Corporate Restructuring
Lessons from Experience

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more than $16.6 billion in nonperforming loans. The average asset recovery rate is 32 percent, and the cash recovery rate is approximately 21 percent.

Huarong has four key principles for managing asset resolutions:

- **Be fair, open, and transparent.** Huarong adheres to these principles in order to explain its activities, explain the market-driven approach, and remain an impartial debt collector.
- **Utilize competition to optimize recovery.** Through competition, Huarong maximizes the market pricing of its nonperforming loans. Huarong stimulates competition during the sale of nonperforming loans by bringing more investors to the market, comparing historical internal recovery rates with competitive bids, and using various joint venture deal structures.
- **Employ checks and balances in management.** To avoid technical failings and moral hazard, Huarong has standardized asset resolution procedures within the framework of government rules and regulations. For instance, it has two separate committees for managing nonperforming loans. One committee is responsible for asset evaluation and pricing, while a separate committee is responsible for final approval of the asset resolution strategy. All asset resolutions must follow established approval procedures, which are guided by collective decisionmaking and authorization.
- **Obtain an optimal balance between high recovery and fast resolution.** The four asset management companies have more than $100 billion in nonperforming loans waiting for resolution. The assets vary by type of industry, location, operating status, and availability of collateral. Huarong quickly assesses the different factors that influence asset value, such as quality, timing, market conditions, and legal issues. For example, Huarong takes measures as quickly as possible to collect assets that are likely to depreciate in value. But Huarong manages assets that have future upside potential until a reasonable market value can be obtained.

Since the loans transferred to Huarong from the Industrial and Commercial Bank of China were underwritten years ago and most of the borrowers had already defaulted, a longer holding period usually results in poor asset quality and lower recoverability. In order to increase the speed of asset resolution, Huarong embraced a strategy of bulk sale transactions, beginning in 2001.

Huarong was the first asset management company in China to sell a large portfolio of nonperforming loans to foreign investors. In that transaction, it auctioned a portfolio of $1.5 billion in nonperforming loans to two groups of international investors: a Morgan Stanley-led consortium and Goldman Sachs. More important, it resolved the regulatory and policy issues that had prevented foreign investors from participating in China's nonperforming loan market. When this transaction took place in 2001, it was a pioneering effort in China's financial reform. With the momentum from this first international auction, Huarong launched a second international auction in December 2003, with a portfolio totaling $3 billion in nonperforming loans involving more than 1,500 borrowers in China. The assets were placed into 22 investment units based on geographic location to appeal to both international and domestic investors; 19 international and domestic investors registered to bid in this transaction. To date, Huarong has negotiated a memorandum of understanding on more than half of the 22 units with several international and domestic investors.

In the first half of 2003, Huarong piloted a Quasi-Nonperforming Loan Securitization Program for a portfolio of nonperforming loans with a face value of $1.3 billion. Under the structure, Huarong cooperates with a trust company in forming an asset securitization trust. With the help of a third-party appraiser and a rating firm, the assets are evaluated. Then the assets are stratified into two classes—preferred and subordinate—based on the level of expected future cash flows. Finally, through the trust company, the interest in the preferred class is transferred to investors. It is not a "true" securitization because China still faces numerous implementation challenges, including legal, accounting, and supervisory obstacles, that limit bona fide securitizations, but it has been rewarding to push the securitization concept and creatively manage a transaction within the existing legal framework. Huarong continues to explore the creative aspects of resolution strategies and methodologies with the objective of maximizing the recovery of nonperforming loans.

**Restructuring Approaches Used in Japan, Shinjiro Takagi**

The past decade of slow economic growth has had a severe impact on Japanese financial institutions. 178 financial institutions went bankrupt between April 1992 and March 2003, and nonperforming loans increased
 sharply. According to the National Bankers Association, total nonperforming loans of Japanese banks reached a peak of approximately ¥40 trillion in March 2002, before falling to about ¥28 trillion by September 2003. At the peak, nonperforming loans equaled less than 10 percent of total loans. Nonperforming loans in small and medium-size financial institutions (including regional banks) remain high, although the nonperforming loans of major city banks have fallen. At the end of October 2002, the Japanese government set as a goal the halving of financial institutions’ nonperforming loans by the end of March 2006.

