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Quasi-Governmental Special Purpose Vehicle to Restructure Ailing Business Corporations in Extraordinary Times: Proposal Based on Japan's Experiences

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This is an amended paper based on presentations made at the Extraordinary Restructuring Solutions For Extraordinary Times session of the Annual Conference of the International Insolvency Institute (III) held in New York on 19 June 2009, and the National Experiences With Out-of-Court Restructuring (OOCR) session of the 9th Forum on Asian Insolvency Reform (FAIR) 2009 held in Bangkok on 18 July 2009.

Introduction

The downturn of the real economy may bottom out in the near future, but its recovery may be 'L'-shaped rather than 'V'-shaped. Many business corporations may have to resolve excess capacity problems to match reduced consumer demands. Compared to declining gross sales, some parts of existing debts owed by many business corporations may become excessive. Without revitalising these business corporations by means of debt restructuring, another economic crisis may occur.

Insolvency law reforms and expedited practice in Japan

Significant changes in reorganisation occurred in Japan between the late 1990s and early 2000s. The Civil Rehabilitation Law was enacted in 1999 to replace the previous Composition Law of 1922. This was followed by a series of changes in bankruptcy related laws, such as the enactment of the new Law for Recognition and Assistance for Foreign Insolvency Proceedings adopting UNCITRAL Model Law in 2000; the enactment of the new Corporate Reorganisation Law (CRL) in 2002 replacing the previous CRL of 1952; the enactment of the new Bankruptcy Law (BL) in 2004 replacing the previous BL of 1922; and the enactment of the new Company Law which includes many new tools to facilitate reorganisation of healthy and distressed business corporations in 2005. The new Company Law also revised provisions regarding the Special Liquidation Proceeding. Chapter 4 of the Revised Act on Special

Measures for Industrial Revitalisation (RASMIR) of 2007 enabled the establishment of the Business Reorganisation ADR mentioned below.

Along with the above legal reforms, Japanese courts have opened their gates to rehabilitation and reorganisation cases that are being handled more speedily. The handling of bankruptcy cases has also been speeded up. In civil rehabilitation cases in Tokyo, a plan will be generally confirmed by the court about six months after the filing of a petition to open the case. In corporate reorganisation cases, which are generally larger in size than civil rehabilitation cases, a plan will be generally confirmed within one year after commencement of the case.

In the past ten years, a lot of private equity funds to target distressed companies were created and advisory/consulting/turnaround firms specialising in rehabilitating distressed businesses became widespread in Japan.

The Industrial Revitalisation Corporation of Japan (IRCJ)

The IRCJ was created in May 2003 by the Japanese Government to dispose of non- and poorly performing loans as well as to revitalise ailing companies with excessive debts to help overcome prolonged recession that lasted over ten years.

The IRCJ rescued 41 enterprise groups consisting of nearly 200 companies by March 2005 and dissolved itself in March 2007, one year earlier than was scheduled.

Upon receiving an application made by a company and its main bank holding the biggest exposure to the debtor company, the IRCJ conducted due diligence and developed operational and financial restructuring plans. The IRCJ then proposed to buy debts owed to financial institutions or requested acceptance of the debt restructuring plan by means of partial debt forgiveness and/or debt-equity swaps as stipulated by the proposed plan. After the solicitation made by the IRCJ, most financial creditors either sold their debts to

the IRCJ or accepted the plan. Outstanding stocks were wiped out or diluted in most cases, and the IRCJ infused new equity into the company. The IRCJ sent hands-on turnaround managers replacing incumbent managers and operated the debtors' business.

Within one or two years of the opening of each case, the IRCJ sold the purchased debts and/or equities to new owners by means of M&A.

The IRCJ was financed by government guarantee and successfully closed its business with a profit.

Newly started Business Reorganisation Alternative Dispute Resolution (BRADR)

The Guidelines of the Out-of-Court Workout were established in 2001 in Japan with reference to the London Approach and INSOL 8 Principles by the Committee, organised by the National Bankers' Association and others, for which I served as a chair. More than 40 large corporations were reorganised using the Guidelines. The Business Reorganisation ADR was created by the Japanese Association of Turnaround Professionals (JATP) last November with the approval of Minister of Economy, Industry and Trade and Minister of Justice based on the aforementioned RASMIR. Turnaround experts, who were appointed in each case by the selection committee of JATP that is chaired by myself, presides over workouts using fair rules which are similar to the Guidelines. The BRADR started business this March and has been handling several big reorganisation cases, including public companies. The government-owned organisations may guarantee a substantial part of debts owed by a debtor during the workout process as DIP financing. In cases where unanimous consent could not be reached, the debtor may file a court-administered mediation proceeding and the court may issue an order which recommends the holdout creditors accept the proposed plan with possible amendments. If the creditors do not object to the order within two weeks, the order becomes effective to bind the relevant parties. If the creditors object to the order, the debtor should convert the case to a statutory reorganisation proceeding in which the proposed plan may be treated as a pre-negotiated plan.

