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**DIP Finance in Japan: Recognizing Reality**

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I Former Environment

In the past in Japan, DIP finance was provided by white knights as an act of mercy, or by a “main bank” as a perceived moral or societal obligation. Thus, DIP financing was not considered as a business in Japanese restructuring practice until just a couple of years ago.

There were several reasons for such practice:

- 1 There was a general perception that any company that has filed for protection under a legal proceeding is a “bankrupt”.
- 2 Until the Civil Rehabilitation Law came into effect in 2000, the Corporate Reorganization proceeding was the only reliable proceeding for restructuring of financially troubled companies. The court supervised the proceeding through a trustee whom it appointed. In order to maintain the trustworthiness of the proceeding, the court’s supervision was so stringent that trustees were unable to contemplate the reality of the financial market where the DIP lenders live.
- 3 The management of a debtor was able to continue operation until its cash almost ran out. By that time, a debtor ordinarily would have quite limited assets free and clear, which could be available as collateral for DIP finance.
- 4 No priming lien was permitted under Japanese laws.
- 5 The Financial Services Agency of Japan has set forth a Manual of Inspection of Financial Institutions, which was ambiguous as to how DIP lending should be classified. Because of the possibility that a DIP loan might be classified by FSA as a loan to a borrower with dubious credibility, it was almost impossible for legitimate Japanese lenders to extend a DIP loan.
- 6 Under the Japanese insolvency system, the filing of a petition for commencement of a chapter 11-type insolvency proceeding does not have the effect of an automatic stay, and the court is required to issue the commencement order only after it is convinced that the statutory requirements are met and the procedure formally starts only upon such court order. The debtor, however, continues business operation even during the gap period and needs working capital. The laws provide that liabilities owed by the debtor during the gap period shall, when approved by the court, have administrative claim status upon formal commencement of the insolvency proceeding upon court order.

Thus, there were the following questions:

- a) What if the chapter 11-type proceeding is converted into a chapter 7-type proceeding prior to the formal commencement order of the court?

b) What if such conversion occurs after the formal commencement order?

There were problems here for the DIP financing, since, in the case of a), the DIP loan extended during the gap period was not treated as an administrative claim, and, in the case of b), the DIP loan was treated as an administrative claim but the priority was only a 3<sup>rd</sup> class administrative claim subordinated to any other administrative claims that have arisen in the chapter 7-type proceeding.

## II Significant Changes in Practice, Legislation and Regulatory Rule

1 Restructuring has become more common in Japan than before, due to out-of-court restructuring through IRCJ (Industrial Revitalization Corporation of Japan), a Japanese version of the INSOL eight principles, and so forth. Also, the popularity of the newly introduced Civil Rehabilitation proceeding has changed the general perception about legal bankruptcy proceedings to one much more friendly.

2 Civil Rehabilitation proceeding has features designed to meet the necessities of small or medium sized debtors, including a DIP system and less stringent control by the court. It has made the DIP financing arrangements closer to just ordinary financial transactions.

3 Filing at an earlier stage is yet to become common, but pre-negotiated filing is getting more and more common. Differently from the US type pre-packaged or pre-negotiated filing, in the Japanese version, the debtor negotiates with a prospective “sponsor” prior to the filing. The sponsor is supposed to provide the necessary finances during the process, and finally acquire the debtor at the exit.

A new law was enacted last year that provides for UCC-type recordation of inventory and finished goods collateralization. The new law also expands the scope of the already existing recordation of receivables collateralization.

It is believed that these developments will make DIP lending safer and more common.

4 Prime lien issue has been discussed in Japan, but no conclusion has been reached among the practitioners, financial industry, and law professors. To enable the creation of a prime lien, procedures to protect the rights and interests of existing lien holders will need to be carefully designed, including those for valuation of the collateral. Probably, we should first study more about the practice in the US, to examine how helpful it is, how often it is used, how it actually works, when it is deemed legal and when not, what are the issues that ordinarily become disputed, and so forth.

5 The Financial Services Agency of Japan has amended its Manual of Inspection of Financial Institutions and the problems in this regard have become less cumbersome.

6 The new Corporate Reorganization Law in force since 2003 has granted administrative claim status to a gap period loan even in the event the proceeding is converted into chapter 7-type proceeding before the chapter 11-type proceeding has been commenced. Also, Bankruptcy Law in force since January 2005 provides a DIP loan with 2<sup>nd</sup> class priority, together with all the other administrative claims, subordinate only to the common interest claims and administrative expense claims that have accrued under the chapter 7-type proceeding after conversion from a chapter 11-type proceeding.

### III Conclusion

DIP financing, which had been provided only by “sponsors” and “main banks,” has come to be provided by foreign capital, such as Lone Star, for the first time as a business, and now is provided even by Japanese banks. Theoretically, the roles of sponsor and lender can be separated. The sponsor helps the debtor operate the business, whereas the lender offers operating capital and/or funds for capital expenditure. In reality, however, such idea has not been accepted for a long time. Now, however, we see a number of foreign and domestic candidates teamed up to acquire Daiei, a Japanese Wal-Mart, which is now in serious financial trouble. Daiei is being sold through an auction process conducted by IRCJ. Each bidder team included a number of large, well known Japanese companies that have never before participated in such process in the full view of the close attention of media.

Certainly, it is just a recent phenomenon that such large, established and reputable companies as Nippon Steel participate in the competitive process to acquire a distressed company. Nippon Steel was forced to appear in the public in order to protect Mitsui Mining from being purchased by Wilber Ross. The traditional attitude of the Japanese business establishment has been rapidly changing, due to the impact of foreign investments in Japan.

A distress market is now being created in Japan. Changes in DIP financing are only a part of such large movements.