2/2/04

Latest Insolvency Issues in Japan

Tomoo Tasaku, Partner
PricewaterhouseCoopers FAS, Tokyo

[This paper is based on my concept paper, "*Corporate Revitalization in Japan*" at the Symposium on Building the Financial System of the 21st Century: An Agenda for Japan & the United States.
Program on International Financial Systems at Harvard Law School and the International House of Japan organized this Symposium at Gotemba, Japan on October 3-5, 2003.]

1. General Environment

Japan has been suffering from distressed loan problem since early 1990s due to banks' aggressive property lending during the second half of 1980s (so-called "bubble economy era"). Internationally, Japan is often accused because of its slow actions against distressed loan problem, but in reality, distressed loans for approximately JPY 90 trillion (US$ 750 billion @US$1=JPY120) were already written off or charged off during FY 1992-2001. Such amount is approximately 80% of inflated lending to properties, construction, non-bank financial institutions and other sectors during 1986-1990. In addition, active non-performing loan trading has been seen in the market since 1997 with the peak period during FY 1999-2000. Regardless of these efforts by banks, newly produced distressed loans have been accumulated on banks' books due to long recession/deflation during 1990s.

<Distressed loans (classified as "Doubtful" or worse) held by major Japanese banks>

[JPY Trillion]	9/00	3/01	9/01	3/02	9/02	3/03	9/03
Existing Amount	N.A.	8.3	9.2	8.5	10.3	5.7	5.4
Newly Accumulated Amount	N.A.	3.4	3.0	6.9	2.0	3.0	3.0
Total Outstanding Amount	12.7	11.7	12.2	15.4	12.3	8.7	8.4

(Source: Financial Services Agency)

Thus, the government has to cope with this vicious circle of distressed loan problem and recession/deflation. Under the zero interest-rate with huge amount of budget deficit, neither monetary policy nor fiscal policy can be effective. One possibility is to stimulate potential demands, through de-regulations and re-regulations, in the field of medical care, education, environmental services, agriculture and other non-manufacturing sectors where labor-intensive works are required and will contribute to absorb unemployment and to mitigate uneasiness for the future.

© *International Insolvency Institute – www.iiiglobal.org*

Fortunately, according to Financial Times dated January 31/February 1, 2004, Japan's jobless rate fell to its lowest level in 2.5 years in December 2003, pointing to improved business conditions and a possible upturn in consumer confidence. On January 30, 2004, the government announced that unemployment dropped to 4.9% from 5.2%, having started in 2003 at a record high of 5.5%. The average for 2003 was 5.3% (0.1% down on the previous year), which is the first annual improvement in thirteen years.

In this context, the government is further strengthening bank examinations by Financial Services Agency ("FSA") and accounting rules have been tightened as well. Consequently, Risona Bank, which was one of the weakest among major banks, and Ashikaga Bank, which was one of the weakest among regional banks, were nationalized in June 2003 and in November 2003, respectively. Both of them have been in the process of reorganization under the new management.

Until late 1990s, the legislation in Japan did not lead to early recognition and quick action on financial difficulties of companies because most of the restructuring used to be settled as out-of-court workouts under the initiative of the so-called "main-banks" and other related parties. Main-banks used to control their borrowers by holding their shares, seconding executives and taking care of various financial problems. The main-bank system used to be well maintained thanks to hidden reserves (unrealized capital gains of shares held by the banks) and less stringent accounting and disclosure rules (which allowed banks to carry bad loans without providing them appropriately and to write them off little by little by utilizing hidden reserves). These hidden reserves have substantially decreased due to the economic recession during the 1990s and the recent strict tightening of disclosure requirements. Thus, the so-called main-bank system has almost collapsed. Partly because of this collapse and partly because of the new legislations (particularly the Civil Rehabilitation Law and the amended Corporate Reorganization Law), early recognition and quick action on financial difficulties of companies have been enhanced. Indeed, some banks have come to prefer solving their distressed loan problems via transparent legal procedures to save time, costs and expenses, finding it is impossible to keep hiding problems forever.

2. Insolvency Laws

Japan does not have a uniform insolvency code. Insolvency laws consist of liquidation and reorganization laws. Under liquidation, the Bankruptcy Law (which is being amended and is scheduled to be effective in 2004) and Special Liquidation procedures (in the Commercial Code) apply. Under reorganization, the Corporate Reorganization Law (which was amended in 2002 and has been effective since April 1, 2003), the Civil Rehabilitation Law (which replaced the Composition Law as of April 1, 2000) and Company Resolution procedures (in the Commercial Code) apply. Thus, these laws generally are in the process of complete overhaul. Company Resolution procedures may be abolished in the near future since the Civil Rehabilitation Law is much more precise and sophisticated and is enough to cover issues that used to be handled by Company Resolution.

