

Circular Transactions in Japan

Introduction

Herbert Smith's May 2009 newsletter¹ considered the impact on Japanese companies of high profile cases reported in the global media that had been filed as a result of the economic downturn.

In this newsletter we consider a particular transaction structure which is not uncommon in Japan and which can lend itself to abuse, as illustrated in some recent high profile criminal convictions. In addition, we have been instructed in a number of related disputes with affected parties seeking to recover losses from their previous trading partners.

The Circular Transaction

Picture a scenario where there are three parties involved in back-to-back sale of goods transactions whereby party A sells goods to party B which re-sells them to party C which then re-sells them to another party down the chain. This type of transaction chain, where B and C are intermediaries between A and the end customer, is common across a variety of industries, particularly where there is an international supplier wanting to sell its products in bulk and utilise established distributors in different regions to ensure maximum end customer coverage.

What if the party C re-sells to is A? The effect would be that the transaction chain would become a circle under which party A is both the first seller and the last buyer of the same goods.

Why would a party enter into a circular transaction scheme?

The benefits to parties B and C are clear; their roles as intermediaries in a circular transaction scheme are no different than their roles as intermediaries in a conventional linear sale of goods transaction chain because in both scenarios they will not expect to come into contact with the goods. Instead, the goods will be delivered straight from the supplier to a party down the chain who has not lined up a re-sale customer. This saves the cost of transporting the goods between all of the parties in the scheme. The documentation for each step in the transaction scheme will usually stipulate that payment becomes due on delivery and so an intermediary will often still produce delivery and shipping confirmations to trigger the payment obligations on the understanding that it has only had deemed delivery. On each re-sale, a party will take a profit margin. Therefore, the benefit to B and C of participating as intermediaries is that they make a profit without having to handle the goods. A, however, will be the party funding B and C's profits so every time a circle is completed it will lose money.

Given this obvious financial disincentive, A will need to have some extra compelling reason to enter into such a loss-making transaction.

It is common for smaller trading companies to require temporary financing to bridge the gap between it paying for goods and receiving payment from the corresponding re-sale transaction. In Japan, such a trading company will often request its larger trading partner for assistance rather than approach a bank. Japanese financing laws allow for trading houses to provide financing without the need for a licence in certain circumstances. These transactions are commonly documented as sale of goods transactions, with the standard 30-60 days to settle the invoice for the "goods" being, in reality, the financing period. Japan is therefore a business environment where circular transactions are permitted business practice among non-publicly listed companies.

Historically, when the contractual validity of circular transactions has been tested in

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¹ "Dealing with increased exposure to fraud in the financial downturn", Herbert Smith Newsletter number 81

commercial disputes, the courts have concentrated on whether each sales contract in the chain is valid and enforceable in itself without considering wider issues, such as the economic imbalance between the parties in participating in the circular scheme (with A funding B and C's profit margins), the financial implications of the scheme (for example the fact that on completion of a circle A, B and C will all have inflated their sales figures and revenues), and other indicators of fraud (such as false products or end customers in the transactional documentation). The result is that where the nature of circular transactions has been examined, it has been held that they are sales rather than financing, regardless of the actual intended purpose of the money movements between the parties.

Circular transactions in the media

It is unsurprising that in the current global economic climate, an increased number of smaller companies are in need for temporary finance. It appears that the economic downturn has also put increased pressure on some company executives to maintain their company revenues. There have recently been a number of reports in the Japanese media of police investigations and some criminal prosecutions and convictions of company executives who have improperly used circular transaction schemes to intentionally and artificially inflate the revenues of their companies.

Perhaps the most high profile of the convictions was the 7 year term of imprisonment handed down to Mr Takasugi, the former Executive Director of the frozen food giant, Katokichi (now Tablemark), in October 2009 for aggravated breach of trust and fraud. The circular transaction schemes orchestrated by Mr Takasugi caused a loss of nearly ¥5 billion to Katokichi and resulted in JPY 3.8 billion being obtained from Mizuho Bank by deception. During closing statements, the defence team requested leniency asserting that it was officially recognised throughout the company that circular transactions were being undertaken as a result of the group's policy of placing growth in sales above everything else.²

Other prosecutions have concentrated on the fact that misstatements have been made in the financial reports of publicly listed companies as a result of the artificially inflated revenues. Such misstatements can constitute a breach of Japanese securities laws, in particular the Financial Instruments and Exchange Law³. In August 2009, the CEO of electronics manufacturer Produce was sentenced to 3 years imprisonment and a ¥10 million fine for misstatements contained in an asset securities report made on the back of ¥11.6 billion of alleged inflated sales⁴. If the media reports are true, there are several further similar investigations underway of other publicly listed companies and their executives.

It would appear that whereas the Japanese courts may be prepared to give privately owned companies relative freedom to contract and increase revenues via circular transactions, they will be more critical of public companies relying on such transactions improperly so as to risk misleading investors.

Practical considerations

Public companies should therefore be very careful to avoid exposing themselves inadvertently to participation in circular transaction schemes. This is especially pertinent if they are introduced into a transaction chain as intermediaries as they may not know all of the parties involved and they will not expect to have contact with the goods. It is advisable to ensure that proper due diligence of the trading counterparties and, to the extent possible, the structure of the transaction, is carried out. The goods should also be verified in terms of firstly, whether they exist and secondly, if they are products with serial numbers, ensure that these are identified on the transactional documentation. There are potentially grave legal consequences for public companies, and their officers, if revenue is misstated in the financial reports so a system of prevention, in the form of robust due diligence, will be the company's best defence.

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Herbert Smith, Gleiss Lutz and Stibbe are three independent firms that have a formal alliance.

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² As reported in the *Shikoku News*, 28 July 2009 and *Yomiuri Shimbun*, 28 October 2009

³ Which came into force on 30 September 2007 replacing the Securities and Exchange Law

⁴ *Mainichi Shimbun*, 5 August 2009