Since publication of a white paper on the economy and finance in October 2003 (which reported slow economic growth), economic news has been encouraging. Exports (particularly to the United States and China) have increased, as has cyclical demand for investment to refurbish machines and facilities. However, it is difficult to say whether the recovery is sustainable. In addition, deflation is expected to continue, although recent statistics indicate some easing of the rate of price declines. Thus the economy could return to sluggish growth, or worse, in the second half of 2004, in the absence of an effective reform of the economic structure.

Japan has taken measures to address the level of nonperforming loans in the banking system, including reforms to the rules governing corporate reorganizations, establishment of the Industrial Revitalization Corporation of Japan, and steps by major banks to improve their workout procedures.

**Improvements in the Legal Structure for Corporate Reorganizations**

Two statutory reorganization proceedings and an out-of-court workout scheme have been established to reorganize distressed business corporations with excessive debts:

- A civil rehabilitation proceeding enacted in 1999 (which abolished the former composition law of 1927), designed for small and middle-size enterprises\(^{13}\)
- A reform of the 1951 corporate reorganization law in December 2002, designed for large corporations\(^{14}\)
- An out-of-court guideline established by the National Bankers Association and other relevant organizations in 2001 referring to the INSOL-8 principles,\(^{15}\)

Major differences between the civil rehabilitation and corporate reorganization concern the rights of secured creditors and the ability of debtors to continue operating the business under reorganization. Under the rules for corporate reorganization, the rights of secured creditors are stayed, and secured claims can be impaired under the reorganization plan, provided it is accepted by a majority. However, under the rules for civil rehabilitation, the rights of secured creditors are neither stayed nor changed without consent of the individual secured creditor (with some exceptions). Also, under corporate reorganizations, incumbent managers are, in principle, to be replaced by a trustee (although the court can appoint an incumbent manager, or managers, as a trustee or deputy trustee). By contrast, under civil rehabilitation, a debtor is not deprived of its right to operate the business and dispose of its assets (again, with some exceptions).

The biggest defect of both types of proceedings is that the rights of unsecured claims of trade creditors and of financial creditors have to be treated equally, in general. The "first-day" order utilized in U.S. Chapter 11 proceedings, which may allow firms to pay the claims of trade creditors in full, is not available. Failure to pay trade credit claims can severely impair the reputation of the firm and reduce the enterprise value of the debtor corporation. Thus, even if all banks agree to a reorganization plan through an out-of-court workout, it may not be practical to convert this agreement to a statutory proceeding (to cram down stubborn minority creditors) without causing trade creditors to accept losses pari passu with the banks. Japanese courts should be more flexible in enforcing the principle of equality of unsecured claims, to take into account the need to maintain trade finance.

The guideline for out-of-court workouts is a useful tool for reorganizing the financial structure of a debtor corporation with excessive debts owed to many banks and other financial institutions at the early stage without impairing the claims of trade creditors. Approximately 20 big cases have been resolved using the guideline so far. The biggest defect of the guideline is that the consent of all financial creditors subject to debt forgiveness or debt-for-equity swaps in the proposed plan is required. No compulsory power exists to induce creditors to accept the plan.

Along with the reform of the law, the practices involved in bankruptcy and reorganization cases are changing dramatically, led by the Tokyo and Osaka district courts. Almost all the courts in Japan are accepting reorganization cases, and the cases are being handled more expeditiously. For example, in 2002 almost 10 times as many civil rehabilitation cases were filed in
the Tokyo district court as composition cases under the former composition law. Previously, judges were reluctant to begin composition and corporate reorganization cases where the prospect of a successful rehabilitation was uncertain.

Corporate reorganization cases are handled more expeditiously now. In most civil cases in Tokyo, a rehabilitation plan is confirmed by court within approximately six months after a petition is filed initiating the case. Corporate reorganization cases, which are larger than civil rehabilitation cases, are dealt with more rapidly as well.

