Update on Japanese Reorganization: Evolution of Civil Rehabilitation and the Interactive Effects with General Insolvency Practices

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Introduction

In order to cope with the long lasting recession, the government of Japan proposed a series of reforms to the insolvency laws, all of which had been outdated due to the changes in economic realities after their original enactment. Such proposals have resulted in new legislation, which included the introduction of the Civil Rehabilitation Law, adoption of extra-territoriality principles and the introduction of the harmonizing mechanisms in the cross-border insolvency setting, reform of the Corporate Reorganization Law, reform of the Bankruptcy Law (liquidation), and reform of substantive laws commonly applicable to bankruptcy/reorganization proceedings. The whole modernization program is soon to be completed by the reform of the special liquidation proceeding this fall.

Introduction of Civil Rehabilitation Law

The most significant reform was the replacement of the composition (*wagi*) with the newly introduced civil rehabilitation proceeding (*minji saisei*) in 2000. The civil rehabilitation proceeding was designed to provide a more reliable and transparent insolvency proceeding to an ailing company (or an individual or any other form of entity) to restructure the balance sheet and to quickly exit the proceeding, while keeping the easy-to-use nature of *wagi*. For such a goal, the civil rehabilitation law has various unique features. The management remains in possession unless the court is convinced that it is necessary to appoint a trustee to rehabilitate the business of the debtor. To make the process flexible, the secured and priority creditors were left out of the scope of the proceeding, but they can conduct voluntary separate negotiations. The legislation provides various provisions to enable the procedure to proceed speedily. Also, it was made clear that the business and the substantial assets of the debtor may be sold to a purchaser subject to court approval, prior to the plan confirmation, and without the otherwise required shareholders' approval, insofar as the sale is necessary for the rehabilitation of the debtor's business, and the debtor is insolvent (, and accordingly the shareholders did not have any beneficial interest in the debtor's assets). The procedure to sell the debtor's assets free and clear of security interests was also provided.

Practice at the Tokyo District Court

In addition to the law, the Tokyo District Court made local rules with respect to the civil rehabilitation administration, which became the *de facto* standard for the most of the other courts. TDC rules were designed to make the civil rehabilitation proceeding a kind of commodity that everybody can use, by standardizing it in terms of timeline and process. The rules fixed the timetable of the proceeding, irrespective of the size of the cases. The court also standardized the proceeding in other various aspects. For instance, TDC avoided, to the utmost extent, appointment of trustees (but always appointed experienced examiners to have him/her monitor the debtors' administration), issuance of catch-all injunction orders prohibiting all the secured creditors from exercising the security rights, application of the avoidance provisions, and so forth. The underlying theory was that the civil proceeding was for those cases without many complexities or serious disputes, and such cases with exceptional complexities should resort to the corporate reorganization proceeding. Such standardization enhanced the predictability of the civil rehabilitation proceeding, and consequently, the number of cases filed with the court has remarkably increased from about 15% of all the corporate failures with the debts exceeding US$90,000 in 1999, the year immediately preceding the introduction of the civil rehabilitation proceeding, to nearly 40% in 2003.

Evolution of Civil Rehabilitation Practice

Now that the civil rehabilitation proceeding has securely been rooted in the Japanese insolvency practice with drastically increased number of users, the court appears to have become more flexible in liberalizing the administration of each individual case. For example, the appointment of trustees, application of avoidance provisions, and other statutorily provided alternatives are sometimes, although on still very limited occasions, utilized, based upon the necessities of individual cases. It is probably fair to say that the civil rehabilitation proceeding has evolved from introductory sales promotional stage to the next stage, where the quality of the products is more closely focused.

Certainly, the users have become aware of the upside of the proceeding and are now pursuing better use of it. For instance, through the process of the civil rehabilitation, the assignment of business, or allotment of newly issued shares, by a debtor to a third party has become quite common in the civil rehabilitation proceeding. Such scheme helps the debtor or its business quickly exit from the proceeding to regain

upward momentum. The party that purchases the business or subscribes for the shares of a debtor has been customarily called the "sponsor" in practice. Sponsors have been common only in large-scale corporate reorganization cases, but as the civil rehabilitation proceeding has become widely used bu the "ordinary" debtors, the practice to search for sponsors also spread among them.

Interactive Developments

The above changes in practice of civil rehabilitation practice have taken place interactively with the recent innovation developed in the corporate reorganization and other insolvency proceedings. Under the pressure from the market and by the bank creditors, who are in turn under the pressure of regulators, the debtors have become keen to exit from the proceeding promptly. Due to such changes in environment, the trustees are more and more inclined to sell the loans and receivables, and to assign the business, rather than to collect the loans and receivables themselves, or to reorganize the debtors' balance sheet while keeping the business within the debtor. Such attempts on the part of the trustees often conform to the interests of the sponsors which ordinarily wish to collect the return quickly from their investment. Such trends that had already taken place in the corporate reorganization and other insolvency practice have clearly affected the basic design of the civil rehabilitation law and the subsequent actual practices involving the proceeding, and, on the other hand, the evolution of the civil rehabilitation proceeding, which has been demonstrated in a large number of cases, is now undoubtedly affecting the corporate reorganization and other general insolvency practices.

Conclusion

After the long lasted recession, Japanese economy is now picking up rapidly, and the atmosphere in Japanese economic environment has changed significantly. Industrial Revitalization Corporation of Japan, Resolution and Collection Corporation and other quasi-public organizations, as well as a number of newly born "private" private equity funds, are working hard to promote the expedited restructuring of troubled companies. In such circumstances, the modernized insolvency laws and practice have been provided just in time for use. By the help of those tools, ailing companies will reorganize themselves, and the "sponsors" will acquire troubled companies, most efficiently through the recovering process of Japanese economy for the years to come.

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