Expedited Debt Restructuring
An International Comparative Analysis

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Chapter 11
Japan

Expedited Corporate Debt Restructuring in Japan

Shinjiro Takagi
### ACRONYMS, ABBREVIATIONS & DEFINED TERMS

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### I. OVERVIEW OF EXPEDITED CORPORATE DEBT RESTRUCTURING PROCEDURES IN JAPAN

There are three schemes available in Japan to address expedite corporate debt restructuring on an expedited basis: one out-of-court workout scheme; and, two statutory reorganization proceedings. These are:

1. The Guideline for Out-Of-Court Workout established by the National Bankers' Association and other relevant organizations in 2001 (the 'Guideline').
2. A Civil Rehabilitation proceeding under the Civil Rehabilitation Law (Minji Jihada) enacted in 1999 ('Civil RL'), which abolished the former Composition Law of 1957; and,
3. A Corporate Reorganization proceeding under the Corporation Reorganization Law (Kaihatsu Kosei-ho) enacted in 1951, which was the subject of major reform in 2002 ('Co. RL').

### A. OUT-OF-COURT WORKOUT

The Guideline is a useful tool to facilitate the reorganization of the financial structure of a corporation with excessive debts owed to banks and other financial creditors at an early stage, without impairing trade creditors' claims. A number of large-size cases have been resolved by using the Guideline. The most significant deficiency of the Guideline is that it requires unanimous consents from all creditors to obtain a debt forgiveness and/or a debt equity swap in the proposed restructuring plan, while no compulsory power exists to induce dissenting creditors to accept the plan. Contrary to the INSOL 8 Principles, the Guideline specifies not only the procedural matters, but also the substantial requirements such as fair and equality rules. Since the Guideline provides for rather rigid requirements, such as the replacement of managers and owners when creditors' rights are generally impaired, it is used to reorganize relatively large corporations. Informal, out-of-court workout proceedings for small and medium-sized corporations are to some extent less strict in applying the above procedures and requirements, while referencing the Guideline.

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1. An English version of the Guideline for Out-Of-Court Workout is attached as Annex 1 to this chapter.
3. Guideline cases include Seibu Department Stores, Nippon Yakin Kogyo and Hazama Construction.
5. See section 2(1) of the Guidelines.
B. STATUTORY REORGANIZATION PROCEEDINGS

Under the Japanese law, there are two statutory reorganization procedures: (1) Civil Rehabilitation; and, (2) Corporate Reorganization.

Recent reforms of relevant insolvency laws have changed the practices involved in reorganization cases dramatically. This has led the Japanese courts to open their gates wider to reorganization cases, and cases are being handled more expeditiously. For example, the number of civil rehabilitation cases filed in the Tokyo district court in 2002 was almost ten times higher than the composition cases under the former Composition Law. Previously, judges were rather reluctant to begin composition and corporate reorganization cases where the prospects for successful rehabilitation were uncertain.

Today, reorganization cases are being handled expeditiously under the Civil RL. In general, a plan is confirmed by the court within approximately six months after the initial filing. In corporate reorganization cases which are generally larger than civil rehabilitation cases, a plan is confirmed within about one year after the adjudication to open the case.

A sale of a going-concern business operations is conducted at a very early stage of a special liquidation proceeding based on the Company Law and the Bankruptcy Law, may constitute a substantial reorganization of viable businesses.

C. CIVIL REHABILITATION AND CORPORATE REORGANIZATION PROCEEDINGS

The major differences between the civil rehabilitation and corporate reorganization proceedings are the following:

1. The civil rehabilitation proceeding is designed — in general — to rehabilitate small and medium sized enterprises (SMEs) whereas the corporate reorganization proceeding is usually used to reorganize larger undertakings.
2. In a corporate reorganization cases, the rights of secured creditors are stayed and secured claims can be altered under a corporate reorganization plan which is accepted by a majority of creditors; on the contrary, in a civil rehabilitation case, secured creditors’ rights can either be stayed or altered without consent of individual secured creditors (with some exceptions as explained later).
3. In a civil rehabilitation proceeding, in principle, a debtor is not deprived of its right to operate the business and dispose of its assets, whereas in a corporate reorganization case, incumbent managers are replaced by a trustee. The Civil RL, however, provides that a court is able to appoint an incumbent manager as a trustee or deputy trustee in some cases where a debtor in possession (DIP) scheme is adopted.

Japan

A problem common to both reorganization proceedings, i.e. civil and corporate reorganizations, is the question about the application of equality principle regarding the rights of unsecured trade creditors and those of unsecured claims of financial creditors (including over-secured part of claims owed to creditors). Even in cases where almost all financial creditors have agreed to an out-of-court workout (that requested financial creditors to partly forgive their loans and/or accept debt/equity swaps before filing a petition to commence a statutory proceeding), the subsequent conversion of the case to a statutory reorganization proceedings with an intention to cram-down a minority of dissenting creditors (by taking advantage of a majority rule available in the court-supervised statutory proceedings) involves some risks, since trade creditors’ rights cannot be left unimpaired. This then may cause a possible deterioration of business reputation and any erosion of enterprise value of the debtor corporation. The Japanese courts should take a more flexible attitude toward applying the principle of equality paying due respect to the economic rationality.

D. THE RESOLUTION & COLLECTION CORPORATION

The Resolution & Collection Corporation ("RCC") was established by the Japanese government in 1996 to take over loan assets owned by bankrupt housing loan companies. It was subsequently reformed in 1998, when another special purpose company which was established in 1995 to buy loan assets of bankrupt financial institutions was merged (by absorption) to the RCC, for the express purpose of buying non and sub-performing loans ("NPLs") from financial institutions including solvent banks and collecting these debts in order to accelerate the removal of significant amount of NPLs from the banks’ balance sheet. The RCC has not only tried to enforce actions against bad and doubtful debts, but it also has actively advised distressed debtors in restructuring their debts and businesses by means of out-of-court workouts and statutory reorganization proceedings (i.e. civil rehabilitation and corporate reorganization proceedings). Although the statutory provisions that created the RCC established that the timeframe in which it can perform purchases of NPLs expires on March 2005, the RCC continues to help restructuring nonviable loan assets entrusted by financial institutions but without having the facility to purchase NPLs anymore.

