Restructuring in Japan

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I. Three Reorganization Schemes

There are three available schemes in Japan to reorganize distressed business corporations with excessive debts. They are; 1) an out of court workout in accordance with the Guidelines for the Workout which was established in 2001, referring to INSOL 8 Principles; 2), a civil rehabilitation proceeding under the Civil Rehabilitation Law which was enacted in 1999 abolishing the former Composition Law of 1927 and; 3) a corporate reorganization proceeding under the Corporation Reorganization Law which was enacted in 1951 and was the subject of major reform in December 2002. Also a Law Relating to Recognition and Assistance for Foreign Insolvency Proceedings was enacted in 2000 adopting many provisions included in the UNCITRAL Model Law on Cross Border Insolvency and thus effectively abolishing notorious terriotorialism. Still, reformation of bankruptcy laws is on the way and expected to be completed before the end of next year of 2003. As reorganization proceedings were expedited and streamlined by the enactments of the Civil Rehabilitation Law and Corporate Reorganization Reform Law, the remaining portion to be reformed in bankruptcy laws may include non-procedural matters including avoidance powers, rejection and assumption of executory contracts, priority for wages and sovereign debts, subordination of insiders' rights and so on.

Along with the law reforms, practices to deal with bankruptcy and reorganization cases are changing dramatically, led by the Tokyo and Osaka District Courts. Almost all courts in Japan are opening their gates wider to reorganization cases and the cases are being handled more expeditiously.

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For example, there were about 10 times more civil rehabilitation cases than former composition cases under Composition Law, which was abolished and replaced by Civil Rehabilitation Law, and filed in the Tokyo District Court in 2002. Previously, judges were very reluctant to open composition and corporate reorganization cases where the prospect of a successful rehabilitation was not certain. Even after the debtor's petition was filed, judges, with little knowledge of normal business affairs, tended to be too careful in opening the cases and were usually reluctant to issue temporary restraining orders that were necessary to protect the debtor from individual debt collection activities. This was because they were afraid of being faced with the prospect of the debtor defaulting once more on its obligations after the court's supervision had commenced.

Bankruptcy cases are handled more expeditiously now. In most civil rehabilitation cases in Tokyo, a plan is confirmed by court about six months after the filing of a petition to open the case. Corporate reorganization cases, which are larger cases than civil rehabilitation cases, are also dealt with more expeditiously.

II. Out of Court Workout

The Japanese Bankers Association, Federation of Economic Organizations and other relevant organizations associated with Financial Services Agency, Ministry of Finance, Ministry of Economy, Trade and Industry, Bank of Japan and the Deposit Insurance Corporation established a committee, with myself as chairman, which introduced "the Guidelines for the Out of Court Workout" on September, 2001. The guidelines were drafted partly referring the "INSOL 8 Principles" for international multi-creditors. The guidelines were designed to extinguish huge amounts of non-performing loans owed to multiple banks and financial institutions in order to enable the debtor corporations to restore their viability.

An outline of the procedure established by the Guidelines follows:

A debtor corporation may apply for a "multi-bank" out-of-court workout in cases where a number of banks have lending exposure to the debtor. The application must be accompanied by financial documents which explain the reasons the debtor came into financial distress and a reorganization plan proposal. The proposed plan should include a business restructuring plan as well as a debt reorganization plan. After investigation of the financial documents and reorganization plan, if the major banks are persuaded that the statements are accurate and the plan is both feasible and reasonable, and the major banks are agreed on the view that there is a likelihood that the plan will be accepted by relevant banks whose debts are proposed to be impaired under the plan, then the major banks will issue a notice of "standstill" to all the relevant banks and convene the first meeting of creditors which will be held within a week after the notice of standstill was issued. At the first meeting of creditors, if the relevant creditors consent unanimously to continue the standstill period, then a creditors' committee may be elected and professionals, including lawyers and accountants who will be in charge of examining the accuracy of financial statements and reasonableness and feasibility of the proposed plan,

may be designated. During the standstill period, relevant creditors should refrain from any collection efforts, enforcement or realization of secured rights, improvement of their exposure relative to other relevant banks and maintain the original balance of their claims. Before the end of the third month after the first meeting, the second meeting will be held at which meeting all relevant creditors will indicate whether they accept the plan or not. When all creditors, whose rights must be amended in order to rehabilitate the debtor, consent to the proposed plan, then the reorganization plan is accepted and the rights of the relevant creditors will be amended according to the provisions contained in the plan. If a creditor or creditors, whose consents are necessary to rehabilitate the debtor, refuses to agree to the plan, then the out-of-court workout is terminated leaving the debtor with the option of filing a petition with a court to open statutory insolvency proceedings.

