Post-IRCJ Challenges: Changing Japanese Culture to Enable Early Revitalization of Troubled Corporations

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Abstract

The Industrial Revitalization Corporation of Japan (IRCJ) was created in 2003 to restructure distressed debtor corporations with excessive debts before their bankruptcy with a view to deterring ever-increasing non- and poor-performing loans. The IRCJ successfully reorganized target debtor companies through the out-of-court workout with multiple financial institutions where unanimous consent of financial creditors is required. Since the lifetime of the IRCJ is limited, the IRCJ cannot rescue troubled corporations after the end of March 2005. From then onward, the out-of-court workout should be utilized more widely in Japan in order to revitalize distressed businesses at an early stage without impairing the rights of trade creditors and deteriorating the value of the businesses. To make the workout most effective, it is important to ensure that the statutory reorganization procedures, including the majority rule, are applied more flexibly and reliably.

I. The Deadline for the Industrial Revitalization Corporation of Japan Loan Purchase May not be Extended

The Industrial Revitalization Corporation of Japan (IRCJ) is trying to do something new in Japan in order to change Japanese culture in the area of corporate or business reorganization. The IRCJ has assisted 23 business corporation groups including huge conglomerates such as Kanebo and Mitsui Mining as of the end of August 2004. It intends to assist more than ten corporate groups including a few huge cases no later than the end of 2004, since the IRCJ cannot purchase those loans owed by distressed corporations from non-main bank financial institutions

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beyond April 2005. Calculating backwards, in order for the IRCJ to buy loans from banks before the end of March 2005, the IRC Commission has to make assistance decisions before the end of this year or mid January at the latest, because it usually takes a few months to persuade non-main banks (*i.e.* the holders of the distressed loans) to sell their loans to the IRCJ.

It may be asked whether this deadline of the IRCJ to purchase loans will possibly be extended if the activities of the IRCJ prove to be successful. My quick and personal answer is that it may not be good to extend the scheduled deadline for buying loans from banks even if some cases potentially suited for the IRCJ assistance scheme are left untouched on the last day of the deadline. One of the reasons why I am opposing the extension comes from my belief that capital markets should take care of themselves without the aid of the IRCJ which is essentially a Japanese government intervention.

II. Out-of-Court Workout with Multiple Financial Creditors May Be an Useful Tool for the Purpose of Reorganizing Troubled Debtor Corporations at an Early Stage

The scheme that is employed by the IRCJ is an out-of-court workout involving multi-financial creditors to resolve and revitalize financially distressed and troubled debtor corporations at an early stage without impairing unsecured trade creditors' rights. The most serious disadvantage of Japanese statutory reorganization proceedings, whether the Corporate Reorganization Law or the Civil Rehabilitation Law, is that initiation of these proceedings usually triggers deterioration of the business value of the debtor corporations. Once the procedure begins, payments to pre-petition trade debts are prohibited and, under such circumstances, suppliers, vendors and sub-contractors tend to refuse transactions with debtor corporations in the ordinary course of business, eventually destroying the business reputation of debtor corporations.

The United States applies a more practical approach to overcome this problem. The prepackaged, prearranged or pre-negotiated Chapter 11 methods allow 100% payments to unsecured trade creditors, while only financial creditors incur losses through partial debts forgiveness, debts equity swaps and debt rescheduling. These methods are very popular in dealing with large reorganization cases in the United States. Before filing the petition for Chapter 11, out-of-court workout involving a large number of financial creditors is employed in many large cases in the United States, while the informal workout makes it easier to revitalize distressed business corporations at an early stage.