E. THE INDUSTRIAL REVITALIZATION CORPORATION

In addition to the RCC, in April 2003 the Japanese government established the Industrial Revitalization Corporation of Japan ("IRCJ"). Its purpose was to accelerate the disposal of NPLs and revitalize corporations with excessive debt by restoring their profitability. In contrast to the RCC, the IRCJ was expected to purchase only those loans owed by distressed debtor companies that are viable and therefore likely to be successfully rehabilitated. Before making a decision to help a troubled debtor corporation, the IRCJ and the "main creditor banks" will

6. Civil Rehabilitation Law of 1999, Law for Recognition and Assistance to Foreign Insolvency Proceedings of 2000, New Corporate Reorganization Law of 2002, New Bankruptcy Law of 2004 and New Company Law of 2006 were enacted and English translations of these statutes can be ordered by e-mail at 'order@eha.or.jp'.

7. Main banks is the banks with the largest credit exposure to the debtor, cf. Article 2(2) of the Guidelines regarding ‘Major Creditor’.
carefully review the feasibility of the reorganization plan proposed by a heavily indebted and distressed corporation. The IRCJ has engaged suitably experienced and qualified professionals, including consultants, accountants, lawyers and restructuring advisors to operate its business. The decision to help distressed companies includes the declaration of the IRCJ's intention to buy the loans at the price designated by the IRCJ from financial institutions other than the 'main creditor banks' that hold the most substantial exposure. Financial creditors are neither legally obliged to sell their claims to the IRCJ nor to accept the proposed debt restructuring plan that provides for a partial debt waiver and/or debt equity swap. In addition to buying loan assets, the IRCJ has infused new money into the assisted companies in the form of capital or new loans. Significant dilutions were involved to wipe out the rights of former owners of the companies. The IRCJ was authorized to use up to JPY 10 trillion to purchase NPLs from banks and/or infuse new money into debtor companies. These funds were obtained in the short-term money market with the Japanese governmental guarantee.

By the end of March 2005, the IRCJ has helped 41 corporate groups (the total number of assisted companies amounts 197). The IRCJ must sell all the purchased assets, including restructured debts and equity, within three years from the date of purchase of the assets. Managers of the debtor companies were replaced by managers appointed by the new owners or the IRCJ. In some cases, the IRCJ has sent turnaround managers to debtor companies to revitalize their businesses operations. The IRCJ is a corporation with a limited life of five years at the maximum. It is now becoming likely that the IRCJ will successfully conclude its operations without incurring any losses before the end of the fiscal year 2006.

F. THE SMALL AND MEDIUM-SIZED ENTERPRISES TURNAROUND COMMITTEES

In 2003, under the initiative of the Ministry of Economy, Trade and Industries ("METI"), the SME Turnaround Committees were created in all 47 municipalities and prefectures in Japan for the purpose of assisting debt restructuring of small and medium-sized enterprises. Professional staff at the SME Turnaround Committees are advising ailing SMEs with excessive debts on how to turn around their business operations and draft debt restructuring plans. The SME Turnaround Committees have also been taking a role of an intermediary between the debtor and financial creditors to make the drafted restructuring plan become feasible. By the end of 2005, the committees have advised and assisted more than 6,000 enterprises.

G. PRIVATE EQUITY FUNDS

Since 2000, inspired by activities of some foreign-originated funds, a lot of private equity funds have been created. They have been purchasing debt and equity of distressed corporations or acquiring debtors' businesses. They are restructuring the debt of acquired companies by means of out-of-court workouts or statutory reorganization proceedings, and revitalizing their business operations to restore their profitability. The number of M&As, including those not involving debt restructurings, has doubled between 1999 and 2004 and is still increasing year after year.

II. OUT-OF-COURT WORKOUT RESTRUCTURING

A. ESTABLISHMENT OF THE GUIDELINE FOR OUT-OF-COURT WORKOUT

The National Bankers Association, the Federation of Managers of Business Corporations, and other relevant organizations associated with the Financial Services Agency, Ministry of Finance, METI, Bank of Japan and the Deposit Insurance Corporation, created a committee that established the Guideline for Out-of-Court Workout in September 2001. The Guideline that references the INSOL 8 principles for international multi-creditors' workout was designed to clear out the immense amount of NPLs owed to multiple banks and financial institutions and restore the viability of debtor corporations.

B. PROCESS OF OUT-OF-COURT WORKOUT BASED ON THE GUIDELINE

The procedure established by the Guideline begins with the debtor corporation applying together with its "main creditor bank" for a multi-creditor out-of-court workout in cases where a number of financial creditors possess lending

9. The Guidelines refer to "Major Creditors". This term is defined in Articles 2(2) as "usually multiple financial institutions, including the banks with the largest credit exposure to the debtor."
exposures. The application must be accompanied by documents that describe the causes of the debtor becoming financially distressed and a proposed reorganization plan. The proposal should include not only a business reorganization plan but also a debt restructuring plan. The 'main creditor bank' then investigates the documents and the reorganization plan to determine whether the descriptions and statements are accurate and the proposed plan is both feasible and reasonable. If the 'main creditor bank' determines that the criteria has been met and agrees that the plan can be acceptable to all other non-main banks whose debts are to be forgiven under the reorganization plan, it will issue a notice of 'standstill' to all other 'relevant financial creditors' and convene the first meeting of creditors.

The 'relevant creditors' are those creditors whose claims are requested to be waived in the proposed plan. They usually consist of banks and other financial institutions, but trade creditors with significant exposures may be included in the category of 'relevant creditors' when the waiver of their trade claims is necessary to accomplish effective debt restructuring. The meeting must be held within two weeks after the notice of standstill was issued.

