

Chapter 2

Examples of APR Violation in Japan in the 1990s

Abstract In the 1990s, there were serious legal distortions and political interventions related to the APR and security interests in the Japanese loan market. In this chapter, we explain some of the most important examples of these APR violations: short-term tenancy protection (*tanki chinshaku ken* in Japanese), mortgages with no residual distribution, the misuse of going-concern value by bankruptcy courts and the *Jusen* Housing Loan Companies (JHLC) problem. Under short-term tenancy protection, a tenant was legally entitled to use a leased house or building for three years, even when the house or building was seized in a foreclosure of the mortgaged house. This protection could also be used to violate the security interest of the mortgagee. Many junior mortgagees fell into a no-residual distribution position, even under fair market prices. Combined with the malfunction of the legal auction after the foreclosure, the junior mortgagees could violate the priority rule to obtain the income transfer from the senior creditor. The misuse of the legal interpretation of the going-concern value by Japanese judges in bankruptcy courts disturbed the APR among various creditors. Finally, the JHLC problem is provided as an example of political interventions existing seniority.

Keywords Short-term tenancy protection (*tanki chinshaku ken* in Japanese) • Mortgagees with no residual distribution • Going-concern value • *Jusen* Housing Loan Companies • Absolute priority rule • Political intervention

2.1 Introduction

In this section, we explain some of the most important examples of APR violation, namely, short-term tenancy protection (*tanki chinshaku ken* in Japanese), mortgages with no residual distribution, the misuse of the going-concern value by bankruptcy courts, and the *Jusen* Housing Loan Companies (JHLC) problem. These examples of APR violation include those through legal violations as well as political interventions. There are various methods to violate the APR, such as the interface of the foreclosure or legal auction, misunderstanding the law, and political intervention.

These examples indicate that there has been extensive disrespect for the security interest and priority rules in Japan.

This chapter is organized as follows. The subsequent section explains short-term tenancy protection (*tanki chinshaku ken* in Japanese) and Sect. 2.3 considers the problem of mortgages with no residual distribution. Section 2.4 criticizes the misuse of the going-concern value by bankruptcy courts. In Sect. 2.5, we explain the *Jusen* Housing Loan Companies problem and political intervention in the bankruptcy procedure of these companies. Section 2.6 concludes.

2.2 Short-Term Tenancy Protection (*Tanki Chinshaku Ken* in Japanese)

Short-term tenancy protection was stipulated in the 395th article of the pre-revised Civil Code. This article was abolished in 2003. Short-term tenancy protection is one of the most well-known and serious examples of legal APR violation in Japan. Mortgages on land or buildings have been used extensively in financial contracts by households as well as large by companies in Japan. Short-term tenancy protection was introduced to protect the lives and the commercial activity of tenants against sudden foreclosure caused by owner's default resulting from debt obligation and bankruptcy.

Under this tenancy protection, a tenant was legally entitled to use a leased house or building for three years after the mortgaged house or building has been seized in a foreclosure. However, this protection could also be used to violate the security interest of the mortgagee. For example, consider a debtor borrowing from a bank with a mortgaged loan. After having received this loan financing, assume that the debtor plots to fundraise from a newer junior financier. For this purpose, the debtor then makes a tenancy contract for his/her building with the new financier. The financial contract is then made as follows. The debtor registers the loan amount as a deposit for the tenancy contract and makes it verifiable. The registered amount is often much more than the real deposit actually paid by the tenant financier. Under the Japanese contract law, such deposits of money need not be kept separately from the owner's (in this case also the debtor's) assets in an escrow account. In this case, the debtor can use this money at his/her discretion. Under the general rule, if the debtor becomes bankrupt, the tenant financier's deposit money is typically subordinated to the loan of the mortgagee bank, and the tenant financier is quickly evicted from the house or building. However, under short-term tenancy protection, the tenant financier was legally permitted to use the mortgaged building for three years after the contracting date, despite the foreclosure and the subsequent auction.

