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POST-IRCJ CHALLENGES: CHANGING THE JAPANESE CULTURE TO ENABLE EARLY REVITALIZATION OF TROUBLED CORPORATIONS

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Post-IRCJ Challenges: Changing the Japanese culture to enable early revitalization of troubled corporations

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In spite of the efforts made by the Japanese banks to dispose of the non-performing loans (NPLs), the aggregate amount of the NPLs in Japan has continued to increase due to the newly born NPLs after the bubble burst in 1991. In October 2002, the Japanese Government announced its intention to reduce the amount of the NPLs by half by the end of March 2005. Since the end of March 2001 when the ratio of the NPLs to the total amount of loans peaked at 8.4%, the amount of the NPLs began to decline. The ratio came down to 5.2% at the end of March 2004 and is expected to come down further to around 4% in September 2004. The Industrial Revitalization Corporation of Japan (IRCJ) was created to restructure the distressed debtor corporations with excessive debts before their bankruptcy with a view to deterring the ever-increasing NPLs. The IRCJ has been trying to reorganize the target debtor companies through the out-of-court workout with multiple financial institutions where an unanimous consent of financial creditors is required. Since the lifetime of the IRCJ is limited, the IRCJ cannot rescue troubled corporations after the end of March next year. From the next year onward, the out-of-court workout should be utilized more widely in Japan in order to revitalize the distressed businesses at an early stage without impairing the rights of trade creditors and deteriorating the value of the businesses. To make the workout most effective, it is important to make the statutory reorganization procedures, including the majority rule, to be applied more flexibly and reliably.

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1. The deadline for the IRCJ loan purchase may not be extended

The IRCJ is making effort of trying to do something new in Japan in order to change the Japanese culture in the area of corporate or business reorganization. The IRCJ has assisted 23 business corporation groups including huge conglomerates such as Kanebo and Mitsui Mining as of the end of August 2004. It intends to assist more than 10 corporate groups including a few huge cases no later than the end of 2004, since the IRCJ cannot purchase those loans owed by distressed corporations from non-main bank financial institutions beyond April 2005. Calculating backwards, in order for the IRCJ to buy loans from banks before the end of March 2005, the IRC Commission has to make assistance decisions before the end of this year or mid January at the

latest, because it usually takes a few months to persuade non-main banks (*i.e*., the holders of the distressed loans) to sell their loans to the IRCJ.

In this summer, some people asked me whether this deadline of the IRCJ to purchase loans will possibly be extended if the activities of the IRCJ prove to be successful. My quick and personal answer is that it may not be good to extend the scheduled deadline for buying loans from banks even if some cases potentially suited for the IRCJ assistance scheme are left untouched on the last day of the deadline. One of the reasons why I am opposing the extension comes from my belief that the capital markets should take care of themselves without the aid of IRCJ which is essentially a Japanese government intervention.

2. Out-of-Court Workout with multiple financial creditors may be an useful tool for the purpose of reorganizing troubled debtor corporations at an early stage

The scheme that is employed by the IRCJ is out-of-court workout involving multi financial creditors to resolve and revitalize financially distressed and troubled debtor corporations at an early stage without impairing unsecured trade creditors' rights. The most serious disadvantage of the Japanese statutory reorganization proceedings, whether the Corporate Reorganization Law or the Civil Rehabilitation Law, is that the initiation of these proceedings usually triggers deterioration of the business value of the debtor corporations. Once the procedure begins, payments to pre-petition trade debts are prohibited and, under such circumstances, suppliers, vendors and sub-contractors tend to refuse the transactions with the debtor corporations in the ordinary course of business, eventually destroying business reputation of the debtor corporations.

The United States applies more practical approach to overcome this problem. The prepackaged, prearranged or pre-negotiated Chapter 11 methods allow 100% payments to unsecured trade creditors, while only financial creditors incur losses through partial debts forgiveness, debts equity swaps and debt rescheduling. These methods are very popular in dealing with large reorganization cases in the U.S. Before filing the petition for Chapter 11, out-of-court workout involving a large number of financial creditors are employed in many large cases in the U.S., while the informal workout makes it easier to revitalize distressed business corporations at an early stage.