At the first meeting of creditors, an unanimous consent among creditors must be obtained to extend the standstill period. If they all agree, then a creditors' committee may be elected. The committee can designate professionals (including lawyers, accountants and consultants) to examine the accuracy of the financial statements and the reasonableness and feasibility of the proposed reorganization plan. During the standstill period, the relevant creditors shall refrain from any collection efforts; enforcement or realization of secured rights; improvement of their exposures in relation to other relevant creditors; and, maintain the original balance of their claims. Before the end of the third month after the first meeting was held, a second meeting must take place at which all relevant creditors are to indicate whether they accept the plan or not. If all creditors whose rights will be impaired by reorganization plan grant their consent to the proposed plan, the reorganization plan becomes authorized and the debts owed to the relevant creditors will be charged according to the provisions contained in the plan. If one or more creditors refuses to agree to the plan, the out-of-court workout process is terminated and the debtor should decide whether to file a petition with a court to begin statutory insolvency proceedings.

C. REQUIREMENTS FOR A REORGANIZATION PLAN

The Guideline is designed to facilitate multiple financial creditor workouts to rehabilitate corporations burdened with enormous amounts of debt. In contrast to the INSOL 8 principles, the Guideline provides for substantial requirements for the reorganization. If the debtor is insolvent, which means that the total amount of debts exceeds the total value of assets, the proposed plan must provide feasible measures to resolve the problem within three years. If the debtor has a negative operating loss, the plan must also show how that loss will be turned into a profit within the three-year period. The plan should provide that the equity of the debtor's controlling shareholders should, in principle, be wiped out and divested, and the equity of existing shareholders should be diluted substantially or eliminated altogether through stock retirement and subsequent capital increases. The plan should, in principle, also request that the debtor's incumbent managers resign upon the creditors' acceptance of the proposed plan.

D. OUT-OF-COURT WORKOUTS FOR SMALL AND MEDIUM SIZED ENTERPRISES

In response to the criticisms by some practitioners regarding the severity of substantial requirements envisaged in the Guideline-based reorganization plans for the restructuring of SMEs, the practicing committee of the Guideline has discussed possible ways to promote a more popular use of the Guideline and a possible relaxation of the requirements (or allowance for some reasonable exceptions) only for SMEs. The Guideline is a valuable tool to reorganize the financial structure of a debtor with excessive debts at the early stage without impairing debts owed to trade creditors. Although the Guideline has not been extensively used during the period in which the IROC has been active, its usage increased again after March 2005 and nearly 50 large corporations have been reorganized through an out-of-court workout resorting to the Guideline. Debts owed by SMEs have been restructured assisted by the RCC, the SME Turnaround Committees, private equity funds and other restructuring advisors who may not strictly adhere to the Guideline but refer to it. The RCC and the SME Turnaround Committees have their own guidelines that align with the Guideline making it more suitable to their needs.

E. NECESSITY OF A NEW STATUTE TO FACILITATE AN OUT-OF-COURT WORKOUT

It is a fact that it is not very easy to obtain unanimous consents of all relevant creditors in out-of-court workout processes. Even during the out-of-court workout stages, sizable amount of loans need to be provided by banks to finance operating overhead costs of the debtor corporations. When the unanimous consent is not reached, the debtor should convert the process to a statutory reorganization proceeding to avail themselves of the majority rule contained in the court-supervised reorganization procedures. However, there is no assurance that the loans provided
during the workout stages would be treated as priority claims, equivalent to the administrative expense status of DIP financing loans during the statutory proceedings that may succeed the workout. Therefore, banks may be reluctant to provide pre-DIP financing loans during workout stages without any assurance that the loans would be treated as priority claims in the subsequent statutory proceeding. Some kind of bridge would be needed in Japan similar to the new statutory schemes adopted by the English Enterprise Act of 2002. What the Enterprise Act is addressing is a means to facilitate out-of-court workouts, whereby a court approval to a proposed restructuring plan can be obtained when the majority of creditors agree to the proposed plan in out-of-court workout albeit recalcitrant minority creditors refusing to consent to the plan, and the debts owed to dissenting creditors can be impaired according to the court-approved plan, enunciating them down. The study group established by the METI and the Ministry of Justice is now discussing possible introduction of such a new legislation to facilitate debt restructuring at the early stage by out-of-court workout process.

F. NEW COMPANY LAW ENABLES 100 PER CENT WRITE-OUT OF EXISTING STOCKS IN AN OUT-OF-COURT WORKOUT PROCESS

The New Company Law of 2003 which became effective in May 2006 provides that a 100 per cent dilution of existing shareholders' rights can be accomplished by a resolution of the shareholders' meeting. Namely, by a special majority of voting shareholders who hold more than two-thirds of the 'designated class of stocks,' it has become possible to wipe out all stocks of that designated class by the articles of incorporation of the company. The 'designated class of stocks' in this context is defined as the stocks that are purchased by the company and wiped out completely by a special resolution of the shareholders' meeting of the designated class. The capability of a company to create such a 'designated class of stocks' needs to be clearly defined in the articles of incorporation; if not, the articles need to be amended to include that provision by a special resolution adopted by the shareholders. The resolution should state that the stock of the newly created class to be purchased and wiped out by the company. This resolution should be adopted by a special class meeting (shareholders of the newly created class of stock). It will also be resolved to issue new stock replacing the wiped-out stock. These three resolutions that should be adopted by the shareholders can be resolved at the same meeting. Before the enactment of the New Company Law, 100 per cent dilution of issued stock without consent of the shareholders was possible only in corporate reorganization proceedings under the Co. RL, but after May 2006 onwards, a complete wiping-out of existing shareholders' rights becomes possible even in out-of-court workouts under the conditions described above.

III. CIVIL REHABILITATION PROCEEDING BASED ON CIVIL REHABILITATION LAW

The Civil RL was enacted to expedite proceedings, abolishing the former Composition Law, establishing the so-called 'rehabilitation proceeding.' In principle, only unsecured creditors are bound by the rehabilitation proceeding of the Civil RL and could be impaired by the rehabilitation plan. To change the rights of secured creditors and those of creditors with priority, e.g., employees' rights and tax and social security debts, the consent of each creditor is needed.

A. COURT SHOULD CONSIDER THE PROCEEDING UNLESS EXCEPTIONAL

A debtor is able to file a petition to commence a rehabilitation proceeding with a district court with competent jurisdiction, when: (1) there is a likelihood that the debtor is not generally able to pay debts becoming due or its debts exceed the value of its assets; or (2) the debtor is not able to pay debts becoming due without seriously impeding the continuation of its business. Upon filing a petition, the court may issue injunction orders which effectively stay creditors' general collection efforts.

