Restructuring in Japan

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Three reorganization schemes

There are three schemes available in Japan to reorganize distressed business corporations with excessive debts. They are:

1. An out-of-court workout, in accordance with the guidelines established in 2001 with reference to INSOL’s eight principles;²

2. A civil rehabilitation proceeding under the civil rehabilitation law enacted in 1999, which abolished the former composition law of 1927; and

3. A corporate reorganization proceeding under the corporation reorganization law enacted in 1951, which was the subject of major reform in December 2002.

In addition, a law relating to recognition and assistance of foreign insolvency proceedings was enacted in 2000, adopting many of the provisions included in the UNCITRAL model law on cross-border insolvency, and thus effectively putting an end to the notorious Japanese territorialism. Still, reformation of bankruptcy laws is on the way and is expected to be completed before the end of 2003. As reorganization proceedings were expedited and streamlined by the enactments of the civil rehabilitation law and corporate reorganization reform law, the remainder

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² Available at the INSOL website, <http://www.insol.org>.
of bankruptcy laws needing reform may include such non-procedural matters as avoidance powers, rejection and assumption of executory contracts, priority for wages and sovereign debts, subordination of insiders’ rights, and so on.

Along with reform of the law, the practices involved in 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. For example, almost ten times the number of civil rehabilitation cases were filed in the Tokyo district court in 2002 than composition cases under the former composition law that preceded it. Previously, judges were very reluctant to begin 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 initiating the cases. They were usually hesitant to issue the temporary restraining orders that were necessary to protect the debtor from individual debt collection activities, because the judges were apprehensive about 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 within about six months after the filing of a petition initiating the case. Corporate reorganization cases – which are larger cases than civil rehabilitation cases – are also dealt with more rapidly.

**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, that on September 2001 introduced *Guidelines for the Out-of-Court Workout* (“the guidelines”). The guidelines, which make reference to the eight INSOL principles for international multi-creditors, were designed to clear out the huge number of non-performing loans owed to multiple banks and financial institutions and
restore the debtor corporations to viability.

The procedure established by the guidelines begins with the debtor corporation applying for a multi-bank out-of-court workout in cases where a number of banks have a lending exposure. The application must be accompanied by financial documents that explain the reasons why the debtor became financially distressed and by a proposal for a reorganization plan. The proposal should include a business restructuring plan as well as a debt reorganization plan. The major banks then investigate the financial documents and reorganization plan to determine whether the statements are accurate and the plan is both feasible and reasonable. If they are persuaded that these criteria are indeed met, and they agree that the plan is likely to be acceptable to all banks whose debts are to be impaired under the reorganization, then the major banks will issue a notice of “standstill” to all the relevant banks and convene the first meeting of creditors. This meeting must be held within a week after the notice of standstill was issued.

At the first meeting of creditors, the unanimous consent of the creditors must be obtained to continue the standstill period. If they all agree, then a creditors’ committee may be elected. The committee can designate professionals (including lawyers and accountants) to examine the accuracy of financial statements and the reasonableness and feasibility of the proposed reorganization plan. During the standstill period, the 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, a second meeting must be held at which all relevant creditors are to indicate whether they accept the plan or not. If all creditors whose rights will be affected by the debtor’s rehabilitation consent to the proposed plan, the reorganization plan can proceed and the rights of the relevant creditors will be amended according to the provisions contained in the plan. If one or more of the creditors refuses to agree to the plan, then the out-of-court workout procedure is terminated. The debtor must decide whether to file a petition with a court to begin statutory insolvency proceedings.

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

Many practitioners have criticized the arrangements under the guidelines, contending 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 those segments.

By the end of 2002, only six big corporations had been reorganized through an out-of-court workout using the guidelines. Concerned that it might be difficult to obtain the unanimous consent of all relevant organizations that would be necessary to revise the guidelines, the practicing committee of the guidelines, with myself again serving as chairman, discussed how to make use of the guidelines more popular. We proposed mitigation of the aforementioned requirements (allowing for some reasonable exceptions).