Thus, the mortgagee bank had to choose whether to sell the mortgaged building with the tenancy contract or to wait until the tenant leaves the building by paying

enough compensation. The former was typically not feasible. The buyer had to pay back the overstated deposit with compensation at the termination of the tenancy contract. Given this expectation, the valuation of the mortgaged building was largely discounted from the market value. Moreover, the tenant financier often colluded with a gang (the Japanese mafia) and sublet the building to them at a very low rent. In the case of a tenancy contract for the building, buyers became afraid of negotiating with the Mafia regarding rent renewal or eviction. Therefore, the price of the building was discounted even further.

Furthermore, mortgaged real estate foreclosed upon by the bank is auctioned, which in Japan, is administered by a court. In the auction, the asset cannot be sold below a price stipulated by the court to protect debtors.¹ The bidding price was often discounted below this price when there was a tenancy contract. Then, it was normally not feasible to sell mortgaged assets with tenants at a court-administrated auction.

The following Fig. 2.1 depicts the percentage rates of the finished and unfinished total mortgage asset auctions filed in lawsuits.² The finished rates were just below 30% until 1999 and approximately 15% between 1993 and 1996. For the same period, the unfinished rates were over 70%. These figures indicate that the Japanese mortgage auction system has not worked well or at least not until recent years.

Although economic eviction of the tenant was feasible, the mortgagee bank had to pay substantial compensation to convince the tenant financier or the colluding Japanese mafia to leave the house. This implies a priority violation between the mortgagee bank and the junior lender because the junior lender (tenant financier) obtains a great deal of money from the mortgagee bank even though the bank does not receive full repayment. Thus, junior creditors used short-term tenancy protection as a very powerful tool to collect their loans.

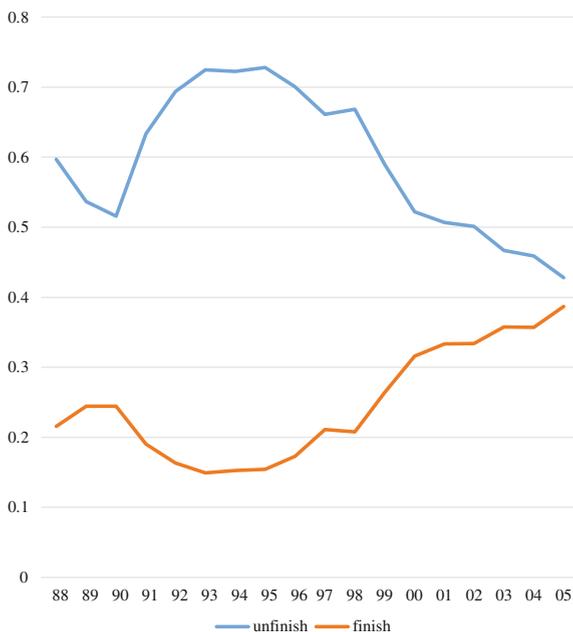
A judgment of the Supreme Court on March 22, 1991 encouraged such abuse of short-term tenancy protection. This decision stipulated that the mortgagee could cancel a tenancy contract if it had obviously been made for the purpose of abuse (as was stipulated in the pre-revised Civil Code). Nevertheless, the judge did not allow the mortgagee any right to evict the resulting illegal occupier. The judgment decreed that such a right belonged only to the owner of the building (i.e., the debtor). The debtor made the tenancy contract with the tenant financier to fundraise the new money. Then, the debtor had no motivation to evict the illegal occupier, and the mortgagee bank lost the legal tools to prevent such abuse of short-term tenancy protection.

After this judgment, the abuse of short-term tenancy protection became widespread and it became a serious social and economic problem in the post-bubble

¹In Japan, the mortgage loan is typically not a non-recourse contract, so the debtor still owes the remaining loan even after the court-stipulated auction. Therefore, the court is cautious about selling debtor assets at a low price.

²The mortgaged assets withdrawn in the process are included in neither the finished rate nor the unfinished rate of this figure.