In Japan, the National Banks Association, the Federation of Economic Organization and other relevant organizations adopted the "Guidelines for Out-of-Court Workout With Multi-Creditors" in October 2001 to facilitate the disposition of non- and poor-performing loans owed to financial institutions by business corporations with a view to reorganizing distressed corporations in a more fair and transparent manner. Regrettably, less than 20 cases had been resolved based on the Guidelines by the end of 2002. One reason why the Guidelines have been rarely used is that "non-main" financial institutions were reluctant to share the losses on a pro-rata basis with the "main banks". For many years, Japanese banks have assumed that it is the main banks' role to keep assisting troubled debtor corporations in their group even when they are in desperate financial conditions. Accordingly, main banks helped their debtor corporations by means of partial debts forgiveness, debts equity swaps and subscription of new equity, etc., over and over again, but this practice had an effect of delaying compete disposition of non- and poor- performing loans up to today.

3. Eliminating possible conflict of interests between creditor banks and debtor corporations in the IRCJ

To accelerate disposition of non-performing loans and facilitate revitalization of troubled business corporations, the IRCJ was established in May 2003, under the newly enacted statute at the initiative of the Japanese Government. The staff of the IRCJ is composed of business consultants, investment bankers, financial advisors, accountants, lawyers and other professionals who are specialized in the field of business and financial reorganization. Before the establishment of the IRCJ, it was the staff of the main banks who primarily drafted the reorganization plans, assisted by employees in the financial sections of the debtor corporations. These plans not only focused on resolving the present financial problems but also included operational

rehabilitation plans, but their main concern was to minimize losses for the creditor banks that employ the drafters of the plans.

At the start of the IRCJ, more than 30 bank staffs who constituted a part of the IRCJ preparation office were sent back to their home banks to avoid this type of possible conflict of interest between banks and debtor corporations that may arise in the course of drafting reorganization plans. Banks that subscribed the initial equity of the IRCJ and were potentially expected to be the main customers of the IRCJ, were astonished to know that they can no longer be involved in the drafting stages of reorganization plans and, moreover, bank employees were excluded from the professional team of the IRCJ. It took nearly one year before the Japanese banks realize that it is crucial to avoid the conflict of interest to truly reorganize debtor business corporations. Initially, banks other than Sumitomo Mitsui Banking Corporation were not very willing to bring their cases to the IRCJ, fearing that the professional staffs of the IRCJ, who are alien to bankers, might force banks to bear unreasonably huge amount of losses. But banks are changing their attitude toward the IRCJ. They came to realize that it is crucial to avoid possible conflict of interest between banks and debtor corporations to achieve truly successful restructuring.

4. How does the IRCJ staff draft reorganization plans ?

The standard methodology employed by the IRCJ Staff in drafting reorganization plans can be described as follows. After conducting intensive due diligence both on financial and operational aspects and market researches, the IRCJ staff specify businesses which are profitable and/or can regain profitability. In planning the strategy and tactics for regaining profitability, they estimate future cash flows based on several possible scenarios. Work is also done to identify non-core businesses to be sold, shut down and/or liquidated, and to plan how and when to dispose of these businesses and their related assets. The entire business or enterprise value is then calculated based on an expected future cash flow, discounted by WACC and other relevant risk factor indices. The enterprise value is also calculated based on EDITDA multiple with reference to the financial statements of comparable business enterprises. Overall assets are evaluated based on a going concern basis as well as on a liquidation basis.

Taking all these aspects into consideration, the operational and financial restructuring plans are completed, paying due regard to the desirable mix of debts and equity. The draft plan also determines how much debt forgiveness and debts equity swaps are required. The plan usually calls for more than 90% dilution of equity to change ownership of the debtor corporation. Thus drafted plans by the IRCJ aims at enabling debtor corporations to come back to the capital markets as rapidly as possible, rather than putting too much weight on minimizing the bank losses. I believe most Japanese banks have come to understand that it is vital to avoid possible conflict of interest between banks and debtors and appreciate using neutral and fair professional advisors like the IRCJ staff.