23. Provisions regarding companies were previously included in the Commercial Code (CC), but the enacted New Company Law has entirely abolished former provisions with regard to business corporations included in the CC. The new law has made significant changes in terms of corporate governance, information disclosure, restructuring, founding, and so forth, for business corporations.

24. See Article 21 of the Civil RL.
25. See Articles 26-30 of the Civil RL.
Upon petition of the debtor, the court should issue an order to commence a rehabilitation case unless it is obvious that the debtor cannot be rehabilitated through the rehabilitation proceeding. The Tokyo District Court usually issues the opening order within 15 days after the filing of the petition.

B. **Debtor can sell its business with court permission during the early stage without shareholders’ consent**

Outside a statutory reorganization proceeding, a special resolution with weighted majority of a shareholders’ meeting is required to sell the company’s business as a going concern. However, after the commencement of the rehabilitation proceeding, the court may permit the sale of the debtor’s business without the shareholders’ resolution if the company is insolvent during the early stage of the proceeding and even before the filing of a proposed rehabilitation plan. M & A’s are an effective tool to revitalize a distressed business. Speedy sale of the business before its deterioration is crucial to avoid the deterioration of the value of the going concern and the company’s assets.

C. **Dip in normal cases**

Managers of a debtor company may be able to remain in their positions, and continue to operate the debtor’s business and dispose of its assets in ordinary course of business. This may occur even after the commencement of a rehabilitation proceeding in a fashion similar to the US Chapter 11 reorganization proceeding. It is a common practice that the court will appoint a supervisor, as a watch-dog over the debtor. The court may appoint a trustee in an exceptional case involving gross mismanagement, depriving the debtor of the managers’ rights. Usually, a qualified and experienced lawyer is appointed as a supervisor or a trustee.

D. **Summarized procedures to verify claims, avoid preferential and fraudulent transfer and assess damages of responsible managers**

Upon the commencement of a rehabilitation proceeding, a debtor has to evaluate its assets and file a copy of the financial statements together with a written report explaining the reasons why it has fallen into financial difficulties. The debtor also has to report these matters orally in a meeting of creditors convened by the court. The documents filed with the court are accessible by interested parties.

The creditors usually have to file their claims with the court and if the filed claim is contested by the debtor or other interested parties, the debtor and the creditor are heard at a summary hearing proceeding. The creditor whose claim is contested and denied by the court in this summary proceeding may file a plenary law suit requesting verification of the contested claim. This plenary law suit works as an appeal to the court’s denial of the creditor’s claim.

The supervisor or a trustee (if it has been appointed) may avoid preferential and fraudulent transfers by filing a summary proceeding designed for this purpose.

The debtor, a supervisor, a creditor or a trustee — if appointed — may file a summarized assessment proceeding for damages which should be compensated by managers who are responsible for the failure of the debtor company.

The above three summary proceedings are designed to speed up the incidental processes within the civil rehabilitation proceedings and the liquidating parties of the summary order are entitled to convert the proceeding to a plenary law suit.

E. **Some restrictions on secured rights**

Under the Civil RL, the secured creditor is still able to enforce its secured rights, but the debtor is able to move to the court after filing a petition to commence the rehabilitation proceeding, requesting an issuance of a temporary stay order prohibiting the enforcement of secured rights during a certain period of time. The purpose of the stay order is to create a reasonable timeframe during which the debtor and the secured creditors can settle the issue between them by negotiation.

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 his/her secured right, even if the debtor has paid a part of the secured debt 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 Civil RL, however, the secured right is extinguished when the debtor pays a sufficient portion of the claim, equal to the value of the collateral. If the secured creditor does not agree with the debtor’s valuation of the collateral, the court decides the amount based on the assessment made by a court-appointed appraiser. Due to this provision, an under-secured creditor cannot insist on full payment even if the underlying debt exceeds the value of the collateral.

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26. See Article 33 of the Civil RL.
27. See Article 46 of the Company Law.
28. See Article 43 of the Civil RL.
29. See Article 38 of the Civil RL, §§ 1001 et seq., Chapter 11, Title 11 USC.
30. See Articles 54 et seq. and 64 et seq. of the Civil RL.
31. See Articles 124 and 125 of the Civil RL.
32. See Article 126 of the Civil RL.
33. See Article 54 et seq. of the Civil RL.
34. See Article 127 et seq. of the Civil RL.
35. See Article 142 et seq. of the Civil RL.
36. See Article 51 of the Civil RL.
37. See Article 148 et seq. of the Civil RL.
F. REHABILITATION PLAN

The debtor shall file the proposed rehabilitation plan before the deadline designated by the court, which usually occurs by the end of third months after the petition to commence the case. The rehabilitation plan provides – among other alternatives – for partial debt forgiveness, rescheduling of the repayment term, debt equity swaps, etc.

Upon the court's permission, the plan can provide for reverse split of stocks, change of the company's articles of incorporation in relation to the authorized amount of stock to be issued by the company, wiping-out of all or a portion of the issued stock and issuance of new stock. The court may allow a plan with those permit-required reversal provisions when the company is insolvent and stockholders have no interest in the company.

The debtor is able to set off profits obtained by the debts forgiveness and/or revaluation of assets against the carried-over losses without any restrictions.

The proposed plan is accepted by the vote of the simple majority of creditors in the amount of debt and number of creditors. It is a double requirement, i.e. in number of creditors and in value of debt. Voting on the proposed plan may take place at a meeting of creditors or by post.

When the proposed plan is accepted by the creditors, the court may confirm the accepted plan. The court should confirm the plan if the plan meets the requirements of the best interest test and the feasibility test. Usually, the confirmation of the accepted plan is made by about the end of the sixth month after filing the petition to commence the rehabilitation proceedings.

G. CLOSING THE CASE

The case is closed with a confirmation order issued by the court, when the confirmation order becomes indisputable by appeal; or, by an order to affirm the confirmation order by an appellate court. If a supervisor is appointed, the case is not closed before the consummation of the confirmed plan or three years after the confirmation order becomes final, whichever occurs first. The cases which are completed by means of a M&A may be closed soon after the confirmation.