The Industrial Revitalization Corporation of Japan

The Japanese government established the Industrial Revitalization Corporation of Japan (IRCJ) in April 2003. Its purpose is to reduce non-performing and poorly performing loans by purchasing loans owed to banks other than the main bank(s) and by helping large corporations with excessive debt to restore their profitability. IRCJ purchases loans owed by distressed debtor companies that are viable and therefore likely to be successfully rehabilitated. Before deciding to help a troubled debtor corporation, IRCJ and the main bank(s) carefully review the feasibility of the reorganization plan proposed by the corporation. In order to assist them in this program, IRCJ engages suitably experienced and qualified professionals, including consultants, accountants, lawyers, and restructuring advisers. The decision to help includes IRCJ’s declared intention to buy loans at a designated price from banks other than the main bank(s). Creditor banks are legally obliged neither to sell their debts to IRCJ nor to accept a proposed debt restructuring plan that provides for partial release of debts or debt-for-equity swaps.

IRCJ was established to complement efforts by the Resolution and Collection Corporation (RCC) to assist banks to reduce their nonperforming loans. RCC was established several years ago for the express purpose of buying nonperforming and subperforming loans from financial institutions and then collecting the debts purchased. In addition, RCC advises distressed debtors about restructuring their debt and business by means of out-of-court workouts, civil rehabilitation, and corporate reorganization proceedings.

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

IRCJ has Y10 trillion at its disposal (financed under the guarantee by the Japanese government) to purchase nonperforming and poorly performing loans from banks. All purchases must be completed before the end of March 2005, and loans and equity must be resold within three years. IRCJ has a life span of five years at the longest.

In Japan, each corporation traditionally had a “main bank” (or banks) whose function was to fund the corporation’s investment and operations. The main banks used to send their employees to the corporations to serve in controlling positions as chairpersons, presidents, directors, and other high-ranking officers. Those managers and high-ranking employees who did not come from main banks were also likely to lose their “spirit of independence” under the protective umbrella of the main banks. The main banks continue to supply loans, producing excessive exposure, even after secondary banks have eliminated theirs. IRCJ tries to resolve the “main bank problem” by stipulating a debt restructuring plan involving only three parties: IRCJ, the main bank, and the debtor corporation. IRCJ was expected to be the last realistic opportunity that the government had to resolve, once and for all, the seemingly insurmountable problem of nonperforming and poorly performing loans in Japan.

IRCJ uses the following procedures to assist distressed debtors.

First, companies that are struggling due to excessive debt draft a reorganization plan with their main bank(s). Staff of the company and the banks develop this plan with help or backing from certified public accountants and restructuring advisers. The reorganization plan should encompass both financial and business reorganization, the first achieved by using debt forgiveness and debt-for-equity swaps to cut interest-bearing debt and increase or decrease capital and the latter by closing and cutting unprofitable businesses in peripheral divisions, strengthening profitable core divisions, and even splitting up the company, by means of mergers, affiliations, and business transfers. Preparing the draft plan usually takes two to three months and involves more than 20 staff, including bank and company staff and external specialists. Financial advisers provide help, and staff look for sponsors and corporate recovery funds.

Second, the main bank and the company hold preliminary discussions with IRCJ’s professional office. The office uses external sources such as restructuring advisers and follows the advice of members of the IRCJ Commission, as
necessary, to review the accuracy of the financial data and the draft’s validity, feasibility, and economic rationale. Revisions are made, as necessary, and the office calls on the advice of certified public accountants, tax accountants, and lawyers, as necessary. The office also performs a due diligence process to set the appropriate market value for the purchase price of debt. This process requires about 20 staff and a two- or three-month period.

Third, once a reorganization plan with high feasibility is completed, the company and its main bank(s) officially apply to IRCJ for aid. After consulting with the relevant ministers, the IRCJ Commission decides whether to offer revitalization support. Based on this decision, IRCJ makes its own decision on support and distributes the plan to the non-main banks, requesting a temporary stay on collections. IRCJ also asks the banks to decide within a maximum of three months whether to apply for debt purchase or to accept the reorganization plan. The detailed reports prepared by the restructuring advisers and specialists are used by the relevant ministers in their consultation and by the commission in making their decision regarding the prospects for the company’s successful revitalization. In other words, a great deal of preparatory work is done out of sight during the period beginning with the prior consultations and ending with the application for revitalization support. Most plans that do not seem likely to succeed, despite revisions made at the review stage, never make it to the official application stage. IRCJ does not publicly release information on plans that make it to the application stage and are not accepted.