© International Insolvency Institute – www.iiiglobal.org

<Insolvency Laws in Japan>

Liquidation	Bankruptcy Law (Applicable to any corporations and consumers)
	Special Liquidation (Applicable to stock companies only)
Reorganization	Corporate Reorganization Law (Applicable to stock companies only; binding on all secured/unsecured creditors, shareholders and other interested parties)
	Civil Rehabilitation Law (Applicable to any corporations and consumers; binding on unsecured creditors only)
	Company Resolution (Applicable to stock companies only)

The insolvency/restructuring legislation is still complicated and is understood only by a limited number of insolvency lawyers who have esoteric expertise in this field. Some financial advisors, turnaround specialists, consultants, accountants, bankers and other professionals also have a good understanding of the legislation, but the legislation had not been fully utilized. Rather, most of the restructuring used to be done as out-of-court workouts under the initiative of banks, finance companies and lawyers, and sometimes of "unlicensed" special fixers without any disclosure of information. This situation has been changing since April 1, 2000 – the effective date of the Civil Rehabilitation Law. This new law allows a debtor to keep its operation as a debtor-in-possession ("DIP") and promotes quicker solutions to problems and the revitalization of businesses.

To maintain viable business operations under statutory reorganization proceedings or out-of-court workouts, it is usually necessary for the debtors to borrow new working capital additionally. Development Bank of Japan ("DBJ"), Mizuho Bank, Shoko Chukin Bank, Aozora Bank and other Japanese commercial banks and finance companies have started to extend credits for distressed borrowers, particularly in the form of DIP financing. Thus, financing to debtors who have filed protections under the Civil Rehabilitation Law or the Corporate Reorganization Law has come to be acknowledged as DIP financing businesses.

Originally, DIP financing was only available to a debtor-in-possession under Chapter 11 proceedings in the U.S. Therefore, financing for debtors under the Japanese Corporate Reorganization proceedings where usually a trustee is appointed is not "DIP" financing because such debtors are not debtors-in-possession. However, in Japan, financing for debtors that are either under the Corporate Reorganization or under the Civil Rehabilitation procedures is customarily referred to as "DIP financing." In addition, under the US Chapter 11 system DIP financing claims are well protected with a status of "super-priority" to other administrative expenses, but in Japan such claims are *pari passu* with other administrative expenses.

© International Insolvency Institute – www.iiiglobal.org

3. Financial Restructuring

As a tool to restructure over-borrowings of distressed companies, debt-to-equity swaps ("DES") have been commonly used in Japan recently. In the past, DES was rarely used in Japan because of the 5% rule restriction. The 5% rule under the Banking Law and the Fair Trade and Anti-Trust Law restricts a bank's ownership of 5% or more of outstanding stocks of a certain company. The rule was established to prohibit banks from having too strong controlling interests in business corporations. However, now that the rule is de-regulated, DES arrangements have been common in Japan.

In the past, conversion from debt to equity had to be done based on the market 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 and the Osaka District Court is following suit. This flexible treatment has contributed to higher utilization of DES in Japan.

e.g., Distressed loan with face value of 100 and market value of 30

(i)	<u>Market value conversion</u>	
	Forgiveness of indebtedness	70
	Conversion to equity	30
(ii)	<u>Face value conversion</u>	
	Conversion to equity	Up to 100, provided that such converted equity is subject to mark-to-market

(As a result of mark-to-market, equity value will be 30 only.)

Even under this environment, some banks are still reluctant to own stocks of unlisted distressed companies because of the lack of a secondary market to sell such stocks in Japan. One possibility is for a bank to sell such stocks to a private equity fund and, as consideration, receive 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 potentiality of such companies. Major Japanese banks, including the Bank of Tokyo-Mitsubishi and Sumitomo Mitsui Banking Corporation, are establishing such funds, and several regional banks are joining in these arrangements. In addition, similar funds are being established in Hokkaido, Osaka, Kyushu and other regions by regional banks, regional companies and local governments so that regional medium and small companies can be revitalized through DES.

Thus, DES has been commonly utilized recently, but forgiving indebtedness is still the major method of financial restructuring in Japan. Particularly in cases where a main-bank had sustained its distressed borrower for too long a while by lending additionally, usually such borrower is with negative equity and it is impossible to implement a financial restructuring without forgiving indebtedness. Therefore, in the preparation of restructuring plans, the main practical difficulties are how to determine the degree of forgiveness and how to convince the related parties, particularly non-main banks. Though the so-called main-bank system is collapsing as explained above, it is still a market practice for the main-bank to forgive more and for small lenders to forgive less or none.