In Japan, the National Banks Association, the Federation of Economic Organization and other relevant organizations adopted the "Guidelines for Out-of-Court Workout With Multi-Creditors" in October 2001 to facilitate the disposition of non- and poor-performing loans owed to financial institutions by business corporations with a view to reorganizing distressed corporations in a more fair and transparent manner. Regrettably, less than 20 cases had been resolved based on the

Guidelines by the end of 2002. One reason why the Guidelines have been rarely used is that "non-main" financial institutions were reluctant to share the losses on a pro-rata basis with the "main banks". For many years, Japanese banks have assumed that it is the main banks' role to keep assisting troubled debtor corporations in their group even when they are in desperate financial conditions. Accordingly, main banks helped their debtor corporations by means of partial debts forgiveness, debts equity swaps and subscription of new equity, etc., over and over again, but this practice had an effect of delaying complete disposition of non- and poor-performing loans up to today.

III. Eliminating Possible Conflict of Interests between Creditor Banks and Debtor Corporations in the IRCJ

To accelerate disposition of non-performing loans and facilitate revitalization of troubled business corporations, the IRCJ was established in May 2003, under the newly enacted statute at the initiative of the Japanese Government. The staff of the IRCJ is composed of business consultants, investment bankers, financial advisors, accountants, lawyers and other professionals who are specialized in the field of business and financial reorganization. Before establishment of the IRCJ, it was staff of the main banks who primarily drafted reorganization plans, assisted by employees in the financial sections of debtor corporations. These plans not only focused on resolving the present financial problems but also included operational rehabilitation plans, but their main concern was to minimize losses for creditor banks that employ drafters of the plans.

At the start of the IRCJ, more than 30 bank staffs who constituted a part of the IRCJ preparation office were sent back to their home banks to avoid this type of possible conflict of interest between banks and debtor corporations that may arise in the course of drafting reorganization plans. Banks that subscribed the initial equity of the IRCJ and were potentially expected to be the main customers of the IRCJ were astonished to know that they could no longer be involved in the drafting stages of reorganization plans and, moreover, bank employees were excluded from the professional team of the IRCJ. It took nearly one year before Japanese banks realized that it is crucial to avoid conflict of interest to truly reorganize debtor business corporations. Initially, banks other than Sumitomo Mitsui Banking Corporation were not very willing to bring their cases to the IRCJ, fearing that the professional staffs of the IRCJ, who are alien to bankers, might force banks to bear unreasonably huge losses. But banks are changing their attitude towards the IRCJ. They came to realize that it is crucial to avoid possible conflict of interest between banks and debtor corporations to achieve truly successful restructuring.

IV. How Does the IRCJ Staff Draft Reorganization Plans?

The standard methodology employed by the IRCJ staff in drafting reorganization plans can be described as follows. After conducting intensive due diligence both on

financial and operational aspects and market researches, the IRCJ staff specify businesses which are profitable and/or can regain profitability. In planning the strategy and tactics for regaining profitability, they estimate future cash flows based on several possible scenarios. Work is also done to identify non-core businesses to be sold, shut down and/or liquidated, and to plan how and when to dispose of these businesses and their related assets. The entire business or enterprise value is then calculated based on an expected future cash flow, discounted by WACC (Weighted Average Cost of Capital) and other relevant risk factor indices. The enterprise value is also calculated, based on a multiple of EBITDA[1] with reference to the financial statements of comparable business enterprises. Overall assets are evaluated based on a going concern basis as well as on a liquidation basis.

Taking all these aspects into consideration, the operational and financial restructuring plans are completed, paying due regard to the desirable mix of debts and equity. The draft plan also determines how much debt forgiveness and debts equity swaps are required. The plan usually calls for more than 90% dilution of equity to change ownership of the debtor corporation. Thus drafted plans by the IRCJ aim at enabling debtor corporations to come back to the capital markets as rapidly as possible, rather than putting too much weight on minimizing bank losses. I believe most Japanese banks have come to understand that it is vital to avoid possible conflict of interest between banks and debtors and appreciate using neutral and fair professional advisors like the IRCJ staff.

V. The IRCJ as a Negotiator, Monitor and Turnaround Player

Upon completion of the draft reorganization plan, the debtor corporation and its main bank jointly ask the IRCJ to assist the debtor using the IRCJ scheme. The Industrial Revitalization Commission will approve assistance for the debtor corporation when it agrees that the proposed draft plan is fair, equitable and feasible. The IRCJ then publicly announces the assistance decision requesting relevant financial institutions, whose claims are proposed to be impaired according to the draft plan, to stay from any individual collection efforts for the period designated by the IRCJ.