5. The IRCJ as a negotiator, monitor and turnaround player

Upon completion of the draft reorganization plan, the debtor corporation and its main bank jointly ask the IRCJ to assist the debtor using the IRCJ scheme. The Industrial Revitalization Commission will approve the assistance for the debtor corporation when it agrees that the proposed draft plan is fair, equitable and feasible. The IRCJ then publicly announces the assistance decision requesting relevant financial institutions, whose claims are proposed to be impaired according to the draft plan, to stay from any individual collection efforts for the period designated by the IRCJ.

Staff of the IRCJ, assisted by lawyers who are retained by the IRCJ, employees of the main bank and those from the debtor corporation, visit creditor non-main financial institutions individually during the aforementioned designated period and persuade them to sell their loans owed by the debtor to the IRCJ or consent to the draft reorganization plan. When and only when all banks unanimously consent to the plan, the IRCJ purchases the loans owed by the debtor from non-main banks at what is deemed as the market price. The price can range between 98% and 95% of the remaining balance of the debts after deducting the forgiven amount indicated in the plan from the face amount of the debts. The IRCJ may become a new owner of the

debtor corporation through infusion of new capital into the corporation if a new owner cannot be found by the expiration of the designated term. In parallel with executing the plan, the IRCJ monitors and advises the new managers of the reorganized corporation on wide areas of its business operation to recover profitability. In many cases, the IRCJ sends new managers who have sufficient skills to turnaround the assisted corporation replacing former managers.

The IRCJ is entitled to borrow money up to 10 trillion Yen under the guarantee of the Japanese government to purchase loans, inject new capital and/or provide DIP loans to the debtor corporations. We have spent nearly 1 trillion Yen as of the end of the August 2004, only 10% of the budgeted amount. The IRCJ must sell all the loans it purchased, equity and other assets it obtained within three years after it obtained these assets. It is expected that the debtor corporations recover earnings power to be able to refinance on their own and find new prospective buyers of equity; if the IRCJ is not able to exit without incurring losses, the losses must be ultimately eaten up by the Japanese national treasury.

6. The IRCJ inspired turnaround business in Japan

Since the establishment of the IRCJ, reorganization business for troubled corporation gained increasing popularity among the Japanese financial community. The IRCJ has been playing a catalyst role in expanding the rehabilitation business in Japan to revitalize distressed corporations that suffer from excessive debts. For example, Japanese mega-banks except the Bank of Tokyo-Mitsubishi created their own subsidiaries as joint venture companies with investment banks to be specialized in rehabilitating their customer debtor corporations that are in doubtful conditions.

Furthermore, a lot of corporate recovery funds have been established in the past couple of years. The total amount of money invested in distressed corporations by both domestic- and foreign-originated corporate recovery funds has almost doubled during 2003. The Resolution and Collection Corporation and many servicers have been increasingly engaged not only in debt collections business but also in debtor rehabilitation business. The Development Bank of Japan plus commercial banks have been keenly providing DIP financing to the reorganized corporations. Many regional recovery funds targeting local small- and medium-sized corporations have been or are being created in almost all prefectures in Japan. Regional Councils to assist reorganization of small- and medium-sized enterprises (SMEs) have also been established in each prefecture throughout Japan aiming at assisting and advising SMEs on drafting and implementing reorganization plans. Japanese Association of Turnaround Professionals and the Education Center for Business Reorganization Advisors have been established to foster talented human resources for corporate turnaround. One caveat of these new movements is that they are to some extent driven by the Japanese government initiatives. Increase in the number of organizations and schemes for business rehabilitation has not overcome the shortage of skilled rehabilitation professionals such as corporate advisors and turnaround managers, however.

7. Global trends toward out-of-court workout

Out-of-court workout with multi financial creditors is a useful tool to reorganize distressed business corporations suffering from excessive debts at an early stage. In this context, prepackaged Chapter 11 in the United States may become a good global model for the workout. In the United Kingdom, the Enterprise Act of 2002 allows an appointment of an Insolvency Practitioner as an Administrator to preside over the out-of-court workout in the pre-insolvency stage without any court order. With a submission of a notice to the court in the competent jurisdiction and a registration with the company recording office regarding the appointment of an administrator, creditors are required to stay from making any collection efforts to allow the debtor to be ring-fenced for one year during which an out-of-court workout is drafted and negotiated. The Court can approve the plan if it is agreed by creditors with claims more than 75% of total debts of relevant classes to apply the Corporate Voluntary Arrangement of the Insolvency Act of 1986 or the Scheme of Arrangement of the Company Act.