© International Insolvency Institute – www.iiiglobal.org

In out-of-court workouts, the level of remaining debts is usually higher since banks want to minimize their losses from forgiveness. However, if the level is higher, the debtor will face financial difficulties again sooner or later. Ultimately, the cases may have to be settled in legal procedures under the Corporate Reorganization Law or the Civil Rehabilitation Law. In out-of-court workouts, naturally the implementation of restructuring plans is difficult because, as mentioned above, such plans are usually not stringent enough to have the debtor revitalize its businesses. However, in legal procedures under the Corporate Reorganization Law or the Civil Rehabilitation Law, implementation is not difficult since plans are feasible enough and legally enforceable.

In most of the cases, restructuring in Japan results in a mere adjustment of the debt/equity structure of the debtor. As mentioned above, forgiving indebtedness is common in Japan, and the debtor may not be regarded as restructured until they become debt-free companies, which can take more than ten years. Since this concept underpins restructuring in Japan, a mere adjustment of the debt/equity structure is common. Needless to say, in addition to financial restructuring, a genuine restructuring of business operations is necessary for actual revitalization of companies in Japan.

4. Operational Restructuring through M&A

If a genuine restructuring of business operations is done in Japan, it is in the context of mergers and acquisitions ("M&A"). When a debtor faces financial difficulties, it has the option to sell its businesses to investors who are either strategic buyers (such as a competitor in the same business segment) or financial buyers (such as investment funds). Once an M&A is completed, the buyer usually restructures the acquired business so that it will coincide with the existing businesses.

However, if the debtor files a petition for legal procedures after the M&A, the sale may be avoided as a preference or a fraudulent conveyance. Therefore, many buyers like to close the deal in the course of legal procedures. Subject to the court's approval under the assumption that a debtor's equity value is zero or negative, both the Civil Rehabilitation Law and the amended Corporate Reorganization Law allow the debtor to sell its businesses, partially or entirely, to a buyer without waiting for a reorganization plan to be confirmed. Thus, if a debtor wants to restructure its business operations genuinely through an M&A, one possibility is to implement such restructuring through legal procedures. If everything is well prepared before the filing, legal procedures will be finished in a month or so.

Such filing may be called a "pre-packaged filing", but precisely speaking, a pre-packaged filing is allowed only under the U.S. Chapter 11 system where a reorganization plan and majority vote for such plan may be made before the insolvency filing. In this sense, a filing after negotiations and arrangements with major lenders (but without a formal plan and majority vote) is to be called a "pre-negotiated filing" or a "pre-arranged filing". In Japan, sometimes a filing with a mere non-binding agreement between a debtor and a potential buyer of the business is called a "pre-packaged filing", but obviously it is a wrong usage of technical terms.

As financial buyers, many private equity funds whose targets are mainly distressed business corporations have been organized recently in Japan. They may acquire troubled

© International Insolvency Institute – www.iiiglobal.org

companies by investing money and controlling the companies in order to restructure and revitalize their businesses. These funds typically acquire loan claims of distressed companies held by Japanese banks, exercise DES and become shareholders of such companies. Subsequently, the funds implement various business strategies so that such companies again become profitable and saleable to other strategic/financial buyers or in the public stock market. Now that the level of non-performing loans sold through bulk sales in 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.

As already mentioned, major Japanese banks are also establishing private equity funds in order to resolve their own sub-performing loan problems.

In this context, the Industrial Revitalization Corporation of Japan ("IRCJ") was established in April 2003 and has been operating as a national asset management company that is in charge of assisting banks in revitalizing their borrowers whose core businesses are still viable. [See Section 7 regarding IRCJ.]

5. Restructuring Advisory Services and Turnaround Management

Restructuring advisory firms that have been established at the initiative of banks, security houses, accounting firms and others have become steadily common in Japan. These advisory teams are expected to help troubled companies in working out their excessive debts and restructuring their businesses effectively. In the past, when the main-bank system was still strong in Japan, banks conducted such advisory services for their borrowers 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. Strictly speaking, if a bank extends advisory services to its borrower regardless of conflict of interest, such bank is subject to lender liability due to excessive control and/or tortious interference.

Turnaround management is to be distinguished from restructuring advisory services. Turnaround management usually means professional activities by a turnaround manager who works for a distressed company as an interim manager, such as a CRO (chief restructuring officer). In the U.S., it is common for distressed companies (e.g., Enron, WorldCom and K-Mart) to retain turnaround managers and implement quick recoveries. In Japan, the concept of turnaround management is being recognized gradually and the Japanese Association of Turnaround Professionals has been operating since April 2003.