The guidelines are designed to facilitate multi-bank workouts to rehabilitate larger corporations burdened with huge amounts of claims and would be applied only in exceptional cases. Therefore, differing from the INSOL principles, the Guidelines specify the details for a business restructuring plan which becomes a part of any proposed plan. If the debtor has negative net worth, the plan must eliminate this problem within an approximate three-year period. If the debtor has a net income loss, the plan must also indicate how that loss will be turned into a profit within three years. The plan should provide that the interest of the controlling shareholders of the debtor should, in principle, be divested, and the proportional interest of existing shareholders should be reduced or eliminated altogether through a capital reduction and a subsequent capital increase. The plan should also provide, in principle, that present managers of the debtor have to retire upon the acceptance the proposed plan by creditors.

Many practitioners have criticized the arrangements stating that the aforementioned requirements are too severe. In contrast, the Japanese Federation of Economic Organizations supports the rigid requirements included the guidelines because they would like to resolve over-competition in certain industries by reducing the number of poorly performing companies in certain industry segments.

Only six big corporations were reorganized through the out of court workout using the guidelines by the end of the year of 2002. As it might not be easy to revise the Guidelines due to difficulties to obtain unanimous consents of all relevant organizations, the practicing committee of the guidelines, with myself as a chairman again, and which is comprised of academic members of the establishing committee, experienced professional advisers and workout practitioners, discussed how to the guidelines could be more popularly adopted and in November 2002 proposed the mitigation of application of the aforementioned requirements admitting reasonable exceptions.

III. Civil Rehabilitation Proceeding

The Civil Rehabilitation Law was enacted to cure defects contained in its predecessor, the Composition Law. First of all, according to the Composition Law (CL), a secured creditor is free to enforce or foreclose its secured right even after the commencement of the case. A debtor had no weapon to induce a secured creditor to accept a composition and/or extension. According to Civil Rehabilitation Law (CRL), a secured creditor is also able to enforce its secured right, but a debtor is eligible to apply for a temporary stay order which prohibits enforcement of a secured right for a certain period. The purpose of the stay order is to create a reasonable time frame during which the debtor and secured creditor may negotiate an acceptable compromise. According to the Japanese Civil Code, which is originated in the Napoleoic Code, a secured right is not limited to the value of collateral. In other words, a secured creditor can refuse to relinquish its secured right even if a debtor has paid a part of the secured debt which is equivalent to the value of the collateral. The secured right cannot be extinguished without the consent of the secured creditor unless the debt has been paid in full. But Civil Rehabilitation Law provides that a secured right is extinguished when the debtor pays a part of claim, which is equivalent amount to the value of the collateral, to the secured creditor. When the secured creditor objects to the debtor's valuation, then the court will decide the amount based on the assessment made by a court-appointed appraiser. Due to the provision an under-secured creditor cannot insist on full payment even if its debt exceeds the value of the collateral.

Other reforms made by the Civil Rehabilitation Law include provisions with regard to mitigation of the majority requirement, court permits for sale of the debtor's business and reduction of capital without shareholders' resolutions. A plan can only alter the rights of unsecured creditors by a majority vote of creditors. But a plan is accepted if a simple majority of creditors who attend the meeting and holding more than one half of total amount of unsecured claims to the debtor accept the lan. The main reason why the Civil Rehabilitation Law mitigated the majority requirement is that government or other state owned financial institutions, who are usually creditors with large amounts of claims, are reluctant to accept plans which alter their claims. These institutions tend to stick to the conservative standards set in their manuals. However, as a plan cannot provide for alteration of a secured creditors' right, to alter a right of a secured creditor, consent of each secured creditor is required. When a debtor is insolvent, a court can permit a sale of all or a part of its business without a shareholders' resolution. A plan can also reduce a company's capital without a shareholders' resolution when the debtor is insolvent, but a shareholders' resolution is still required to increase capital. This is inconsistent when compared with proceedings under Corporate Reorganization Law where both reduction and increase of capital can be done without a shareholders' resolution. In civil rehabilitation proceedings, a debtor continues as a debtor in possession (DIP) under the loose supervision of a court appointed supervisor. A trustee may be appointed in rare cases but only under exceptional circumstances.

IV. Corporate Reorganization Proceeding

The Corporate Reorganization Law was modelled after Chapter X of the old United States Bankruptcy Act of 1898 as amended 1938. The Law was enacted in 1951

and amended partly in 1951. The Corporate Reorganization Reform Law was enacted in 2002 and will be effective in April 2003.