Fourth, with the exception of a few creditors that can be excluded without impeding revitalization, IRCJ purchases the debt when the non-main banks apply for debt purchase or agree to the reorganization plan. IRCJ withdraws from the decision process if it does not gain the cooperation of the necessary financial institutions, and in this case the companies are likely to go through statutory reorganization procedures. IRCJ sells the purchased debt within three years of purchase, and during this time it monitors the progress of the plan with the main bank. Any breakdown in the revitalization process is likely to trigger statutory reorganization procedures.

IRCJ Activities during the First Year

The Industrial Revitalization Corporation of Japan started business operations on May 8, 2003. After intensive due diligence of debtors’ assets and investigation of the feasibility of the draft reorganization plans made by professional staff of IRCJ, the Industrial Revitalization Commission decided to assist the reorganization of the following debtor corporations before the end of January 2004:

- Kyushu Industrial Transportation Corporation, which operates passenger and cargo transportation and other businesses, including travel agencies and hotel operations. Kyushu Industrial Transportation is an unlisted company with approximately 4,700 employees. If it had declared bankruptcy, the adverse impact on the regional industry would have been severe.
- DIA Construction is a condominium developer with about 3,700 employees doing business all over Japan and listed on the Tokyo Stock Market.
- Usui Department Store is a local department store in Koriyama, Fukushima, whose shutdown would have caused a serious decline in the shopping arcade in Koriyama, the biggest city in Fukushima Prefecture.
- Mitsu Mining had been in the coal mining business since 1911 and was the biggest coal mining company in Japan before exiting the business several years ago. Mitsu Mining and its subsidiaries engage in many kinds of business, including trading of coal, production of coke, manufacture of machinery, operation of cement plants, transportation of cargo, and development of land. Mitsu Mining is a listed company with more than 800 employees.
- Meisei Shokai is a trading house for chemicals, electronics, and other products.
- Matsuya Appliances is a chain store with 1,000 employees.
- Tsumasubishi Department Store is located in Tsuru, the capital city of Mie Prefecture. Its closing might have had a severe impact on many retail stores in the city.
- Yagami Medical Supplies is a wholesaler of medical supplies with nearly 200 employees.
- Kimmon Manufacturing is a listed company group and the top manufacturer of meters for natural gas, liquified petroleum gas, and water in Japan, with approximately 2,500 employees.
- Fuji Yugo is a wholesale business of oil and oil products.
- Osaka Marubish is a well-known hotel located just in front of Osaka station.
Journalists criticized the selection because the number of targeted companies was small and the companies were smaller than expected in size. They questioned whether IRCJ could help Japan to regain its prosperity when it was not given the opportunity to reorganize the largest, most influential corporations with excessive debts. The difficulty was that IRCJ could select only those cases requested by the banks. The largest Japanese banks (the main banks) were reluctant to bring large, influential cases to IRCJ because they were concerned about losing control of the valuation process. The main banks tend to assume the largest responsibility for maintaining finance to distressed companies (the smaller banks often refuse to roll over loans when they become due, and the main banks, which may have indirectly controlled the debtor corporations for years, find it difficult to persuade other banks to share losses on a pro rata basis in a workout process based on the out-of-court guidelines) and prefer to keep control over the reorganization process. However, the main banks saw their financial strength deteriorate during the prolonged economic recession and thus have little room left to help corporations with large debts. Banks are gradually changing their attitude toward IRCJ and have brought more cases this year.

**Differences between Asset Management Companies in Foreign Countries and IRCJ**

Several countries have established asset management companies to purchase nonperforming loans of financial institutions. In 1989 the Resolution and Trust Corporation was established in the United States. As a number of savings and loan associations and savings banks, whose main business was housing mortgage loans, went bankrupt as a result of the fall in real estate prices, many nonperforming loans of bankrupt institutions were transferred to the Resolution and Trust Corporation and disposed of. In 1992 and 1993, two asset management companies were established in Sweden, where the amount of nonperforming loans rose when the real estate bubble burst, and two of the four major banks were nationalized after going bankrupt. By taking over the nonperforming loans in each bank, two asset management companies were established. Elsewhere, two successful examples are KAMCO, which was established in Korea, and Danaharta, which was established in Malaysia, both in 1998 in response to the currency crisis in Asia. Asset management companies were also established in Finland, Indonesia, Mexico, the Philippines, Spain, and seven African countries including Ghana, but they are not known to be successful.

