

Changing Bankruptcy Practice and Laws in Japan: Its Future Effects

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1 Reformation of insolvency laws in Japan

In recent years, bankruptcy practices all over the world are changing considerably. Especially, Japanese bankruptcy practices and laws are changing rapidly to meet economic need in a few years.

There are five types of statutory insolvency proceedings in Japan. They are straight bankruptcy under Bankruptcy law, special liquidation under Commercial Code, Civil Rehabilitation under Civil Rehabilitation Law, Corporate Reorganization under Corporate Reorganization Law, Corporate Arrangement under Commercial Code. Preceding two proceedings are for liquidation, other three are for rehabilitation. The corporate

reorganization proceeding is designed to reorganize large corporations and the corporate arrangement proceeding is rarely used because unanimous consents is required to the arrangement is accepted.

Abolishing former Composition law, Civil Rehabilitation Law was enacted in 1999 and came into force in 2000, followed by reformation of the Civil Rehabilitation Law and enactment of Law for Recognition and Assistance of Foreign Insolvency Proceedings in 2000, respectively. Reformation of Corporate Reorganization Law is on the way and expected to be finalized in next year.

2 Changing insolvency practice

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

3 Opening gates wider

For example, 223 civil rehabilitation cases were filed in Tokyo District Court in fiscal year 2000, whilst only 36 composition cases under the Composition Law, which is the predecessor of Civil Rehabilitation Law, were filed in the same court in the previous fiscal year. Formerly, judges were very reluctant to open rehabilitation and reorganization cases where the successful rehabilitation was not sure. Judges, with little knowledge of normal business affairs, tend to be too careful in opening the cases and would even issue temporal restraining orders to stay individual collection efforts for fear of a second failure during court supervision while the case is pending.

Cases in former Composition Law, many debtors could not make payments according to the terms of the confirmed plans which provided for partial payments with extended deadlines for several years. Sometimes, creditors complained to courts about their insufficient supervision of debtors. Therefore, judges tended to regard themselves as blameless for the consequences of their conservative action in to opening the composition cases.

4 Expedited proceedings

Bankruptcy cases are handled speedily now. In most civil rehabilitation

cases in Tokyo, a plan is confirmed by a 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 speedily. The Kyo-ei Life Insurance, now Gibraltar Insurance, reorganization case for which I served as the trustee or administrator was closed within six months after the opening order was issued. The Kyo-ei case is the biggest bankruptcy case ever happened all over the world with huge amount of debts as huge as approximately \$ 540 trillion of the total amount of debts. Nippon Lease, Life Credit and Chiyoda Life Insurance cases were all closed within a year. Tokyo Life Insurance reorganization case which was opened this April is also expected to be closed before the end of this year. With the exception of Tokyo Life Insurance case, these reorganization cases could be completed mostly due to the involvement of American originated investors and financial advisors.

5 Late filings for insolvency proceedings

Huge amounts of debts

Wide use of promissory notes

Historically in Japan, distressed business debtors have not filed a petition for rehabilitation and reorganization procedures in the early stages of their financial distress. Instead, most troubled business corporations used to file the petition on a few days prior to when the debtor dishonors a promissory note it had issued. Promissory notes are widely used in Japan to pay accounts payable. Rather than cash, these promissory notes are delivered in the next month after goods are sold or services rendered to the seller or subcontractor. The payment day of the promissory notes ranges from four to six months after the date of the issue. By the time a promissory note is dishonored by the issuer the trade creditor may have another three, four or five bad promissory notes issued by the same debtor who will also be dishonored when they came due. Therefore, when the trade creditor learns that the purchaser is not able to pay its debts, the amount of the trade creditor's claim may total five, six or seven months worth of purchases. For this reason, bankruptcy in Japan is a panic, and the total amounts of debts are relatively large compared to the available assets. This is the unique feature of Japanese bankruptcy compared to that of U.S.A. and European countries. The promissory note became popular in Japan after W.W.II, when little cash or other financial resources were available. A small sheet of paper with a revenue stamp, which is titled a promissory note, is a good tool to buy material and other goods and services without cash. After selling the finished goods made of purchased material, the issuer of the note can pay the note using the sales revenue. One

of the reasons why the Japanese economy could survive after the war may be the wide use of these notes.