6. Guidelines for Out-of-Court Workouts

Japanese Bankers Association, Japan Federation of Economic Organizations ("JFEO") and other relevant organizations, together with FSA, Ministry of Finance, Ministry of Economy, Trade and Industry, Bank of Japan and Deposit Insurance Corporation established a committee in June 2001 and the committee subsequently published "the Guidelines for the Out-of-Court Workouts" on September 19, 2001. The Guidelines were

© *International Insolvency Institute – www.iiiglobal.org*

drafted partly based on the “Statement of Principles for a Global Approach to Multi-Creditor Workouts” issued by INSOL International (International Federation of Insolvency Professionals). The Guidelines were designed to have banks and other financial institutions agree to out-of-court workout plans through transparent procedures with independent advisors.
An outline of the procedures established by the Guidelines is as follows:

A debtor may apply for procedures of multi-bank out-of-court workouts in cases where a number of banks have lending exposures to the debtor. The application must be accompanied by financial documents that explain the reasons the debtor came into financial difficulties and a proposed restructuring plan. The proposed plan should include an operational restructuring plan in addition to a financial restructuring plan. If the major banks are convinced that the statements in the documents are accurate and the proposed plan is feasible and reasonable, and if the major banks agree 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 issue a notice of “standstill” to all the relevant banks and convene the first meeting of creditors which is to be held within a week after the notice of standstill. At the first meeting of creditors, if the relevant creditors consent unanimously to continue the standstill period, then a creditors’ committee may be formed and professionals, including lawyers and accountants who are in charge of examining the accuracy of financial statements and reasonableness and feasibility of the proposed plan, may be retained. During the standstill period, relevant creditors should refrain from any debt collection, enforcement of security interests, improvement of their positions relative to other relevant banks and should maintain the original outstanding balance of their claims. Within three months after the first meeting, the second meeting is to be held and at this meeting all relevant creditors are to indicate whether they accept the plan or not. When all creditors, whose rights are to be impaired for the purpose of improving the debtor’s financial position, consent to the proposed plan, then the plan is accepted by such creditors and the rights of the relevant creditors are amended and changed in accordance with the provisions contained in the plan. If unanimous consent is not achieved, then the out-of-court workout is terminated and the debtor has an option to file a petition at a court under the formal insolvency proceedings.

Since the Guidelines are designed to facilitate multi-bank workouts to revitalize basically large companies with huge amounts of debts, they are not necessarily applicable to all the out-of-court workouts. Different from the INSOL principles that state only the procedures, the Guidelines specify not only the procedures but also the following substantive details for a restructuring plan:

(i) If the debtor has negative net worth, the plan must have solutions by which the debtor will have positive net worth within three years or so.
(ii) If the debtor has a pretax loss, the plan must have solutions by which the debtor’s pretax income will be positive within three years or so.
(iii) If the debtor enjoys forgiveness of indebtedness, then the plan must provide in principle that the interest of the controlling shareholders of the debtor should

© *International Insolvency Institute – www.iiiglobal.org*

be reduced or diluted substantially.

(iv) If the debtor enjoys forgiveness of indebtedness, then the plan must also provide in principle that existing executives of the debtor should resign upon the creditors' acceptance of the plan.

Many practitioners have criticized the arrangements of the Guidelines, stating that the aforementioned requirements are too stringent. However, JFEO supported the strict requirements of the Guidelines because JFEO aimed to resolve the problem of over-competitions in certain industries, particularly the construction industry. In JFEO's opinion, rescuing inefficient companies in some industries should not be done too easily, and reduction of numbers of poor-performing companies is desirable in market economy.
In reality, only several companies have been reorganized through the out-of-court workouts using the Guidelines. Since it was not easy to revise the Guidelines due to difficulties to obtain unanimous consents of all relevant organizations including JFEO (which is now reformed and renamed as Japan Business Federation) again, a working committee of the Guidelines with academicians, experienced professional advisors and workout practitioners was formed in 2002 so that the Guidelines could be more commonly adopted. In October 2002, the committee proposed the mitigation of application of the aforementioned requirements with the following reasonable exceptions:

<Exceptions of Requirements under the Guidelines>

	Guidelines	Exceptions
Improvement of negative net worth position	Within three years	Within five years with rationale
Improvement of pretax loss position	Within three years	Exceptions allowed with rationale
Reduction or dilution of shareholders' equity	Basically required in case of forgiveness of indebtedness	Not always required for medium and small companies
Resignations of executives	Basically required in case of forgiveness of indebtedness	Not always required if executives are not responsible for distressed situations