The biggest difference between asset management companies in foreign countries and IRCJ is that, in Japan, there is no enforcement power, and financial institutions do not have to bring cases to IRCJ. In the asset management corporations in foreign countries, enforcement is effective, and nonperforming loans must be brought to the asset management companies directly or indirectly. Officials in financial institutions have an obligation to collect debts owed by debtor corporations as much as possible. IRCJ, however, determines whether a revitalization plan is feasible from the viewpoint of a neutral third person and, after inspecting the details, decides whether to support it or not. It is natural that officials of financial institutions are concerned that IRCJ may request a greater haircut than the institution expected. In fact, the staff member in IRCJ who specializes in revitalization not only reduces the cost but also draws up a future plan by proposing a new business model; for this reason, the expected future income is more accurate, and the assessment of the corporation's value is appropriate. Professional staff of IRCJ assume that the requested haircut is even smaller than that of a conservative business plan, but it took a long time for people to understand this fact.

Second, foreign asset management companies sold their purchased assets rapidly using several schemes, including securitization and foreign venture funds, or resold assets after revitalizing debtor corporations whose business was relatively simple, such as real estate developers and hotels. On the contrary, IRCJ does more than revitalization; it also is available for any kind of business, including manufacturing. IRCJ must carry out a difficult task without any compulsory power.

**Establishment of Bank Subsidiaries to Revitalize Debtor Corporations**

The large banks have also taken independent actions to promote restructuring of debtor corporations. After the establishment of IRCJ in May 2003, Mizuho bank group, UFJ bank group, and Sumitomo Mitsui bank group established decentralized bank subsidiaries to revitalize customer debt corporations and affiliates one by one. They established these subsidiaries by making a partnership with investment banks, such as Cerberus, Merrill Lynch, Morgan Stanley, and Goldman Sachs, to tap their expertise in revitalizing businesses.
Mizuho and UFJ established consolidated subsidiaries (as holding companies in the group obtained a majority of the stock), while Goldman Sachs owns 51 percent of the Sumitomo Mitsui affiliate. All of these subsidiaries and affiliates were established to revitalize debtor corporations with nonperforming or poorly performing loans by transferring debts to the specialized subsidiaries. Although the receivables of several thousand companies have been transferred to these affiliates, transfer to a consolidated subsidiary is not a significant off-balance transaction. Still, these special revitalization corporations may assist with the process of conducting due diligence and drafting restructuring plans for debtor corporations, which have a reasonable prospect of restoring their profitability. These subsidiaries establish a "bad bank" to manage the debts, similar to the asset management companies, like Securum and Retriva in Sweden. One of the reasons why mega bank groups create these specialized revitalization corporations might be to exercise their own banks' control and initiative in disposing of nonperforming loans without involving IRCJ. Moreover, the debtor corporations might benefit from loans to maintain operations.

Care must be taken that affiliates of the main banks pay sufficient attention to debtors' profitability and cash flow. The negotiation of restructuring plans between the debtor corporation and its main banks can be difficult. The debtor may be forced into agreeing to a restructuring plan that fails to restore financial viability. Involving a neutral third party, like IRCJ, can be helpful in reaching agreement on a sustainable plan. Reaching such an agreement is in the interest of the bank as well, to avoid having to provide additional financial support or incur further losses.

Human Resources for Corporate Restructuring

Japan might yet be seen as having effective reorganization laws and out-of-court solutions as a result of the enactment of an effective civil rehabilitation law, corporate reorganization reform law, and out-of-court workout guidelines. IRCJ and RCC may be good schemes to restore the Japanese economy. Japan now has effective tools to reorganize troubled businesses. However, having the right tools in place is not enough. Japan also needs highly skilled human resources—that is, restructuring advisers and turnaround managers, who are capable of reconstructing and regenerating the business of troubled corporations. The past few years have seen the establishment of organizations, including the Japanese Association for Business Recovery, the Education Center for Restructuring Advisers, and Japanese Association of Turnaround Professionals, to foster, educate, and train more specialists in the field of insolvency and business recovery.

Revolutionary cultural changes are required to restore the Japanese economy. In January 2003, the Ministry of Economy, Trade, and Industry proposed guidelines to restore the health of troubled businesses, based on the advice of a committee organized for that purpose. Among other things, the guidelines include proposals to abandon the main bank system and amend the life-long employment system, which had been instituted to build up company loyalty but impeded outside monitoring.