The Draft French Law which is expected to be enacted by the end of 2004,sets a provision for an appointment of a "*mandat ad hoc*" by a commercial court to preside over the out-of-court workout as a pre-insolvency proceeding. The commercial court can approve the plan if it is agreed by creditors with claims more than 75% of total debts without opening a plenary insolvency proceeding. The commercial court can also approve the priority of DIP financing made during the course of workout. These above English and French statutes can be interpreted as a codification of out-of-court workout. Many Asian countries and other developing countries have adopted similar kind of out-of-court workout schemes under the recommendations made by the IMF and other international organizations. The out-of-court workout is gaining increasing ground world-wide.

8. More flexible court administration of statutory reorganization proceedings are preferable

Obtaining unanimous consent to the reorganization plan under the out-of-court process is not easy even for the IRCJ which enjoys strong Japanese government support. To make it easier to obtain consent in workout in Japan, it appears vital that Civil Rehabilitation and Corporate Reorganization Laws, which provide for statutory reorganization proceedings, should be interpreted and applied as flexible as possible.

When a pre-negotiated plan is agreed by the majority of the creditors as required by the statutes for the approval by the court, the debtor can file a petition for a statutory proceeding to opt out minority and stubborn creditors. But upon the filing of the petition for a statutory proceeding, a court issues a temporary restraining order which prohibits the debtor from paying all pre-petition debts including debts owed to trade creditors with the exception of small amount of debts of any kind in usual. And after the issuance of the opening order to commence a reorganization case, the debtor is automatically prohibited paying all debts owed before the opening the case with same exception by statutory provisions. It may become difficult for the debtor corporations to continue their business because trade creditors tend to refuse supply of goods and services that are necessary to continue the debtors' daily business. This will deteriorate the debtors' enterprise value. In the case of an out of court workout with multiple financial creditors, relevant financial creditors usually agree to pay trade debts in full during course of workout and in its reorganization plan as well. Therefore, my proposal is as follows. In the case where an out of court workout is converted to a statutory reorganization proceeding, because minority creditors do not consent the proposed plan but more than sufficient number of majority creditors, whose acceptance is required for the court approval of the plan to cram down minority creditors, agreed, the court should permit to pay trade debts in full, changing present practice mentioned above which prohibits all payments of old trade debts. In the United States, federal bankruptcy courts usually issue a first day order to permit payment of pre-petition trade debts owed to critical vendors after the initiation of a statutory proceeding.

The debts owed by a reorganizing debtor during the course of out-of-court workout as a DIP financing to defray operating expenses should not be impaired, whereas other pre-petition debts may be impaired in the converted statutory reorganization proceeding mostly. Rather the DIP loans should be treated as administrative expenses like as the DIP financing loans extended after the opening of the converted case. The court should permit to pay debts owed by pre-petition DIP financing in full according to terms of the DIP financing contract agreed between the DIP financer and the debtor.

To obtain unanimous consent easier and successfully in an out-of-court workout with multiple financial creditors, it is critical to make it easier to use a statutory reorganization proceeding by taking advantage of the majority rule. Stubborn minority creditors may come to know that they are objecting in vain, when the case is converted to a statutory reorganization cases. My recommendation is that the Japanese judicial society should interpret and apply statutory reorganization proceedings to be more flexible to facilitate reorganization of distressed debtors at an early stage. Otherwise, law reformation may be needed.

In conclusion, I would like to claim that the question of "How many large cases have been dealt with by the IRCJ?" is not crucial; what is crucial is "Can the IRCJ change the Japanese culture to enable early reorganization?" – and we have so many challenges ahead.

Appendix 1 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 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, the court decides 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 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, where both reductions and increases in capital can be accomplished without a shareholders' resolution.

Appendix 2 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.

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 a trustee 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, then a court might appoint the turnaround managers as a trustee and/or deputy trustees. A corporate reorganization proceeding, with its stronger weapons, was more useful than civil rehabilitation for larger corporations. It is hoped that a pre-arranged 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 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, 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 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.