Fig. 2.1 The finished and unfinished rates of the total mortgage asset auction. *Sources* Annual Legal Report, Courts in Japan, 1988–2005 (<http://www.courts.go.jp/>)



Japanese economy.³ Junior creditors often use such short-term tenancy protection to prevent the security holder (i.e., the senior creditor) from selling a mortgaged building at a fair value at auction. Therefore, junior creditors have used short-term tenancy protection as a powerful tool to collect loans by violating the priority among creditors.

2.3 Mortgages with no Residual Distribution

Another well-known example is the problem of mortgages with no residual distribution. In the Japanese legal system, it is possible to register multiple mortgages. Thus, the second, third, and many more junior mortgagees often lend money to the same debtor. Priority depends on the order of the mortgage establishment. In the 1990s, in Japan, the price of real estate declined steeply and rapidly. As such, many junior mortgagees fell into a no-distribution position, even under fair market prices.

In the Japanese legal system, when an asset is sold in a court-administrated auction, all the mortgages are deleted legitimately. In that case, junior mortgagees

³On November 24, 1999, the Japanese Supreme Court canceled and modified this judgment. This was an exceptionally rapid action in the history of the Japanese Supreme Court. Short-term tenancy protection was abolished in 2003.

receive nothing until the senior creditors are repaid in full. However, under the malfunctioning of the court-administered auction, this legal procedure does not work well. Despite the rapid decline in real estate prices, which resulted in the price stipulated by the court-administrated auction to be usually higher than the market price, adjustments were made only slowly. In this case, mortgaged assets tended to be sold only rarely at court-administrated auctions (see Fig. 2.1). Further, as explained above, the abuse of short-term tenancy protection made this problem even more serious because the asset price was greatly discounted by the tenancy contract.

In this situation, junior mortgagees sometimes obtain a great deal of money, even though their senior mortgagees are not repaid at full value. A typical example is as follows. Assume that there are two mortgagees in a building: the first mortgage is for four billion yen and the second is for three billion yen. The market value of this building is now four billion yen without mortgages. Thus, the first mortgage can be secured completely by the fair market value of the asset, but the second mortgagee will receive no distribution.

With the malfunctioning of the court-administrated auction, the senior mortgagee faces difficulty in selling the asset even in the normal market, that is, outside the court-administrated auction. If the asset is sold in the normal market, the position of the second mortgagee is preserved unless the loan can be repaid completely. After such a market trade, the second mortgage rises in order of seniority, that is, it becomes the first mortgage under the Japanese mortgage law. Therefore, if the mortgagor (the original owner and debtor) defaults on the loan again, the traded asset can be foreclosed again by the preserved mortgagee. Therefore, the buyer must repay the original owner's remaining loan after the trade and the trade price must be discounted from the fair market value by the amount of the remaining loan. In the above example, the market price of real estate with mortgages becomes at most one billion yen—even if the first mortgagee renounces the mortgage for the remaining loan at revenue—because the second mortgagee remains even after the market trade, and thus, the trade price is discounted by the second mortgage loan, which is equal to three billion yen.

In such a situation, the first mortgagee persuades the second mortgagee to renounce the establishment by paying him some compensation before the market trade,⁴ which implies that the first mortgagee does not have full priority. In the above example, if bargaining power is split evenly, the compensation to the second mortgagee may amount to 1.5 billion yen based on a simple Nash bargaining calculation, and the repayment to the first mortgagee becomes 2.5 billion yen. This is a priority violation.

Furthermore, in reality, many subordinated mortgages were registered specifically to obtain such compensations. Mortgages with no residual distribution also worked as powerful tools for APR violation.

⁴See Morita (2000) for more detail.