The recipient of a promissory note can obtain cash by selling the note to a bank at discounted rates calculated using the interest rate and the creditworthiness of the issuer. Buying such notes is one of the main routine businesses of Japanese banks. To make the buying note business safer, bankers' associations established their own rules regarding notes clearing houses. The notes clearing house rules provide that member banks must suspend credit transactions for two years with any note issuer who dishonors its notes twice within a six months period. A bad note issuer who was suspended credit transactions with its banks cannot issue notes and checks any more because it is not able to maintain its checking accounts with member banks. The banker's association practice of prohibiting member banks from doing business with bad notes issuer has the effect of purging the issuer from business society. In effect, the punishment is a death penalty for any merchant who issues a bad note. To avoid this, a note issuer tries to increase its liquidity by means of extending the due dates of notes. By extending due dates of future notes for an additional month, the issuer has more cash during that one month period. To obtain more cash, some merchants exchange notes each other without any true commercial transaction, then they sell the changed notes to banks pretending the notes were given for the payments of accounts payables. The promissory note which issued without true transaction but issued for the purpose only to sell the notes are called "yuzu tegata" or "borrowed notes" and the sale of the yuzu tegata may constitute a fraud.

6 Changing practice

From the early 1990s, large Japanese corporations reduced the number of promissory notes issued changing a long-held business practice. One reason may have been to save the costs of revenue stamp payments. Revenue stamps based on the face value of the note are required.

Another reason for not issuing notes may be also to reduce cost of managing the notes. The quantity of notes is now gradually decreasing, but the due dates of accounts receivable are not accelerated. A buyer may pay a seller by check or by remitting money to a seller's designated bank account on the same day as the promissory notes would have been due .

Without a promissory note, a supplier or vendor loses the ability to obtain cash by discounting the promissory note to a bank. A supplier or vendor can sell the accounts receivable, instead. This requires sending a letter by certified registered mail to the

buyer-debtor for the purpose of perfecting the assignment of an account receivable. A buyer who receives such a notice may suspect the supplier's financial creditability when the buyer learns that the account receivable has been sold to a third party. To make the perfection procedure easier, a new statute titled "Law Regarding Special Perfection Procedure for the Assignment of Claims" was enacted in 1998. According to the new law, an assignment of claims is perfected when the registration of the assignment has been made by joint petition of an assignee and an assignor at the designated registration office of competent jurisdiction. There is an exemption from the registered mail requirement stated in the related provisions of the Civil Code.

In any event, only large corporations with good financial reputations can stop using promissory notes and the notes are still widely used in Japan. I hope this harmful practice of using promissory notes in the ordinary course of business will change in near future.

7 Transparency

To reiterate tremendously large amounts of debt compared to assets and late filing for insolvency are unique features of Japanese bankruptcy practice. These unique features might be related to the insufficient transparency of Japanese business corporations. While things are changing gradually, most Japanese business corporations still practice the lifelong employment system. An employee expects to continue to work for his/her employer-corporation up to mandatory retirement age, say, sixty or sixty five years old. A business corporation is not an entity for its shareholders, but rather exist for the benefit of the people who work for the corporation as employees, officers, directors or executives. A Japanese business corporation is a big family consisting of its employees, officers, directors, executives and their family members. Directors are not representatives of shareholders, but rather promoted employees. Among employees, a smart guy who has few enemies and is in favor with his superior can be promoted and go up the ladder to achieve executive status. A guy of vitality with some enemies may go up the ladder to some extent, but it might be very difficult to reach the top because some of his enemies may try to remove the ladder. In Japan, a success story is non-failure story. When I was an administrator for the reorganization of Kyo-ei Insurance, journalists asked me why I did not take any action to blame Kyo-ei's former managers' their liability. Apart from the Chiyoda, Toho Insurance and Sogo cases, Kyo-ei executives didn't anything wrong, rather they failed rescue Kyo-ei at an early stage in effective way. Executives, directors and officers of Japanese corporations are like the head of their family and thus are reluctant to disclose its

secret. This is another Japanese tradition continued of long standings. But again things are changing in Japan. The Civil Rehabilitation Law is more informative to creditors than the Corporate Reorganization Law. The Corporate Reorganization Law is currently being amended makes its proceedings more transparent proceeding to the public, with the exception on trade secret. The Commercial Code, which contains many provisions for business corporations has been amended several times in the past decade and more reforms can be expected to achieve an international business standard. The Security Exchange Law was amended several times in recent years to disclose financial information. International accounting standards, consolidated financial statements system and current value accounting system has been adopted in Japan by these law reforms in recent years.