7. The Resolution & Collection Corporation ("RCC") and the Industrial Revitalization Corporation of Japan ("IRCJ")

In 1996, the Japanese government established RCC whose task was to assume or buy non-performing loans (usually classified as "Doubtful" or worse) from financial institutions, including bankrupt ones, and to accelerate collections of such debts. RCC has not simply tried to enforce its security interests against debtors, but it has also been active in trying to assist such debtors by advising them to restructure their debts and businesses through out-of-court workouts, Civil Rehabilitation and Corporate Reorganization proceedings.
In addition to RCC, the Japanese government established IRCJ in April 2003. IRCJ has commenced its operation in May 2003 and its principal function is to buy sub-performing

© International Insolvency Institute – www.iiiglobal.org

loans (usually classified as "Sub-Standard" or better) owed to non-main-banks (other than loans held by main-banks). In contrast to RCC, IRCJ purchases loans owed only by distressed companies whose businesses are still viable and therefore likely to be successfully revitalized. Before making a decision to help a distressed company, IRCJ and the main-bank carefully review the feasibility of the restructuring plan proposed by the distressed company. In order to assist banks and companies in this program, IRCJ retains experienced and qualified professionals, including accountants, lawyers and restructuring advisors. The decision to help includes the declaration of IRCJ's intention to buy the loans from banks other than the main-banks. However, banks are not legally obliged to sell their loans to IRCJ. They have options to sell their loans at the price designated by IRCJ, to accept a proposed restructuring plan that inevitably will reduce the value of their claims, to sell such loans directly to investors in the market or to enforce the debtor to go into legal procedures.

While RCC may buy debts owed by medium and small companies, IRCJ basically purchases debts owed by large companies whose insolvency filings might have a material impact on relevant industrial societies. IRCJ may recommend distressed companies to reduce their own business lines and/or to merge with or to be acquired by another companies so that over-capacity or over-supply problems in relevant industries could be resolved.

As already explained, the main-banks used to second their employees to distressed companies for a few years so that they could act in controlling positions as chairpersons, presidents, directors and other high ranking offices. In such an environment, many managers and high-ranking employees of the companies who were not from main-banks were likely to lose the spirit of independence under the protective umbrella of the main-banks. Thus, it was believed that the main-banks, as patrons of the distressed companies, should continue to supply loans, producing additional excessive exposures even after other non-main-banks had reduced their exposures. In this game, every player knows other players' behaviors and does not like to change its strategy (so-called "Nash equilibrium").

IRCJ tries to change rules of the game and to resolve problems of asymmetry of information and high transaction costs among players through the following process:

(a) To scrutinize a restructuring plan proposed by a debtor and its main-bank;
(b) To convince other non-main-banks to sell their claims to IRCJ;
(c) To implement the restructuring plan only by three parties, i.e., IRCJ, the main-bank and the debtor; and
(d) To find an exit, including refinancing, IPO, MBO and M&A

Excluding unofficial consulting cases, IRCJ has officially handled eleven deals since its inception. Some criticizes that the number of officially handled deals is too small, but it is remarkable for a limited staff (approximately one hundred executives and employees) to have handled one deal a month on average.

IRCJ may be similar to a national asset management company ("AMC"). Similar AMCs were established in some countries as follows:

© International Insolvency Institute – www.iiiglobal.org

<AMCs in other countries>

	U.S.A.	Korea	Sweden
Step 1: Strict asset valuation ⇩	Closure of S&Ls [S&L: Savings and loan association]	Nationalization of seven banks	Nationalization of two banks
Step 2: AMC as an intermediary ⇩	RTC (1989-1995) [RTC: Resolution Trust Corporation]	KAMCO (1997-) [KAMCO: Korea Asset Management Corporation]	Securum (1992-1997), Retriva(1993-1995*) (*)Absorbed by Securum
Step 3: Sale in the market	Quick sale	Quick sale	Turnaround and value-addition

It is a national AMC's role to help private sectors when they cannot act rationally by themselves. IRCJ may particularly similar to Swedish AMCs but what is unique in Japan is that Step 1 and Step 2 are happening simultaneously.
Thus, IRCJ is playing roles of both an AMC and a restructuring corporation, handling not only distressed real estate loans but also distressed corporate loans extended to manufacturing, distribution and other industries.
In addition, what is remarkable is that in every country, monetary policies and fiscal policies were fully implemented in order to mitigate recessions, unemployment and other damages arising from AMCs' actions to cope with distressed loan problems since AMCs' actions by themselves do not result in economic recoveries.

© *International Insolvency Institute – www.iiiglobal.org*