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38. See Article 163 of the Civil RL.
39. See Article 154 et seq. of the Civil RL.
40. See Articles 166 and 166-2 of the Civil RL.
41. See Article 169 et seq. of the Civil RL.
42. See Article 174 et seq. of the Civil RL.
43. By the 'best interest test' one refers to the fact that the plan must be better than liquidation to creditors.
44. See Article 188 of the Civil RL.
IV. CORPORATE REORGANIZATION PROCEEDING UNDER CORPORATE REORGANIZATION LAW

As the process of a corporate reorganization proceeding under the Co. RL is roughly similar to that of a civil rehabilitation proceeding, only differences between the corporate reorganization and civil rehabilitation will be described.

A. ELIGIBILITY

While any kind of legal entity or individual is eligible to file a petition to commence a civil rehabilitation proceeding, only a stock company is eligible for a corporate reorganization proceeding. While neither the Co. RL nor the Civil RL imposes limits on eligibility by size of the debtor, the use of the Co. RL is intended for larger corporations and the Civil RL for small and medium-sized enterprises. Since the Civil RL allows managers to remain in their positions as DIP, managers of larger corporations are inclined to choose the civil rehabilitation proceeding in some cases. In such circumstances, a creditor may file a petition to convert the case to a corporate reorganization proceeding aiming to deprive the managers' position in the debtor corporation that commenced a rehabilitation proceeding under the Civil RL.

B. STRONGER WEAPONS THAN CIVIL REHABILITATION

All creditors' and shareholders' rights are affected in a corporate reorganization proceeding. During a corporate reorganization proceeding all rights, i.e. not only the rights of unsecured creditors but also those of secured creditors and creditors with priority (e.g. employees' debt and tax or social security debt), are stayed. Usually, these rights are also impaired by means of a reorganization plan. To balance, the rights of managers and owners of the debtor are deprived and wiped-out in the reorganization case.

The proposed reorganization plan is accepted when the majority of unsecured creditors who hold a simple majority of the aggregate amount of unsecured debts agree to the plan. The plan providing for an extension in the maturity of the claim of secured creditors will only be accepted when the secured creditors who hold two-thirds of secured debts in amount agree to the reorganization plan. The plan providing for impairment of the secured rights, e.g. debt for equity swap and debt forgiveness, is accepted by secured creditors when the secured creditors who hold three-fourth of the secured debts in amount agree. No consent is required for tax and social security debts when the plan provides to extend repayment term for less than three years. No shareholder has a voting power to the plan when the debtor company is insolvent, i.e. the amount of debts exceeds assets. Most debtor corporations in reorganization cases are insolvent.

When one or more classes accept the plan while others do not, the court can still confirm the plan amending it to pay the creditors of the non-accepting classes more than they would have received in a constructive liquidation proceeding.

The plan can provide for the sale of debtor's businesses, M&As of companies, wiping out of stock, issuing new stock, split of stock, consolidation of stock, split of the company, exchange of stock, transfer of stock, etc., without any resolution at a meeting of shareholders which is required by the Company Law outside the reorganization proceeding.

C. CHANGE OF OWNERS AND MANAGERS

The Co. RL provides for a fair and equitable rule: when creditors' rights are impaired in any ways, the shareholders' rights must be wiped out completely. Since the plan may provide for issuance of new stock, total replacement of owners of the debtor company is accomplished in almost all reorganization cases in Japan.

A trustee must be appointed in any reorganization cases at the time of the commencement of the case to deprive of the rights of the managers of the debtor company and usually an interim trustee is appointed upon filing of the petition to open the case. Because the owners of the debtor who elected former managers are purged by the confirmation of the plan, there is no ways to revive the former managers.

The reformed Co. RL of 2002, however, provides that the court may appoint an incumbent manager/s as a trustee when he/she is not responsible for the failure of the debtor corporation. For example, the court may appoint, as a trustee, a turnaround manager/s who has been appointed during the pre-filing workout stage to replace former managers to revitalize the debtor's business.

45. See Article 1 of the Co. RL.
46. See Article 47 of the Co. RL.
V. CASE STUDY: THE 'X CONSTRUCTION CORPORATION CASE' (A HYPOTHETICAL OUT-OF-COURT WORKOUT CASE BASED ON THE GUIDELINE)

An analysis on a hypothetical case of an Out-of-Court Workout case based on the Guideline is provided in this section for illustration purposes. It is useful to exemplify the importance of expedited and alternative techniques in dealing with debt restructuring.

TIMELINE: MAIN EPISODES

<table>
<thead>
<tr>
<th>Year</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1889</td>
<td>Mr. X started his construction business as a sole proprietor.</td>
</tr>
<tr>
<td>1917</td>
<td>X partnership was established.</td>
</tr>
<tr>
<td>1930</td>
<td>X Construction Ltd. was founded.</td>
</tr>
<tr>
<td>1962</td>
<td>X Construction Corporation was listed in the Tokyo Stock Exchange.</td>
</tr>
<tr>
<td>2002</td>
<td>The first debt restructuring plan was made with four banks which had the main exposure.</td>
</tr>
<tr>
<td>2003</td>
<td>An Out-of-Court Workout based on the Guideline took place.</td>
</tr>
</tbody>
</table>

X Construction Corporation ('X') has been engaged in civil and building construction business being the 10th biggest construction company in Japan.

X was especially well-known as a well-established civil constructor and had constructed many roads, bridges, dams, power plants not only in Japan but also in foreign countries.

During the bubble economy when the property prices soared, X had been aggressively engaged in land, housing, resort and golf-course development operations, purchasing numerous real properties and incurred huge amounts of debt. The management of X encouraged their employees to initiate new development businesses such as golf courses, resort facilities, etc.

The X group was comprised of approximately 60 subsidiaries and affiliated companies. Its total amount of annual revenue reached its peak as much as JPY 700 billion in 1992. After the burst of the bubble, the revenue declined year after year to come down to JPY 200 billion in 2002.
The total amount of debt was JPY 770 billion in 1993. It was owed to nearly 150 banks and financial institutions.