8 Over-dependence on land mortgage and little attention on to cash flow

For many years, Japanese banks loaned money to business corporations taking mortgages on parcels of land rather than relying on cash flow or the profitability of borrowers. They did not need to monitor the debtor corporation's profitability, because the value of the land which is the collateral of the mortgage continue to rise. There was no need for a creditor bank to file a petition to foreclose on a mortgage even in default, because the defaulted debtor could sell the land voluntarily and get more than enough money to pay mortgage. Consequently, many employees of Japanese banks have insufficient ability to monitor their customers' cash flow and profitability. Therefore, it is not easy for a bank to advise its debtor-corporation to take appropriate steps to address their financial difficulties at an early stage. That is one reason why many Japanese corporations are in a desperate state by the time when they file petitions for insolvency proceedings. But things are changing here also. The Development Bank of Japan, the Fuji Bank, the Shoko Chukin Bank and other Japanese banks have started DIP loan business financing debtor-corporations who have filed Civil Rehabilitation proceedings. DIP financing cannot be pursued without monitoring the debtor's cash flow. I hope that younger employees of banks are trying to monitor debtors' profitability in spite of sitting on land mortgages only.

9 Optimistic valuation on loans and assets

U.S.A. and EU countries have advised Japan to write off huge amounts of its non-performing loans or bad loans immediately and the Prime Minister Koizumi, his staff and other government officials would try to do so to rescue the desperate Japanese

economy. But it is not easy to change the Japanese way of thinking regarding bad loans. For example, most Japanese banks had not classified Mycal as a possible bankruptcy debtor at the time when it filed a petition for civil rehabilitation procedure. They disregarded its huge debts compared to its assets. When I was an administrator for Kyo-ei Insurance, a large well-known Japanese trading house corporation owed Kyo-ei more than ten billion Japanese Yen and since Prudential, which is the new owner of the reorganized Kyo-ei, feared that the debtor might be bankrupt in near future, Prudential wish to sell the debt at discounted rate as soon as possible. For normal Japanese, it is hard to imagine that the trading house would file for bankruptcy or reorganization. At the request of Prudential, I negotiated with the trading house to let it purchase the loan at a discounted price and they agreed to do so. However, Prudential again feared the proposed transaction would be avoided if the trading house filed for a reorganization proceeding in the near future.. It may be incredible for normal Japanese to understand reason why Prudential was so concerned.

10 Difference of valuation standards

According to the provisions of the Corporate Reorganization Law, a trustee is obliged to assess all assets of a reorganizing corporation based on going concern value before he/she drafts a reorganization plan. According to the Special Reorganization Law for Financial Institutions the Policyholders' Protection Corporation represents insurance policyholders to vote on a reorganization plan. Policyholders are entitled to vote on a plan by themselves, but most policyholders are not interested in doing so. The PPC can accept or reject a plan on behalf of policyholders who do not vote. The PPC values assets of reorganizing insurance companies for the purpose of simultaneously assessing the reasonableness and feasibility. As the PPC did not appraise assets from a new investor's point of view, the PPC's conclusion for valuation was conservative. Values of loans were rather optimistic. Prices of real estate were estimated partly on going concern value partly but with reference to Kojikakaku which is the Ministry of Construction's annual estimated land price. Both in the Kyo-ei and Chiyoda Insurance cases, there was a significant difference between the PPC's valuation and the trustees' valuation. In the Kyo-ei case, the PPC finally agreed to the trustee's appraisal on the condition that if the assets were sold at the prices higher than the valued prices, then the difference should be shared by the reorganized Kyo-ei and its policyholders at 30% vs 70% basis within eight years. The PPC was delighted to hear the trustee of Kyo-ei, myself, promise never to request any aid, which might amount 500 billion yen, from the PPC or the Japanese government, and it conceded and agreed to my proposal for profit sharing aimed at successful reorganization. But the

trustee of Chiyoda and the PPC could not agree on the appraisal. Consequently, Chiyoda had no choice but to sell almost all its assets at bidding to prove the value of the assets. It is no good to sell valuable assets in haste without looking for better chance.

11 Need to change the way of thinking and business culture

These things reflect the difference of Japanese thinking way and that of Americans. Japanese banks are urged to write off non-performing loans immediately. However, to write off bad loans requires a change to the Japanese way of thinking and to the culture of both banks and business corporations. It is not easy and many Japanese business enterprises feel they are being pushed to have more quickly than is comfortable for them.