The corporate reorganization proceeding provides a debtor-corporation with strong weapons to enable it to reorganize its business. Even secured creditors cannot enforce or realize their secured rights pending the proceeding and a reorganization plan, which is accepted by majority, is able to provide for alteration of secured creditors' rights. When the commencement order to open the corporate reorganization proceeding is issued, governmental organizations are stayed from collecting sovereign debts. Moreover, a reorganization plan can provide for various means to reorganize debtor-corporations without observing the provisions of the Commercial Code which regulates corporations. These include reduction of capital, issuance of new stocks, sale of the debtor's business, and merger and formation of new corporations.

A distinctive feature of the former Corporate Reorganization Law was that it did not adopt the DIP system. Upon an opening order issued by a court, incumbent managers of a debtor corporation are deprived of their power to operate the debtor's business and dispose of its assets. Under former chapter X of the former American Bankruptcy Act, only managers of a debtor-corporation with debts more than $250,000 were deprived of their power and managers of a debtor whose aggregate amounts of debts did not exceed $250,000 were able to remain in its possession. However, unlike the former American law, Japanese former Corporate Reorganization Law provided that managers of every reorganizing debtor corporation must be removed and a court appointed trustee or administrator was vested with all the power of managers replaced by them. Moreover, the fair and equitable rule required that all stocks of a debtor-corporation must be entirely extinguished when the debtor was insolvent. A reorganization plan which alters creditors' rights must provide for 100% dilution of capital and all rights of the debtor's owner must be removed completely. In theory, the corporate reorganization proceeding is suitable for larger corporations whilst the civil rehabilitation proceeding is, in theory, for middle or smaller size corporations. But even large corporations, including Sogo and Mycal which are large Japanese retail stores, filed petitions for civil rehabilitation instead of the corporate reorganization proceeding. After the Civil Rehabilitation Law became effective in April 2000, many large corporations filed a petition for a civil rehabilitation proceeding. The principal reason why even large corporations did not file for corporate reorganization proceedings, might be due to the lack of a US style DIP system.

However, the Corporate Reorganization Reform Law of 2003 made a lot of changes to the former Corporate Reorganization Law. Changes made by the Reform Law include reformation in terms of transparency of proceedings, greater disclosure of information, clear and simplified valuation standards for assets and collateral of secured rights, mitigation of the majority requirement, expedited procedures, simplified proceedings for filing and fixing of claims, shortening of the payment term for the balance of partly released claims and others.

With regard to the DIP system, the Reform Law made it clear that a court may appoint existing executives as trustees or deputy trustees in some cases.

According to the Reform Law, the reorganization plan is accepted by unsecured creditors if (i) a simple majority of unsecured creditors who attend the meeting, and holding more than one half of total amount of unsecured claims, accept the plan, (ii) a plan which provides for deferred payments only for secured debts is accepted by secured creditors if secured creditors holding more than two third of total amount of secured claims to the debtor accept the plan, and (iii) a plan which provides for partial release of secured debts is accepted by secured creditors if secured creditors holding more than three fourths of the total amount of secured claims to the debtor accept the plan.

The Reform Law adopted a "current value" basis for valuation standards for assets and collateral instead of the more complicated "going concern" basis.

A reorganization plan must be proposed within one year after the commencement of the case. Other reformations to streamline a corporate reorganization proceeding were made in the Corporate Reorganization Reform Law of 2002.

Due to partly adopted DIP system, when managers who did not resolve problems of the distressed corporation and were replaced by turnaround managers before a filing the petition, the reformed corporate reorganization proceeding, with the aforementioned stronger weapons, may be more useful than civil rehabilitation for larger corporation. It is therefore to be hoped that a prepackaged corporate reorganization proceeding will be far more widely used in Japan after the commencement of the new reforms in April of 2003.

The Corporate Reorganization Reform Law did not change the rule which mandates to extinguish stocks of old shareholders when rights of creditors are altered and the debtor-corporation is insolvent, i.e., liabilities exceed assets.

The Special Reorganization Law of 1996 for Financial Institutions is applicable only for banks, credit unions, insurance and security corporations to reorganize or liquidate them paying due consideration to the rights of depositors, policy holders and customers of security corporations.