Civil rehabilitation proceeding

The civil rehabilitation law was enacted to cure the defects contained in its predecessor, the composition law. First of all, according to the composition law, a secured creditor is free to enforce or foreclose its secured right, even after commencement of the case; a debtor had no weapon to induce a secured creditor

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3 The committee was composed of members of the academic community, experienced professional advisors and workout practitioners.
into accepting an arrangement or an extension. Under the civil rehabilitation law, a secured creditor is still able to enforce its secured rights, but a debtor is eligible for a temporary stay order prohibiting enforcement of that 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 can negotiate an acceptable compromise.

According to the Japanese civil code, which is based on the Napoleonic Code, a secured right is not limited to the value of the collateral. In other words, a secured creditor can refuse to relinquish its secured right, even if a debtor has paid that 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. Under the new civil rehabilitation law, however, a secured right is extinguished when the debtor pays a enough of the claim to be equal to the value of the collateral. If 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 this provision, an under-secured creditor cannot insist on full payment even if the underlying debt exceeds the value of the collateral.

Other reforms made by the civil rehabilitation law include mitigation of the majority requirement, court permits for sale of the debtor’s business, and reduction of capital without shareholders’ resolutions. A plan may only alter the rights of unsecured creditors if it is accepted by a simple majority of creditors holding more than one half of the total amount of unsecured claims. The main reason why the civil rehabilitation law mitigated the majority requirement is that government or other state-owned financial institutions, which are usually creditors with large numbers of claims, are reluctant to accept plans that 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’ rights, in order to alter those rights, the 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. However, this is inconsistent with the corporate reorganization law (see below), where both
reductions and increases in capital can be accomplished without a shareholders’ resolution.

**Corporate reorganization proceeding**

The corporate reorganization law was modeled after chapter X of the old United States Bankruptcy Act of 1898, as amended in 1938. The Japanese law was enacted in 1952 and partly amended in 1967. The old Japanese reorganization law was revised and updated with the enactment of the corporate reorganization reform law in 2002 (effective 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 that is accepted by majority can provide for alteration of secured creditors’ rights. When the commencement order is given to open a corporate reorganization proceeding, governmental organizations are stayed from collecting even sovereign debts. Moreover, a reorganization may be exempt from various provisions of the commercial code that would otherwise govern the debtor corporation, such as the requirements concerning the reduction of capital, the issue of new shares, the sale of the debtor’s business, and merger and formation of new corporations.

A distinctive feature of the earlier corporate reorganization law was that it did not adopt a U.S.-style “debtor in possession” (“DIP”) system. Upon an opening order issued by a court, the incumbent managers of a debtor corporation were deprived of their power to operate the business and dispose of its assets. Under chapter X of the former American Bankruptcy Act, only managers of a debtor corporation with debts of more than US$250,000 were deprived of their power; managers of a debtor whose aggregate debt did not exceed US$250,000 were able to remain in possession. There were further differences. For instance, unlike the former American law, the old Japanese corporate reorganization law provided that managers of every reorganizing debtor corporation must be removed and a court-appointed trustee or administrator vested with all of their powers. Moreover, the Japanese fair and equitable rule required that all shares of a debtor corporation
had to be retired when the debtor was insolvent. A reorganization plan that altered
the creditors’ rights had to provide for 100 percent dilution of capital and all rights
of the debtor’s owner were eliminated completely.

In theory, the corporate reorganization proceeding was supposed to be
suitable for larger corporations whilst the above-described civil rehabilitation
proceeding was better for middle- or smaller-sized corporations. But even large
corporations, such as the large Japanese retail stores Sogo and Mycal, 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 petitions under it, and not under the corporate reorganization
law. The principal reason why even large corporations did not file for corporate
reorganization proceedings might be attributable to the lack of a U.S.-style DIP
system.

In civil rehabilitation proceedings, a debtor may continue in possession of
the business under the loose supervision of a court-appointed supervisor. A trustee
may be appointed in rare cases, but only under exceptional circumstances. Indeed,
the new corporate reorganization reform law made it clear that a court may
appoint existing executives as trustees or deputy trustees in some cases.
Consequently – due partly to this DIP system – when managers who were unable
to resolve the problems of the distressed corporation were replaced by turnaround
managers before filing a petition, the corporate reorganization proceeding, with its
stronger weapons, was more useful than civil rehabilitation for larger corporations.
It is hoped that a prepackaged corporate reorganization proceeding will be far
more widely used in Japan after the new corporate reorganization reform law
comes into effect in April of 2003.