Conclusions

This review of the experience of asset management companies reveals common principles that were central to their success. First, asset management companies need effective policies and procedures for the disposal of assets. These processes must be transparent and designed within the framework of appropriate governance structures. Ensuring that they are short-lived agencies helps to establish the right incentives for rapid disposal of assets and for corporate reorganizations that address underlying problems.

Second, time is of the essence. Asset management companies are rarely in a position to manage the ongoing business operations of distressed corporations. Without effective management, assets will deteriorate due to lack of maintenance; lack of employee, supplier, and customer commitment; and inability to respond to changes in the business environment.

Third, asset management companies must acquire assets at a realistic price and be prepared to dispose of assets at market prices, without regard to historical cost. If asset management companies purchase distressed assets at book value (for example, to assist in the recapitalization of the banks), then their managers must not be held accountable for losses relative to this (inflated) purchase price.

Fourth, asset management companies should engage the private sector in the process of asset disposition. The papers presented in this chapter describe innovative measures by Korean and Chinese asset management companies to use private expertise, for example, through joint ventures with investment banks.
Finally, asset management companies need to be flexible. No single financial technique is appropriate for each situation, and a menu of instruments is necessary to deal with distressed corporations.

Appendix 6.1: Civil Rehabilitation Proceeding in Japan

The civil rehabilitation law was enacted to cure the defects of the composition law. According to the composition law, a secured creditor was 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 the part of the secured debt that 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 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 determines the amount, based on the assessment made by a court-appointed appraiser. Due to this provision, an unsecured 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 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, in order to alter the rights of secured creditors, 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 6.2: Corporate Reorganization Proceeding in Japan

The corporate reorganization law was modeled after the old U.S. 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 a proceeding, and a reorganization plan that is accepted by majority can alter the rights of secured creditors. When the commencement order is given to open a corporate reorganization proceeding, government organizations are stayed from collecting even sovereign debts. Moreover, a reorganization may be exempts from various provisions of the commercial code that would otherwise govern the debtor corporation, such as requirements concerning the reduction of capital, the issue of new shares, the sale of the debtor's business, and the merger and formation of new corporations.

A distinctive feature of the earlier corporate reorganization law is that it did not adopt a U.S.-style debtor-in-possession (DIP) system. On 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. There were further differences. For instance, unlike the former U.S. 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 be 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, while the civil rehabilitation proceeding was better for middle- or smaller-size 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, a court might appoint the turnaround managers as trustees 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 prearranged corporate reorganization proceeding will be used far more widely in Japan now that the new corporate reorganization reform law has come into effect in April 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 the 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 half of the total amount of unsecured claims, a plan that provides for deferred payments 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.

Appendix 6.3: Out-of-Court Workout in Japan

The National Bankers Association, Federation of Economic Organizations, and other relevant organizations associated with the Financial Services Agency, the Ministry of Finance, the Ministry of Economy, Trade, and Industry, the Bank of Japan, and the Deposit Insurance Corporation established a committee, which introduced the Guidelines for the Out-of-Court Workout. The guideline, which makes reference to the INSOL-8 principles for international multi-creditors, was designed to clear out the huge number of nonperforming loans owed to multiple banks and financial institutions and to restore the debtor corporations to viability.

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

At the first meeting of creditors, the unanimous consent of the creditors must be obtained to continue the standstill period. If they all agree, then a creditor committee may be elected. The committee can designate professionals (including lawyers and accountants) to examine the accuracy of financial statements and the reasonableness and feasibility of the proposed reorganization plan. During the standstill period, the relevant creditors should refrain from any collection efforts, enforcement or realization of secured rights, or improvement of their exposure to other relevant banks and must maintain the original balance of their claims. Before the end of the third month after the first meeting, a second meeting must be held at which all relevant creditors must indicate whether they accept the plan or not. If all creditors whose rights will be affected by the debtor's rehabilitation consent to the proposed plan, the reorganization plan can proceed, and the rights of the relevant creditors will be amended according to the provisions contained in the plan. If one or more of the creditors refuses to agree to the plan, then the out-of-court workout procedure is terminated. The debtor must decide whether to file a petition with a court to begin statutory insolvency proceedings.