Between 1992 and 2000, X had drafted its own operational restructuring plans and implemented them five times, trying to recover its profitability. None of which was successful.

In 2001, X drafted the first debt restructuring plan assisted by its main bank which had the biggest exposure. Among other things, the draft plan requested the four major banks which had relatively big exposures to forgive portion of their debts which amounted to JPY 122 billion in total. It took nearly ten months until the four major banks consented to the plan in the absence of the Guidelines. But the burden of debts was still too heavy and X could not recover its profitability.

The Guideline for Out-of-Court Workout with Multi-Creditors was enacted in September 2001 with the aim of accelerating disposal of non and poor-performing loans in Japan.

As of the end of September 2002, the total assets of X amounted to JPY 400 billion and the total amount of its debts was JPY 375 billion. The total amount of interest-bearing debts was 176 times X’s annual EDITDA.

Under such circumstance, X drafted - again - a new debt and operational restructuring plan assisted by consultants and other professionals. With the consent of the main bank that had the biggest exposure to the proposed plan, X initiated an out-of-court workout proceeding based on the Guideline on 15 January 2002 and sent a notice of Standstill through fax transmission to about 60 relevant banks and financial institutions, requesting their debt to be impaired by the proposed plan.

At the first creditors’ meeting which was held on 29 January 2002 the CEO of X explained to the attending creditors the contents of the proposed plan (which was sent in advance with the standstill notice), as well as the reasons why X must be restructured. Then, he requested the creditors to accept the plan.

The three experienced lawyers and one certified public accountant, who were elected at the creditors’ meeting, were appointed as “professional advisors.” The role of the advisors was to analyze the proposed plan and report to the creditors on the fairness and the feasibility of the plan.

The plan proposed partial debt forgiveness (or haircut) totalising JPY 140 billion and debt for equity swap to the financial creditors in the amount of JPY 110 billion. Secured claims should be paid in full and most of unsecured creditors or the over-secured part of secured claims should be paid in 50 per cent of their value. In addition, repayment dates of the financial claims were to be rescheduled.

The plan also called for splitting the group of companies into good and bad companies. The good companies would continue X’s core businesses such as civil and building construction that seemed profitable, while bad companies would handle non-core businesses such as land and resort developing operations which were making losses. Namely, the good companies succeeded assets and liabilities which were related to the construction businesses, while bad companies succeeded assets and liabilities which were related to the non-core businesses.

All assets of the bad companies were intended to be sold within three years and their proceeds would be used for the repayment of the succeeded debts which were mostly secured claims. When the proceeds from the assets of the bad companies become insufficient to repay the debts (the value of the assets was inferior to the amount of debt), creditors of the bad companies would had to relinquish the outstanding balance of their claims.

The bad companies were the parent companies of the good companies, owning 51 per cent of the stock of the good companies. The rest of the good companies’ stock went to the shareholders of X on a pro rata basis.

Upon completion of the sale of all assets of the bad companies – within the three-year timeframe – they would file a petition to commence a special court-supervised liquidation under the Company Law. Subsequently, 51 per cent stock of the good company owned by bad companies would be sold in the stock markets and the proceeds were to be credited to creditors who had pledged on the stock. Afterwards, the bad companies would disappear.

The new X which was the good company continued its operation as a listed company in the Tokyo Securities Exchange.

An operational restructuring plan for the good company was developed. The plan provided for several means including reduction of redundant 1,000 employees to recover its profitability. Most of the management of X was replaced by new managers.

After intensive due diligence, the panel of professional advisors filed a report on the proposed plan with the creditors at the end of October 2002 including answers to creditors’ questions which requested investigations by the advisors.

The second creditors’ meeting was held on 15 November 2002 at which all relevant creditors expressed their intention to accept the proposed plan. Between mid-September and mid-November 2002, many meetings had been held between the debtor and each creditor to discuss the contents of the plan.

Had unanimous consents of relevant creditors not been obtained, the debtor should have had to file a petition to commence a statutory reorganization proceeding, i.e. a civil rehabilitation or corporate reorganization proceeding, but all relevant creditors of the X ultimately consented to the proposed plan.

The bad companies were closed at the end of March 2006 and the market price of the New X’s stock has doubled.
ANNEX: KEY LEGISLATION

THE GUIDELINE FOR MULTI-CREDITOR OUT-OF-COURT WORKOUTS OFFICIAL ENGLISH TRANSLATION

1. Multi-Creditor Workout subject to this guideline

(1) A multi-creditor workout implemented under this Guideline is one that aims for rehabilitation of a corporation in operational difficulties through forbearance and/or composition of debt (mainly financial debt), etc., based on an agreement between the creditors and the debtor in place of procedures in accordance with the Corporate Reorganization Law or Civil Rehabilitation Law, etc. This guideline is intended to cover only limited range of multi-creditor workout, namely those in which a number of financial institutions are involved as Major Creditors or Relevant Creditors defined below.

(2) The rehabilitation of a corporation presumed in this guideline should primarily be conducted under the Corporate Reorganization Law or Civil Rehabilitation Law, etc. However, only when such legal procedures are deemed to considerably erode the enterprise value of the corporation and cause a hindrance to the rehabilitation of the corporation, and when a multi-creditor workout under this guideline shall be implemented.

(3) As a precondition for the debtor requesting the creditors for forbearance and/or composition, the multi-creditor workout under this guideline expects that the debtor independently exert the maximum efforts towards rehabilitation, that the debtor shall clarify the responsibility for mismanagement and that the shareholders (especially the controlling shareholder, if any) fulfill all of their responsibilities to the maximum extent.

2. Rules for multi-creditor workout

(1) This guideline has been prepared by representatives of financial and other industries with consultation to neutral and fair advisors such as academics and experts in the field of multi-creditor workout described in Article 1 above in a fair and speedy manner. Although this guideline has no legal enforceability, it is expected that financial institutions, etc. as Major or Relevant Creditors, corporations as debtors, and other relevant stakeholders voluntarily respect and observe this guideline. In a sense, this guideline represents a general consensus among the financial and other industry regarding informal workouts for companies truly deserving to be rehabilitated.