Creation of Enterprises Turnaround Initiative Corporation of Japan (ETICJ)

The bill to establish a new quasi-governmental corporation to assist revitalisation of ailing companies became law on 19 June 2009 and the new corporation is expected to be created before the end of September. The new law is similar to the IRCJ law with minor amendments. The main companies targeted are medium-sized corporations whose failure may

have an adverse impact on local economies. Other small and medium-sized companies can be reorganised assisted by SMEs Turnaround Associations which were created in 47 prefectures in 2003, the year in which the IRCJ was created. Larger corporations could be reorganised by expedited workout without the purchase of debts by the public sector, possibly assisted by the aforementioned BRADR. For the purpose of infusing new money into distressed SMEs, there are regional funds which are created to help revitalise local enterprises in each prefecture as well as private equity funds which are specialised for investment in distressed companies. In addition to the new ETICJ, we have several options to restructure business corporations in Japan such as: expedited statutory reorganisation procedures supervised by courts; the aforementioned new BRADR; SME Turnaround Associations; the Enterprises Restructuring Group of the Resolution & Collection Corporation; local restructuring funds in every 47 prefectures; and private equity funds specialised in investing in distressed corporations. This competitive environment might have contributed to improve professional expertise to restructure distressed corporations in Japan.

Larger corporations are to be saved through provision of loans and/or infusion of equities by the Development Bank of Japan under the guarantee of the Japanese Government, according to the special emergent legislation.

Proposal to create a quasi-governmental organisation to revitalise ailing corporations

In order to save ailing business corporations that are socially useful, providing liquidity and assisting their restructuring effort is essential to restore the health of the national economy. To serve that purpose, it could be effective to establish a government-backed special purpose corporation operated by private sector professionals who possess rich experience and specialised expertise in reorganising troubled companies in each country. The corporation would administer the following workout processes in the following stages:

- 1 Application made by ailing companies which are useful for the national economy.
- 2 After preliminary due diligence, a decision whether to help the applicant is to be made.
- 3 Notice of standstill or stay to financial creditors (i.e., moratorium).
- 4 Facilitating provision of finance by financial institutions under the guarantee of Governmental agencies.
- 5 Financial and business due diligence conducted by professional experts.

- 6 Developing business and financial restructuring plans for the companies assisted by professional experts.
- 7 Soliciting and persuading creditors and other affected parties to accept the proposed restructuring plans.
- 8 Execution of the accepted plans.
- 9 In some cases purchasing debts and infusion of capital may be useful.

Independence from political interference and freedom from corruption is not only critical but also essential for the effectiveness of the organisation and its officers.

The staff must consist of professional experts recruited from the private sector, not government bureaucrats.

Appendix

Emergent Proposal to Create Quasi-Governmental Organisations to Rescue and Revitalise Ailing Corporations

Purpose

Due to the unprecedented devastating drop in consumer demand, a lot of business corporations are suffering from severe financial difficulties, such as cash shortage problem caused by negative cash flow and incurring excessive amount of debts compared to their down-sized operation. To save such ailing business corporations that are useful socially, providing liquidity and assisting their restructuring effort is essential to restore the health of the national economy. To tackle these matters in a limited period of time, it would be effective to establish a government-backed special purpose corporation operated by private sector professionals who possess a rich experience and specialised expertise in reorganising troubled companies in each country.

Organisation and outline of the process

The corporation should be formed on the initiative of the national government and capitalised by the public sector, including the government, with a limited life of five years (i.e., to be formed as a sunset corporation), and operated by board members, executives and staff recruited from the private sector who have special expertise in restructuring troubled businesses. Board members and executives should be appointed by the government and must be politically independent.

And staff with advanced skill in turnaround management is essential. Most team leaders of the IRCJ have an MBA degree in business schools from the USA or UK.

