretsu*.” Moreover, as discussed below, numerous critical evaluations of the main bank system have appeared in recent years.

² *Ichikawa v. Nihon Shokuen Seizo Co.*, 29 Minshu 456, 458 (Sup. Ct., Apr. 25, 1975).

³ Milhaupt (1996).

⁴ M&R write: “Despite all the theory devote to the subject, as often as not main banks do not stay around to help troubled firms. To illustrate the point, ...[a]mong the 52 TSE-Section 1 firms with 3 or more consecutive loss years, only 60.3 percent [maintained their main bank relationship unchanged]. ... Among the 24 firms with 4 loss year the figure was 70.8 percent, but for the 34 firms with 5 or more loss years it was 50.0.”

⁵ For example, from 1980-1990, 43,164 business bankruptcies, 871 were of firms with 100 million yen (about \$1 million) of capital or more.

⁶ A commonly cited example is the acquisition of Heiwa-Sogo Bank by Sumitomo Bank in October 1986. MOF persuaded Sumitomo to absorb Heiwa Sogo. Sumitomo bore the cost of resolving the distressed bank, but it was able to expand its branch network (e.g. Hanazaki and Horiuchi, 1998).

⁷ See Wall Street Journal, September 26, 2001, p. C1. Reporting that foreign owned Shinsei Bank is being pressured by the Financial Services Agency to take a more lenient stance toward troubled borrowers.

⁸ For example, in a 1991 survey on the perceived role of the main bank, only 10% of the large firm respondents and 16% of small firm respondents thought it was no different from other banks. Nihon Keizai Research Center Report, cited in OECD (1996).

⁹ In support of this claim, I rely in part on M&R’s scholarship on the role of corporate directors in Meiji Japan (Miwa and Ramseyer, 2000b). Although the focus of their analysis is quite different from my own, Okazaki and Okuno (1999) also stress that pre-war Japanese corporate governance was quite distinct from the system that emerged in the wartime and postwar periods.

¹⁰ Although it should be noted that recent experience in Russia and Eastern Europe has also proven disastrously misguided the notion that demand for well functioning markets and market-oriented institutions will create a supply of the same.