(2) When one of the Major Creditors (usually multiple financial institutions) including the banks with the largest credit exposure to the debtor) receives a sincere request from a debtor for a multi-creditor workout under this guideline, the Major Creditors shall deal with the request sincerely and promptly, and the Major Creditors and the debtor shall mutually cooperate to ensure the orderly and expeditious progress of the procedures of the workout.

(3) Relevant Creditors (creditors, including major creditors, whose rights shall be affected if a rehabilitation plan is approved) shall sincerely cooperate to the multi-creditor workout in accordance with these rules.

(4) Relevant Creditors and the debtor shall mutually obligated to keep confidentiality of the information obtain in the process of the multi-creditor workout.

(5) Fairness and equity shall be observed as the principle of the multi-creditor workout in accordance with this guideline, transparency shall be respected.

3. Corporations eligible for multi-creditor workout under this guideline

A corporation can apply for the multi-creditor workout if all the conditions below are fulfilled.

(1) The corporation is in operational difficulty mainly due to excessive debt, and it is difficult for the corporation to rehabilitate itself through its own efforts.

(2) The possibility exists that the corporation can rehabilitate with support of creditors as the enterprise value of the company still exists (i.e. the business is profitable and promising, with a business base including technological know-how, a brand name, an established trading area and highly capable personnel) and operating profit have been posted in the major financial statements, etc.

(3) There is a concern that petition for the Corporate Reorganization Law or the Civil Rehabilitation Law, etc. may deteriorate the credibility of the debtor, considerably erode the enterprise value of the corporation and cause a hindrance to the rehabilitation of the corporation.

(4) Rehabilitation of the corporation through the multi-creditor workout is considered more economically reasonable for creditors in recovering their credits than liquidation via bankruptcy or the procedures under the Corporate Reorganization Law or the Civil Rehabilitation Law, etc.

4. Commencement of the multi-creditor workout

(1) A debtor fulfilling the necessary conditions indicated in Article 3 above requests its Major Creditors for a multi-creditor workout under this guideline. Upon request, the debtor shall provide the Major Creditors with relevant information which sufficiently explain the current and past state of assets, liabilities and profit/loss, the reason for the lapse into operational difficulties and a rehabilitation plan of the corporation, etc.

(2) Major Creditors shall examine the information mentioned in (1) above provided by the debtor, have the debtor explain in detail, and make an examination on the points indicated below to decide whether it is reasonable to issue a ‘Standstill Notice’. When multiple Major Creditors exist,
the decision to issue such a Notice shall be made by unanimous consent of all of Major Creditors. Items to be examined are as follows:

(A) Whether the conditions of Article 3 are fulfilled.
(B) Whether the Relevant Creditors are expected to agree to the rehabilitation plan.
(C) Whether the rehabilitation plan is feasible.

(3) When the Major Creditors decide that it is reasonable to issue a Standstill Notice based on (2) above, the Major Creditors and the debtor shall issue the Notice in their joint name to all the Relevant Creditors.

(4) The range of Relevant Creditors is usually limited to financial institutions, but can include other creditors with large amounts of credit exposures when deemed appropriate.

(5) The Standstill Notice shall be issued in writing and include a notice calling the first meeting of creditors (indicating date, time, and place of the meeting). In addition, explanatory documents (debtor's financial information stating the state of assets, liabilities, profit/loss and a rehabilitation plan proposal, etc.) for such meeting shall also be attached to the notice.

(6) The decision on whether a Standstill Notice is to be issued shall be made promptly. When Major Creditors have determined that the issuance of such a Notice is not appropriate, they shall inform the debtor of such fact forthwith. When it is necessary for Major Creditors to obtain additional information for determining whether to issue a Standstill, they have the right to request additional documents or further explanations from the debtor. The decision not to issue Standstill Notice means the decision that the multi-creditor workout under this guideline will not be implemented.

5. The first meeting of creditors and the creditors' committee

(1) The debtor and Major Creditors shall convene the first meeting of creditors within two weeks from the date when the Standstill Notice was issued to the Relevant Creditors.

(2) The debtor and Major Creditors shall convene the first meeting of creditors in joint names. In principle, a chairman of the meeting shall be elected from among the Major Creditors at the beginning of the meeting. The chairman presides over the meetings of creditors (including the second and subsequent meetings) and makes efforts toward the orderly progress of the meeting.

(3) The items below shall be implemented at the first meeting.

(A) An explanation by the debtor regarding the current and past state of assets, liabilities, profit/loss in addition to the details of the rehabilitation plan proposal. Furthermore, questions and answers regarding the explanation as well as an exchange of opinions among the Relevant Creditors present shall also be conducted.

(B) Discussion of whether it is necessary to assign a professional advisor such as certified public accountant, licensed tax accountant, legal attorney, real estate appraiser or other professional advisor in order to

examine the state of assets, liabilities, profit/loss and assess the accuracy and feasibility of the rehabilitation plan proposal. When such is necessary, an appropriate professional advisor shall be appointed.

(C) Determination of the duration of the Standstill ('Standstill period').

(D) Determination of the date/time and place of the next meeting of creditors.

(E) Determination of whether a creditors’ committee is to be established, and if such has been determined, the selection of committee members.

(F) Determination of other necessary matters.

(4) The creditors’ committee shall select the chairperson from among its members by mutual vote. The chairperson shall preside over the committee.

(5) The creditors’ committee shall examine the appropriateness and feasibility of the rehabilitation plan proposal, report the results of such examination to the Relevant Creditors, and carry out matters referred to the committee by the meeting of creditors, and matters necessary to facilitate the orderly processing of the multi-creditor workout under this guideline.

(6) When a creditors’ committee is established by the meeting of creditors, determination on matters stipulated in Article 5(2)(B) or D, or Article 6(1)(A) or C (3) may be referred to the committee.

(7) Resolution of meeting of creditors shall be made by unanimous consent of all Relevant Creditors in attendance. However, procedural matters that are related to neither rights nor obligations of the Relevant Creditors may be determined by the approval of a majority of the Relevant Creditors.