Japan is not yet in a situation where my proposed solution above is in critical need. But some countries which are struggling with the severe economic downturn need a scheme for expedited workout solution assisted by international organisations. We need to pay attention to the point that credit default swaps may be an obstacle to successful workout. In addition, obtaining unanimous consent would be very difficult in those countries where an out-of-court workout solution is not usually used. The majority rule involving the courts or other appropriate authorities may be helpful in these situations.

The corporation would administer the following workout processes in the following stages:

- 1 Selecting target ailing companies which are useful to the national economy.
- 2 Notice of standstill or stay to financial creditors (i.e., moratorium).
- 3 Facilitating provision of finance by financial institutions under the guarantee of governmental agencies.
- 4 Financial and business due diligence conducted by professional experts.
- 5 Drafting business and financial restructuring plans for the companies assisted by professional experts.
- 6 Soliciting and persuading creditors and other affected parties to accept the proposed restructuring plans.
- 7 Execution of the accepted plans.

Rules

- 1 Troubled companies (TC) are able to apply for assistance from the corporation (CO).
- 2 TC must be economically useful for the country and its people.
- 3 CO should help only those companies whose continued operation is beneficial for the country and its people.
- 4 Upon the decision by the Board of Directors (BOD), the CO undertakes preliminary due diligence (DD) research on the TC's usefulness, possibility of survival, financial status and other related matters, within two weeks after the filing of the application.

- 5 Within a few days after the completion of the DD, the BOD must decide whether the CO will assist the TC or not.
- 6 Once the assisting decision (AD) is made by the BOD, the CO issues a notice of standstill (NS) immediately by fax or other appropriate device to all relevant creditors of the CO.
- 7 The relevant creditors (RCs) include banks, financial institutions, bond holders, indenture trustees and other financial creditors with whom the CO has debts. Trade creditors with huge claims, whose participation is indispensable for sustainable restructuring of the CO, could be included in the RC category.
- 8 Upon issuance of the NS, all RCs are prohibited from taking any collection actions against the CO and their co-debtors, including guarantors, to maintain their exposure as of the issuing date of the NS. Prohibitions include:
 - 1 any acts to collect or recover a claim,
 - 2 commencement or continuation of judicial or administrative action or proceeding,
 - 3 enforcement of a judgment,
 - 4 obtainment or repossession of property,
 - 5 realisation of secured rights,
 - 6 any acts to create, perfect or enforce any lien or secured rights,
 - 7 setoff of any debts.
- 9 Within a week after the NS, the CO and the TC must convene a creditors' meeting and report the present status of the TC.
- 10 Within two months after the NS, the CO should study the past, present and future financial and operational status of the TC under DD aided by external professional experts, and the TC must draft operational and financial reorganisation Plans assisted by the CO and other professional experts.
- 11 When the TC is loss making and/or insolvent (i.e., liability exceeds assets), the Plans must provide appropriate means to turn to profitability and dissolve insolvency within three years.
- 12 The Plans must be equal, fair, equitable and feasible.
- 13 When the Plans provide for debt forgiveness and/or debt-equity swap, claims should be treated on *pro rata* and/or *pari passu* principles.
- 14 When the Plans provide for impairment of claims by any means, equity of the TC, if any, should be wiped out or diluted.
- 15 Should incumbent managers be responsible for the TC's difficulty, the Plans must provide for the replacement of the management of the TC.
- 16 Within two weeks after the Plans are completed and the BOD are satisfied that the Plans meet the abovementioned requirements, the BOD should approve the Plans.
- 17 Within one month after the approval of the Plans by the BOD, the TC and the CO should solicit and persuade the RC to accept the Plans.
- 18 Within one month after the acceptance of the Plans, the TC must execute and consummate the Plans.
- 19 Upon the substantial consummation (SC) of the Plans, the process is completed.
- 20 Anytime before the completion of the process, the BOD can cancel the AD if the Plan does not meet the aforementioned criteria or unforeseeable changes in other circumstances occur.
- 21 During the period that begins with the AD and ends with the SC or the abovementioned cancellation, the CO may ask financial institutions to provide financing to the TC to defray its overhead costs under the guarantee of the governmental agency.
- 22 The CO is entitled to purchase and sell the TC's debts and equities. The CO is also entitled to obtain the TC's equities by other means and dispose of them.
- 23 When the case is converted to statutory insolvency proceedings, the loan debts owed to financial institutions by the TC that were provided under the aforementioned Rule 21 will be treated as priority debts in the same way as administration expenses.