12 Secured creditor's right under Civil Rehabilitation Law

The Civil Rehabilitation Law was enacted in 1999 to cure defects contained its predecessor the Composition Law (Wagi-ho). First of all, according to the 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 CRL, a secured creditor is also able to enforce its secured right, but a rehabilitating debtor is eligible to apply for a stay order which prohibits enforcement of a secured right for a certain period. The stay order may induce a secured creditor negotiate with the debtor. According to the Japanese Civil Code, which is originated in the Napoleonic Code, a secured right is not limited to the value of collateral. In other words, a secured creditor can refused 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 is not be extinguished without the consent of the secured creditor until the debt is paid in full. But Article 148 et.al. of CRL provides that a secured right is extinguished when the debtor pays the court-designated amount to the secured creditor. This is the amount assessed at the request of the debtor by a court-appointed appraiser as equivalent to the value of the collateral. Due to Article 148 et.al. an under-secured creditor cannot insist on full payment even if its debt exceeds the value of the collateral.

13 Highlights of Civil Rehabilitation Law

Other reform made by the Civil Rehabilitation Law include the 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 Rehabilitation plan can only change rights of unsecured creditors by majority. But a plan is accepted if simple majority of creditors who attended the meeting holding more than one half of total amount of unsecured claims to the debtor accepted the plan. This simple majority requirement is the most generous in the world. The main reason why the CRL mitigated the majority requirement is that governmentally or officially owned financial institutions, who are usually creditors with large amounts of claims, are reluctant to accept plans which impair their claims and stick their conservative manual standards. Apart from an unsecured right, to change a secured creditor's right by a plan requires unanimous consent. When a debtor is insolvent, a court can permit a sale of all or a part of its business without a shareholders' resolution. A rehabilitation plan can also reduce a company's capital without a shareholders' resolution when the debtor is insolvent, but inconsistently, to increase capital a shareholders' resolution cannot be dispensed with. In civil rehabilitation proceeding, a debtor continues as a DIP under the loose supervision of a court appointed supervisor. A trustee may be appointed in rare cases with exceptional circumstances.

14 Debt for equity swaps

Even in civil rehabilitation cases, debt for equity swaps are rarely used. To change a creditor's rights, plans provide for composition and extension mostly. Roughly 50% to 90% of debts are discharged, with the balance will be paid over a three to ten year period.

There are several reasons why DES is not widely used in Japan. One of main reason is the 5% rule under Banking Law and Security Exchange Law which restrict bank ownership more stocks than 5% out of outstanding stocks. The 5% rule was established to prohibit banks from having strong controlling power on business corporations. But the Financial Supervisory Agency and the Security Exchange Surveillance Committee expressed their intention to ease the requirements to permit owning stocks in excess of 5% of outstanding stocks. Another reason why DES is not used is the lack of a secondary market to transact second class stocks in Japan. But RCC plans to create such markets in Japan.

15 Corporate reorganization with strong weapons

The Corporate Reorganization Law, which was modeled after Chapter X of

the former United States Bankruptcy Code of 1898 as amended 1938, enacted in 1951 and amended in 1972, is still in effect. The Corporate Reorganization Law provides a debtor-corporation with strong weapons to reorganize. 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 impairment of secured rights. The Corporate Reorganization Law also suspends proceeding to collect 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.

16 Lack of DIP system in corporate reorganization proceeding

A distinctive feature of Corporate Reorganization Law is that it does not adopt 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 Corporate Reorganization Law provides that managers of every reorganizing debtor corporation must be purged and a court appointed trustee or administrator is vested with all power of managers replacing them. Besides, the absolute priority rule requires that all stocks of a debtor-corporation must be entirely wiped out when the debtor is insolvent. A reorganization plan which impairs creditors' rights must provide for 100% dilution of capital and all rights of the debtor's owner must be diminished completely. In theory, Corporate reorganization proceeding is suitable for rather larger corporations whilst civil rehabilitation proceeding is for middle or smaller size corporation in theory. But even large corporations including Sogo and Mycal filed petitions for civil rehabilitation instead of corporate reorganization proceeding. After the Civil Rehabilitation Law became effective in April 2000, no large corporations except insurance companies, for which Special Reorganization Law for Financial Institutions is applied, has filed a petition for corporate reorganization proceeding. The biggest reason why even large corporations do not file for corporate reorganization proceeding despite of strong weapons vested by the Corporate Reorganization Law may be lack of the DIP system.