6. Standstill

(1) All Relevant Creditors and the debtor shall refrain from taking the following acts during a Standstill Period. The mere receipt of a Standstill Notice shall not constitute an cause for acceleration of payment set forth in Bank Transactions, etc.

(A) The debtor shall not dispose of its assets or assume new liabilities except for the disposal or assumption of such that takes place in the ordinary course of business, or except for the case in which a meeting of creditors or a creditors’ committee to whom decision-making power has been entrusted by the meeting of creditors permits the debtor to dispose of its assets or assume new liabilities.

(B) The debtor shall not, for the sole benefit of a limited number of Relevant Creditors, perform any act of extinguishing its debts such as the repayment of debts (including accord and satisfaction, herein after same), or set-off, nor provide any credit enhancement such as collateral and guarantee.

(C) Each Relevant Creditor shall maintain the outstanding credit exposure (including the credit balance or loans on notes, overdrafts, and loans on decree) as of the date when the Standstill Notice is dispatched, and shall not improve its position against the debtor relative to other
creditors. The Relative Creditor also shall not perform any act of extinguishing debts of the debtor, such as the receipt of debt repayment or the exercise of its right of set-off, request the debtor to provide additional collateral or guarantee, exercise its security right, or file a request for compulsory execution, provisional attachment, provisional disposition, or statutory bankruptcy procedures.

(2) The Standstill Period shall commence from the date when the Standstill Notice is dispatched and end on the date when the first meeting of creditors closed. If, at the first meeting of creditors, the Standstill Period is decided to be extended to a date not exceeding three months from the date of the meeting of creditors, the Standstill Period shall be extended to such date. However, if a further extension is considered necessary, a revised extension of the Standstill Period may be determined at the second meeting of creditors or the meeting of creditors held at the continuance dated specified in Article 8(5).

7. Contents of a rehabilitation proposal
A rehabilitation plan proposal shall include the following:

(1) Business plan
A business plan shall reflect adequate self-help efforts by the debtor and include the following items in principle:
(A) Causes of operational difficulties,
(B) A detailed business restructuring plan (including solutions to causes of operational difficulties),
(C) Measures to strengthen its capital, including support through the injection of new capital and debt-equity swaps,
(D) A projection of the debtor’s assets, liabilities and profits/losses for approximately the next ten years,
(E) A fund raising plan,
(F) A debt repayment plan.

(2) When the debtor’s net worth is virtually negative, its rehabilitation plan proposal shall indicate that such negative net worth will be eliminated and become positive within approximately within three years from the starting date of the first fiscal year after approval of the proposed plan.

(3) When the debtor has incurred loss, its rehabilitation plan proposal shall indicate that such loss will turn to profit within approximately within three years from the starting date of the first fiscal year after approval of the proposed plan.

(4) When the debtor shall be granted composition by the Relevant Creditors, the interests controlling shareholder of the debtor shall, in principle, be divested, and the pro-rata position of existing shareholders shall be reduced or terminated through a capital reduction and a subsequent capital increase.

(5) When the debtor shall be granted composition by the Relevant Creditors, executives of the debtor shall, in principle, retire.

(6) The adjustments of rights under a rehabilitation plan proposal shall be aimed at equal treatment among creditors, and the share born by each creditor shall be examined individually, taking equitable treatment into consideration.

(7) Relevant Creditors shall be able to expect that the rehabilitation plan proposal be economically reasonable, such as including the certainty that a larger amount of credit will be recovered than in the case of liquidation via bankruptcy, or procedures in accordance with the Corporate Reorganization Law or the Civil Rehabilitation Law, etc.

8. Approval of a rehabilitation plan

(1) Major Creditors (a creditors’ committee if such is established) shall report the results of an examination and evaluation concerning the appropriateness and feasibility of a rehabilitation plan proposal to all Relevant Creditors prior to the second meeting of creditors.

(2) The report mentioned in (1) above of this Article as well as questions and answers between creditors and the debtor, and exchanges of views among attendant Relevant Creditors regarding a rehabilitation plan proposal shall be conducted at the second meeting of creditors.

(3) The deadline for expressing in writing whether Relevant Creditors agree to the rehabilitation plan proposal or not shall be determined at the second meeting of creditors.

(4) When all Relevant Creditors submit written consent to a rehabilitation plan proposal, the plan will be approved. In that case, the debtor shall assume the obligation to implement the rehabilitation plan, while Relevant Creditors’ rights shall be adjusted in accordance with the plan, and those creditors shall treat relevant credits in accordance with the stipulations of the rehabilitation plan, such as forbearance and/or composition.

(5) In the case where the second meeting of creditors needs to be continued in order to change a part of a rehabilitation plan proposal or for other purposes, a continuance date (including the time and place) for the meeting may be determined. Proceedings in (2) and (3) of this Article shall also be carried out when the continued meeting is held.

(6) In the case where all Relevant Creditor’s consent to a rehabilitation plan proposal (including an amended rehabilitation plan proposal according to (5) above of this Article) cannot be obtained by a deadline determined according to the provisions specified in (3) and (5) of this Article, the multi-creditor workout in accordance with this guideline shall terminate, and the debtor shall take appropriate measures such as the filing for statutory bankruptcy procedures.

9. Other

(1) When a rehabilitation plan is approved, the debtor shall disclose an outline of the plan to public in an appropriate manner. However, the debtor may be exempted from such disclosure requirement if there is a possibility that
the disclosure will cause a material adverse effect to successful rehabilitation of the debtor.

(2) After approval of a rehabilitation plan, the debtor shall report on progress in implementation of the plan to Relevant Creditors at regular meetings of creditors or other occasions in accordance with the provisions of the rehabilitation plan.

(3) In case where the debtor cannot fulfill its debt repayment obligation to Relevant Creditors in accordance with the rehabilitation plan, the debtor must take appropriate measures such as the filing for statutory bankruptcy procedures. The debtor must not leave such non-performance of the obligation unsettled. However, the debtor may be exempted from taking those measures if all Relevant Creditors give consent to an amended rehabilitation proposal.

(4) The debtor shall bear all fees and expenses incurred in connection with multi-creditor workout under this guideline, including those for professional advisors, those in connection with holding of meetings of creditors and the creditor’s committee.

(September 2001)