In short, the corporate reorganization reform law of 2003 made a lot of
changes to the old corporate reorganization law. Modifications introduced by the
new reform law include improvement in terms of transparency of proceedings,
greater disclosure of information, clear and simplified valuation standards for
assets and the 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 many
more. In addition, the new reform law adopted a current value standard for
valuing assets and collateral, instead of the more complicated going concern basis. Other changes to streamline the corporate reorganization proceeding were made in the new reform law. However, the new law did not change the rule that mandates the retirement of shares when the rights of creditors are altered and the debtor corporation is insolvent.

According to the new reform law, the reorganization plan is accepted by unsecured creditors if:

1. the plan is accepted by a simple majority of unsecured creditors who attend the creditors meeting and who together hold more than one half of total amount of unsecured claims;

2. a plan that provides for deferred payments only for secured debts is accepted by the secured creditors holding more than two thirds of the total amount of secured claims; and

3. a plan that provides for partial release of secured debts is accepted by the secured creditors holding more than three fourths of the total amount of secured claims.

A reorganization plan must be proposed within one year after commencement of the case.

The Special Reorganization Law of 1996 for Financial Institutions is applicable only to banks, credit unions, insurance companies, and stock brokerage firm. The law allows such companies to reorganize or liquidate, with due consideration of the rights of depositors, policy holders and customers.

Other restructuring devices

Corporate Recovery Funds

Many private equity funds, whose main targets are distressed businesses, were organized in Japan in 2002. These equity funds rescue troubled corporations by investing money and exercising control over the corporations in order to
Restructure their businesses. They typically acquire the loan claims of distressed companies, execute debt-to-equity swaps, and become shareholders. Subsequently, they implement various strategies so that the companies regain profitability and become saleable to other investors or the public in the stock market. Major Japanese banks are also establishing equity funds now, to assist their own under-performing loans. As the level of non-performing loans sold by banks on the open market drops, those private equity funds that used to invest in non-performing loans are now expanding their operations into direct investments in distressed companies. The market is becoming increasingly competitive.

**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., debtor in possession, or 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, providing financing to debtor corporations that have filed for civil rehabilitation, corporate reorganization and out-of-court workout proceedings. The Development Bank of Japan is the most aggressive DIP financing provider, having closed fifteen 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. Therefore, strictly speaking, financing for debtors under present Japanese corporate reorganization proceedings is not “DIP financing”, because such debtors are not debtors in possession. However, financing for Japanese debtors that are engaged in 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.

**Debt-to-Equity Swaps**
Debt-to-equity swaps have been commonly used in Japan since January 2002 in order to restructure huge debts owed by large listed corporations. Prior to January 2002, debt-to-equity swaps were rarely used, because of the 5 percent rule restriction. The 5 percent rule under the Banking Law and the Fair Trade and Anti-Trust Law prohibits bank ownership of more than 5 percent of a company’s outstanding shares. The rule was established to prevent banks from having strong controlling interests in business corporations. After the Financial Services Agency and the Fair Trading Commission recently eased application of the rule, however, debt-to-equity swap arrangements became popular.

In the past, conversion from debt to equity had to be based on a value that was estimated from the proportion of debt likely to be repaid. 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 debt-to-equity swaps in Japan.

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

**Restructuring Advisory Services**

Restructuring advisory service business sector corporations that were established at the initiative of banks, stock brokerage firms accounting firms and others has become steadily more popular in Japan. Advisory teams are established by these firms 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.
Independent advisory service providers were not generally sought after. However, these days both banks and companies need independent advisory services under more transparent procedures, and the demand for such services is increasing. Restructuring advisory services require in-depth knowledge of and experience with insolvency laws, accounting, mergers & acquisitions, corporate valuations, real estate, human resource management, economy and industry, business strategies, marketing and other social sciences.

**Turnaround Managers**

The only corporate restructuring device we do not have in Japan is what is commonly referred to as a turnaround manager. In order to restore the health and profitability of viable but loss-making businesses, it is indispensable to have highly talented, knowledgeable and experienced business turnaround managers. Regrettably, the number of such talented and experienced turnaround managers, who are sufficiently well equipped to successfully restore distressed corporations in Japan, is limited. Unfortunately, too, the benefits to be obtained from engaging talented professionals from independent turnaround management businesses has yet to be fully embraced in Japan.