17 Reform of Corporate Reorganization Law

Now amendment reformation of the Corporate Reorganization Law is under way and outlines of the draft new Corporate Reorganization Law may be completed before the end of this year. Many changes may be made to the Corporate Reorganization Law. They may include transparency of proceedings, disclosure of information, clear valuation standards for assets and secured rights, mitigation of the majority requirement, expedited procedures, simplified proceeding for filing and fixing of claims, shortening of the payment term for the balance of partly released claims and others. The advisory Committee for Reformation of Corporate Reorganization Law organized by Ministry of Economy and Industry, of which I am the chairman, and the insolvency committees of bar associations strongly recommend amending the provisions regarding power of debtors' managers to adopt a partial DIP system. Our recommendation is that in principle trusteeship may be maintained, but in exceptional cases managers may continue in possession to operate the debtor's business and dispose of its assets. For example, managers who took position to restructure the debtor-corporation after its difficulty replacing old managers or managers whose talent is indispensable to operate its business are not necessarily purged and may remain in their positions. Another proposal to amend the DIP system is that a court may appoint existing executives as a trustee or deputy trustees in some cases. In any event, some change may be made regarding the DIP system. A bill to reform the Corporate Reorganization Law is expected to be passed within the next year.

18 Guidelines for out of court workout

The National Banks Association, Federation of Economic Organizations and other relevant organizations associated with Financial Supervisory Agency, Ministry of Finance, Ministry of Economy and Industry, Nippon Bank and Deposit Insurance Organization established a committee, again with myself as chairman, which introduced "the Guidelines for the Out of Court Workout" on September 19 of this year. The guidelines were drafted referring the "INSOL 8 Principles" for international multi-creditors workout established by INSOL International, the international association of insolvency practitioners. INSOL principles came from the London Approach which developed for multi-banks out-of-court workout on the initiative of the Bank of England. The guidelines were designed to wipe out huge amounts of non-performing loans owed to multiple banks and financial institutions in order to the debtor corporations to restore their viability.

19 Outline of the out of court workout

An outline of the procedure established by the guidelines follows:

A debtor may apply for multi-banks out-of-court workout with major banks which are owed by the debtor huge amounts of debt. Application must be accompanied by financial statements which explain the reasons the debtor came into financial distress and proposal of a reorganization plan. The proposed plan should include business restructuring as well as a debt reorganization plan. After investigation of the financial statements and reorganization plan, if the major banks are persuaded that the statements are accurate and the plan is feasible and reasonable, and the major banks are agreed on the view that there is likelihood that the plan will be accepted by relevant banks whose debts are proposed to be impaired by the plan, then the major banks will issue a notice of “standstill” to all the relevant banks and convene the first meeting of creditors. 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 of the accuracy of financial statements and reasonableness and feasibility of the proposed plan, may be designated. In 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 balance of claims. Before the end of the third month after the first meeting, the second meeting will be held at which all relevant creditors will indicate whether they accept the plan or not. When all creditors whose rights must be changed in order to rehabilitate the debtor consent the proposed plan, then the reorganization plan is accepted and the rights of the relevant creditors will be changed according to the provisions contained in the plan. If a creditor or creditors, whose consent are necessary to rehabilitate the debtor, refuses to agree 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 regular insolvency proceedings.

20 DES by out-of-court workout

DES is also recommended in the guidelines. However, to make DES, easier the assessment of tax and accounting problems on stocks obtained in exchange for debt at face value but with nominal value should be clarified.

The guidelines are designed to manage multi-bank workouts to rehabilitate larger corporations with huge amounts of claims and would be applied only in exceptional cases. Nonetheless, I hope the guidelines are workable to wipe out bad loans as is being urged in order to restore Japanese economic prosperity.

Full English translations of the “Civil Rehabilitation Law”, “Corporate Reorganization Law”, and “Bankruptcy Law” are available at Eibun-Horeisha, Inc. Phone 03(5276)5955, Fax 03(5276)5572

“The Guidelines for out-of-court workout” is available at “<http://www.zenginkyo.or.jp/>”

Reference materials written in English

“Collier International Business Insolvency Guide” published by Matthew Bender
Kodama, The New Japanese Reorganization Procedures, ABI Journal Vol.XX. No.8, page 18

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