2.4 The Misuse of the Going-Concern Value by Bankruptcy Courts

In addition, many legitimate rights and procedures may also violate the APR and security interest under the Japanese bankruptcy law. Takagi (1995), a former judge of the bankruptcy court in the Tokyo High Court, claims that there have been many judgments in the bankruptcy court under the Japanese Corporate Reorganization Laws (*Kaisyā Kousei Hou* in Japanese) that violate the APR. He suggests that Japanese judges have misused the legal interpretation of the going-concern value of the firm and disturbed the APR among various creditors. For this reason, the Japanese legal committee did not adopt the concept of “going-concern value” in the recent reform of the Japanese Corporate Reorganization Laws.⁵

2.5 The *Jusen* Housing Loan Companies Problem

There were also political interventions related to existing seniority, as in the case of the *Jusen* Housing Loan Companies problem. A company’s “main banks” are its primary creditors and they hold a large part of the secured loan to the company. However, when the JHLC was liquidated, the Japanese parliament forced the main banks to forgive a proportion of the loan greater than that of the junior creditors. The junior creditors were mainly the Finance Company managed by the Japan Agricultural Cooperative (JAC).

According to an article in *Nikkei* (September 12, 1995, p. 3), the entire loan to the seven JHLCs amounted to 12.9 trillion yen at the end of March 1995, including a loan of 5.5 trillion yen from the JAC. The estimated total loss of the JHLCs was 6.41 trillion yen, and the government decided on the following loss sharing: The main banks’ loss was 3.5 trillion (the entire amount of all the loans made by the main banks), whereas the JACs’ loss was only 0.53 trillion yen, and the remaining loss of 1.7 trillion was shared among the other creditors (e.g., regional banks) and the deposit insurance organization.⁶

Although many main bank loans were senior to those of the JACs, the JACs’ losses were just under 10% of their loan, while those of the main banks were 100%. Even if we recognize the greater responsibility of the main banks, the losses of the

⁵Japanese Corporate Reorganization Laws (*Kaisyā Kousei Hou* in Japanese) were revised in 2003 and the article stipulated for the concept of going-concern value was abolished.

⁶The loss shared by the deposit insurance organization was 0.68 billion yen. See *Nikkei* article (June 19, 1996).

JACs were still less than those of the other creditors. This was because the JAC held overwhelming political power over the Liberal Democratic Party during that time.⁷

This loss-sharing scheme had a serious impact on other firms' bankruptcy procedures and/or financial restructuring. The regional banks and other medium-sized and small financial companies insisted on the responsibilities of the main bank over the other financially distressed firms so that they do not easily accept the debt forgiveness and other forms of loss sharing proposed by the main banks. This implies that the main banks clearly recognized that the fair priority rule in Japan does not work effectively.

2.6 Conclusions

In this chapter, we explained the examples of APR violations in the Japanese loan market in the 1990s. The short-term tenancy protection act was abused to prevent the foreclosure sale and deprive the mortgagee of the compensation payment, which is required for the eviction from the mortgaged real property. As a result, the junior creditor, who is collusion with the tenant, obtains the gain accruing to the senior creditor.

The problem of mortgages with no residual distribution involves many junior mortgagees falling into a no-residual distribution position, even under fair market prices, due to the rapid decline in land price in the 1990s. As a result, the legal foreclosure sale could not work effectively and the junior mortgagees obtained the compensation payment from the senior mortgagee who had to delete the junior mortgage to sell the mortgaged property in the open market. In this case, the junior mortgagees with no residual redistribution could violate the APR to obtain the gain from the senior mortgagee.

Japanese bankruptcy courts unintentionally aided the violation of the APR. The judges misinterpreted the legal definition of the going-concern value of a firm, thus disturbing the priority rule among various creditors.

Another example of political intervention in the APR is the *Jusen* Housing Loan Companies problem. In these companies, the junior creditor was mainly the Finance Company managed by the Japan Agricultural Cooperative, which had overwhelming political power. As such, the Liberal Democratic Party had strong incentives to intervene in the bankruptcy procedures.

In the following part, we analyze the perverse lending behavior of senior creditors (main banks) when there is an APR violation, as explained in this chapter. For this purpose, we start from the specific basic model in the next chapter.

⁷The agricultural cooperation companies are a well-known lobbying group that exerts pressure on the LDP, which depends on voters in agricultural areas.

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