The guideline is designed to facilitate multibank workouts to rehabilitate larger corporations burdened with huge amounts of claims and applies only in exceptional cases. Therefore, contrary to the INSOL-8 principles, the Japanese guideline specifies the requirements for a business restructuring plan, which can become part of any proposed plan. If the debtor has a negative net worth, the plan must eliminate this problem within approximately three years. If the debtor has a net loss, the plan must indicate how that loss will be transformed into a profit within the three-year period. The plan should provide that the interests of the debtor's controlling shareholders should, in principle, be divested, and the proportional interest of the existing shareholders should be reduced or eliminated altogether through a capital reduction and subsequent capital increase. The plan should, in principle, also require that the debtor's present managers retire on the creditors' acceptance of the proposed plan.

Many practitioners have criticized the arrangements under the guideline, contending that the requirements are too severe. In contrast, the Japanese Federation of Economic Organizations supports the rigid requirements included in the guideline, because members would like to resolve excess competition in certain industries by reducing the number of poorly performing companies in those segments.
By the end of 2003, more than 20 corporations had been reorganized through an out-of-court workout using the guideline. The practicing committee of the guideline discussed how to make the guideline more popular, including allowing for some reasonable exceptions. The guideline is a good tool for reorganizing the financial structure of a debtor with excessive debts at an early stage without impairing debts owed to trade creditors. But to obtain the unanimous consent of all relevant financial institutions is almost impossible.

Notes

1. Danamodal was formed to recapitalize banks.
2. Special administrators are appointed only if Danaharta is satisfied that the borrower is unable or is likely to be unable to pay its debts, the survival of the borrower as a going concern is threatened, or a formal restructuring of the debts of the borrower would be more advantageous than a winding-up. All appointments of special administrators are approved by the Oversight Committee.
3. The publication outlines the following loan restructuring principles: a proportionately larger haircut for shareholders than for creditors, fair treatment to secured and unsecured creditors, no dilution of inadequate security, only one opportunity for restructuring, and the requirement that borrowers work for lenders. It also details the following guidelines: maximize the overall recovery value and return to Danaharta, minimize the involvement of taxpayers’ money, ensure the fair treatment of all stakeholders, and use, where appropriate, Danaharta’s special powers to leverage and benefit the banking system as a whole.
4. Asset restructuring involves the sale of business or collateral and applies the principles of competitive bidding, the preservation and enhancement of the value of the business or collateral, and the orderly disposition of assets through a transparent process.
5. RM 1 = US$0.263.
6. Corporate loans under court restructuring are loans to companies under court receivership or composition proceedings, whether they are secured or unsecured. Corporate loans under workout are loans to companies under private workout programs, which have been agreed by creditors for restructuring distressed assets.
7. The Korean government supported debt-to-equity swaps by a special law (the Corporate Restructuring Promotion Act). Debt-to-equity swaps were exempt from limitations on banks’ stock purchase limits. Similarly, by commercial law, the price of the new issue must be higher than par (5,000 won). The new issue price under par value is up to the court’s approval. In the case of debt-to-equity swaps, shareholders’ approval was sufficient and did not require court approval. Debt-to-equity swaps and convertible debt were used as well in corporate reorganization and workouts. Debt-to-equity swaps involved considerable risks for the creditor. The converted equity lost value if the debtor was liquidated, and values and controls were diluted if there was a subsequent swap.
8. By extended debt maturity, the present value of debt was reduced and became an effective debt write-off. During a grace period, only interest was repaid.
9. As a workout vehicle, corporate restructuring vehicles need to have a simple creditor status, meaning a single debtor rather than a portfolio.
10. Corporate restructuring vehicles are special-purpose vehicles that assist the restructuring process by relieving banks of the burden of managing nonperforming assets and by improving the efficiency of the process.
11. The volume of these equities held on the books of banks has been growing since the workout initiatives were introduced.
12. Accounting forbearance was discussed but not introduced in the legislation.
13. See appendix 6.1 for the detail.
14. See appendix 6.2 for the detail.
15. See appendix 6.3 for the detail.
16. Although the main bank system was pervasive for a long time in Japan, the financial environment is changing. Corporations with a good financial reputation are able to raise funds in the capital market and no longer rely on the main banks. Nevertheless, corporations that are unable to raise money from the market have continued to rely on the main banks.