V. Other Restructuring Devices

A. Corporate recovery funds

Many private equity funds whose targets are mainly distressed business corporations have been organized in 2002 in Japan. They may rescue troubled corporations by investing money and controlling the corporations in order to restructure their business. They typically acquire loan claims of distressed companies, execute debt to equity swaps and become shareholders. Subsequent to that, they implement various strategies so that such companies again become profitable and saleable to other investors or in the public stock market. Major Japanese banks are also establishing private equity funds in order to resolve their own sub-performing loan problems.

Now that the level of non-performing loans sold on the open market by banks is decreasing, those funds that used to invest in non-performing loans are also

expanding their businesses into direct investments in distressed companies. Thus, the market is pretty competitive.

B. DIP financing

To maintain viable business operations pending statutory reorganization proceedings or out of court workouts, there is almost a mandatory requirement for the infusion of new money, i.e., DIP financing. The Development Bank of Japan, the Mizuho Bank, the Shoko Chukin Bank and other Japanese commercial banks and finance companies have started DIP lending businesses, financing to debtor-corporations who have filed civil rehabilitation, corporate reorganization and out of court workout proceedings. DBJ is the most aggressive DIP financing provider, having closed 15 deals in the period between May 2001 and December 2002. I hope that DIP financing will be more popular in Japan in the near future.

Originally, DIP financing was only available to a debtor in possession under Chapter 11 proceedings in the United States of America. Therefore, financing for debtors under present corporate reorganization proceedings is not "DIP" financing because such debtors are not DIP. However, in Japan, financing for debtors that are under corporate reorganization, civil rehabilitation and out of court workout proceedings, is customarily referred to as "DIP financing."

Under the US Chapter 11 system, DIP financing claims are well protected with a status of "super-priority". However, in Japan, such claims are pari passu with other administrative expenses.

C. Debt to equity swaps

Debt to equity swaps (DES) have been commonly used in Japan since January, 2002 in order to restructure huge debts owed by large listed corporations. Prior to January 2002, DES was rarely used in Japan because of the 5% rule restriction. The 5% rule under the Banking Law and Fair Trade And Anti-Trust Law restricts bank ownership of more than 5% of outstanding stocks. The rule was established to prohibit banks from having strong controlling interests in business corporations. But after the Financial Services Agency and the Fair Trading Commission recently mitigated the application of the rule, DES arrangements have become more popular in Japan.

In the past, conversion from debt to equity had to be done based on the value of the debt. However, since 2000, the Tokyo District Court has been approving a conversion from debt to equity based on the face value of the debt. This flexible treatment has contributed to higher utilization of DESs in Japan.

Even under this environment, some banks are still reluctant to own stocks of unlisted distressed corporations because of the lack of a secondary market to transact second-class stocks in Japan. However, private equity funds can be utilized to cope with this problem because banks can sell such stocks to the fund and, as consideration, receive an investment interest in the fund. In the future, if such stocks appreciate, as an investment interest holder, the bank may receive dividends from the fund. In this way, the bank does not have to hold the stocks of distressed companies but still can capture the upside potential of such companies. As already mentioned, major Japanese banks are establishing this type of fund, and several regional banks are joining in such arrangements.

D. Restructuring advisory services

Restructuring advisory service business sector corporations which have been established at the initiative of banks, security companies, accounting firms and others have become steadily more popular in Japan. These advisory teams are expected to help troubled corporations to workout their excessive debts and restructure their businesses effectively. In the past, when the so-called "main bank system" was very strong in Japan, such advisory services were performed by banks and independent advisory service providers were not generally sought. However, these days both banks and companies need independent advisory services under more transparent procedures, and demands for such services are increasing. Such services should be based on deep knowledge of and experience in insolvency laws, accounting, M&A, corporate valuations, real estate, human resource management, economy and industry, business strategies, marketing and other social sciences.

E. Turnaround managers

The only corporate restructuring device we do not have in Japan are what is commonly referred to as turnaround managers. In order to restore the health and profitability of viable but loss making businesses, human capital, through the engagement of highly talented, knowledgeable and experienced business turnaround managers is an indispensable necessity. Regrettably, there are quite limited numbers of talented and experienced turnaround managers sufficiently well equipped to successfully restore distressed corporation in Japan. Unfortunately, the benefits to be obtained from engaging talented professionals from independent turnaround management businesses has yet to be fully embraced in Japan.

VI. The Resolution & Collection Corporation and the Proposed Industry Revival Corporation

The Resolution & Collection Corporation was established by Japanese government several years ago for the express purposes of buying non and sub performing loans from financial institutions and then collecting purchased debts in order to accelerate the removal of massive volumes of non-performing loans from the balance sheets of banks. The RCC has not simply tried to enforce against bad and doubtful debtors, but it has also been active in trying to assist by advising distressed debtors to restructure their debts and business by means of out of court workouts, civil rehabilitation and corporate reorganization proceedings.