**The Resolution & Collection Corporation and the Proposed Industry Revival Corporation**

The Resolution & Collection Corporation (“RCC”) was established by the Japanese government several years ago for the express purpose of buying non-performing and sub-performing loans from financial institutions and then collecting the debts purchased in order to accelerate removal of substantial numbers of non-performing loans from the balance sheets of banks. The RCC has not simply tried to enforce actions against bad and doubtful debts, it has also been active in trying to assist distressed debtors with advice about restructuring their debt and businesses 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, tentatively called
the Industrial Revitalization Corporation of Japan (“IRCJ”). Its purpose is to reduce
the entire Japanese non-performing loan sector by 50 percent over the next two
years, by purchasing loans owed to banks other than the main banks where the
exposure is significant and by helping the larger distressed debtor corporations
with excessive debt to restore their profitability. In contrast to the RCC, the IRCJ
would purchase loans owed only by distressed debtor companies that are viable
and therefore likely to be successfully rehabilitated. Before making a decision to
help a troubled debtor corporation, the IRCJ 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 IRCJ will
engage suitably experienced and qualified professionals, including accountants,
lawyers and restructuring advisors. The decision to help includes the declaration
of the IRCJ’s intention to buy the loans from banks other than the main banks.
Creditor banks are not legally obliged to sell their debts to the IRCJ. However, in
practice, unless they sell their loans at the price designated by the IRCJ, they will
have to accept a proposed debt restructuring plan that inevitably will reduce the
value of their claims.

While the RCC may buy debts owed by mid- and small-sized companies,
the IRCJ may purchase debts owed by larger corporations whose bankruptcy
might have a material impact on relevant industries. The IRCJ is able to
recommend that debtor corporations reduce their size, or merge with or be
absorbed into other corporations in order to resolve over-capacity or over-supply
problems in the relevant industries. The IRCJ was formed in May 2003.

In Japan, each corporation had a main bank (or banks) whose function was
to supply money needed for the corporation’s investment and operations. The
main banks used to send their employees to the corporations to serve in controlling
positions as chairpersons, presidents, directors and other high-ranking offices.
Those managers and high-ranking employees of the corporations who did not
come from main banks were also likely to lose their “spirit of independence” under
the protective umbrella of the main banks. The main banks continue to supply
loans, producing additional excessive exposure, even after secondary banks
eliminated theirs out of concern for potential non-performance. The IRCJ will try
to resolve the “main bank problem” by stipulating a debt restructuring plan
involving only three parties: the IRCJ, the main bank, and the debtor corporation. The IRCJ 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.

Conclusion
Japan is struggling to come to terms with the severity of the prolonged recession that commenced in 1991; the country 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 of an effective civil rehabilitation law, corporate reorganization reform law and the out-of-court workout guidelines. The IRCJ 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 businesses. However, we 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 the business of troubled corporations. Thousands of companies should be reorganized now in Japan.

In March 2002, the Japanese Association for Business Recovery (“JABR”), of which I am president, was established and became a member of INSOL International. The purpose of the JABR is to foster business restructuring across many aspects, including laws, economics, sociology and other social sciences. The most important role of the JABR, among other things, is to foster, educate and train more specialists and professionals in the field of insolvency and business recovery. Responding to a suggestion made by one of my closest friends, Richard Gitlin, the JABR invited Mr. Jay Alix – a pioneer of the turnaround business in the United States – to speak at the successful symposium held on December 10, 2002 to introduce the turnaround management business to Japan. The JABR is now working on arranging for more turnaround managers, establishing the Institute of Restructuring Advisors, and fostering sufficient numbers of professionals in Japan.

To rapidly restore the Japanese economy, quite revolutionary cultural changes must be accomplished. In January 2003, The Ministry of Economy, Trade and Industry proposed the guidelines that suggest methods to cure the problems
and restore the health of troubled business corporations at an earlier stage, according to the advice of the committee that was specifically organized for that purpose. Among other things, the guidelines may include proposals to abandon the aforementioned “main bank system” and amend the life-long employment system, which had been instituted to build up company loyalty but impeded outside monitoring.