In addition to the RCC, the Japanese government announced in November 2002 that it will establish another corporation in the near future, which has been tentatively titled "Industry Revival Corporation". Its principal function will be to buy loans owed to banks, other than "main banks" (to be explained later), with the biggest exposure and to help larger size distressed debtor-corporations with excessive debts to restore their profitability in order to reduce the entire Japanese non-performing loan sector by 50% over the next 2 years. In contrast to the RCC, the IRC would purchase loans owed only by distressed debtor-companies which are viable and therefore likely to be successfully rehabilitated. Before making a decision to help a troubled debtor-corporation, the IRC and the "main banks" will carefully review the feasibility of the reorganization plan proposed by a heavily indebted and distressed corporation. In order to assist them in this program, the IRC will engage suitably experienced and qualified professionals, including accountants, lawyers and restructuring advisors. The decision to help includes the declaration of the IRC's intent to buy the loans from banks other than the "main banks". Creditor-banks are not legally obliged to sell their debts to the IRC. However, in practice, they have to sell their loans at the price designated by the IRC or accept a proposed debt restructuring plan which inevitably will reduce the value of their claims.

While the RCC may buy debts owed by mid and smaller size companies, the IRC may purchase debts owed by bigger corporations whose bankruptcy might have a material impact on relevant industrial societies. The IRC is able to recommend debtor-corporations to reduce their own size, merge with or to be merged by other corporations in order to resolve over-capacity or over-supply problems in relevant industries. The IRC is expected to be formed in the coming April or May 2003.

In Japan, each business corporation had "a main bank" or "main banks" the function of which was to supply needed money for investment purposes and operations with the corporation. And the "main banks" used to send their employees to the corporations to act in controlling positions as chairpersons, presidents, directors and other high-ranking offices. Many managers and high ranking employees of the corporations who did not come from main banks were likely to lose the spirit of independence under the protective umbrella of the main banks. The "main banks" tend to continue to supply loans, producing additional excessive exposure even after the "non-main banks" had eliminated their exposure, fearing potential non-performance against their loans. The IRC will try to resolve the "main banks" problem by means of stipulating a debt restructuring plan involving only three parties, i.e., the IRC, "main banks" and debtor-corporations. The IRC might in fact be the last realistic opportunity that the government has to resolve, once and for all, the seemingly insurmountable non-performing loan crisis in Japan.

VII. Conclusion

Japan is struggling to come to terms with the severity of the prolonged recession which commenced in 1991. Japan continues to make valiant efforts under the ever worsening environment of the deflationary spiral. Japan might yet be seen as one of those countries to have adopted effective reorganization laws and out of court solutions through the enactment f an effective Civil Rehabilitation Law, Corporate Reorganization Reform Law and the Guidelines of Out Of Court Workout. The IRC initiative may be the last chance to restore a strong and vibrant Japanese economy. We cannot fail again. In Japan, we now have effective tools to reorganize troubled business. However, we now need to embrace the use of our highly skilled human resources, i.e., restructuring advisors and turnaround managers who are able to reconstruct and regenerate troubled business corporations. In Japan, thousands of companies should be reorganized now.

In March 2002, the Japanese Association for Business Recovery ("JABR"), of which I am president, has been established and became a member association of the INSOL international. The purpose of the JABR is to foster business restructuring across many aspects, including laws, economics, sociologies and other social sciences. Among other things, the most important role of the JABR is to foster, educate and train more specialists and professionals in the field of insolvency and business recovery. Per to suggestions made by one of my closest friends Richard Gitlin, the JABR invited Mr Jay Alix, who is a pioneer of turnaround business in the United States, to speak at the symposium held successfully on December 10 2002. The purpose of the symposium was to introduce the turnaround management business to Japan. The JABR is now going to organize turnaround managers and establish the Institute of Restructuring Advisors as well to foster sufficient number of professionals in Japan.

To rapidly restore the Japanese economy, quite revolutionary cultural changes must be accomplished. The Ministry of Economy, Trade and Industry is now going to propose before the end of January 2003 the Guidelines which suggest how to cure the problems and restore the health of troubled business corporations at earlier stage, according to the advice of the Committee which was organized for that specific purpose. Among other things, the expected Guidelines may include proposals to abandon the aforementioned "main banks" system and amend the life-long employment system, which was deemed good to build up loyalty dedicated to a business corporation but impeded outer monitoring.