Staff of the IRCJ, assisted by lawyers who are retained by the IRCJ, employees of the main bank and those from the debtor corporation, visit creditor non-main financial institutions individually during the aforementioned designated period and persuade them to sell their loans owed by the debtor to the IRCJ or consent to the draft reorganization plan. When and only when all banks unanimously consent to the plan, the IRCJ purchases the loans owed by the debtor from non-main banks at what is deemed as the market price. The price can range between 98% and 95% of the remaining balance of the debts after deducting the forgiven amount

1. A measurement of business profitability. The abbreviation stands for: 'earnings before interest, taxes, depreciation and amortization'.

indicated in the plan from the face amount of the debts. The IRCJ may become a new owner of the debtor corporation through infusion of new capital into the corporation if a new owner cannot be found by the expiration of the designated term. In parallel with executing the plan, the IRCJ monitors and advises the new managers of the reorganized corporation on wide areas of its business operation to recover profitability. In many cases, the IRCJ sends new managers who have sufficient skills to turnaround the assisted corporation replacing former managers.

The IRCJ is entitled to borrow money up to 10 trillion yen under the guarantee of the Japanese government to purchase loans, inject new capital and/or provide DIP (Debtor In Possession) loans to debtor corporations. We have spent nearly 1 trillion yen as of the end of the August 2004, only 10% of the budgeted amount. The IRCJ must sell all the loans it purchased, equity and other assets it obtained within three years after it obtained these assets. It is expected that debtor corporations recover earnings power to be able to refinance on their own and find new prospective buyers of equity; if the IRCJ is not able to exit without incurring losses, the losses must be ultimately eaten up by the Japanese national treasury.

VI. The IRCJ Inspired Turnaround Business in Japan

Since the establishment of the IRCJ, reorganization business for troubled corporations has gained increasing popularity among the Japanese financial community. The IRCJ has been playing a catalyst role in expanding the rehabilitation business in Japan to revitalize distressed corporations that suffer from excessive debts. For example, Japanese mega-banks except the Bank of Tokyo-Mitsubishi created their own subsidiaries as joint venture companies with investment banks specialized in rehabilitating their customer debtor corporations in doubtful conditions.

Furthermore, a lot of corporate recovery funds have been established in the past couple of years. The total amount of money invested in distressed corporations by both domestic- and foreign-originated corporate recovery funds has almost doubled during 2003. The Resolution and Collection Corporation and many servicers have increasingly engaged not only in debt collection business but also in debtor rehabilitation business. The Development Bank of Japan plus commercial banks have been keenly providing DIP financing to reorganized corporations. Many regional recovery funds targeting local small- and medium-sized corporations have been or are being created in almost all prefectures in Japan. Regional councils to assist reorganization of small- and medium-sized enterprises (SMEs) have also been established in each prefecture throughout Japan, aiming at assisting and advising SMEs on drafting and implementing reorganization plans. The Japanese Association of Turnaround Professionals and the Education Center for Business Reorganization Advisors have been established to foster talented human resources for corporate turnaround. One caveat of these new movements is that they are to some extent driven by Japanese government initiatives. The increase in the number of organizations and schemes for business rehabilitation has not overcome

the shortage of skilled rehabilitation professionals such as corporate advisors and turnaround managers, however.

VII. Global Trends toward Out-of-court Workout

A. Prepackaged Chapter 11 in the United States

Out-of-court workout with multi-financial creditors is a useful tool to reorganize distressed business corporations suffering from excessive debts at an early stage. In this context, prepackaged Chapter 11 in the United States may become a good global model for the workout.

B. English new Enterprise Act of 2002

In the United Kingdom, the Enterprise Act of 2002 allows appointment of an insolvency practitioner as an administrator to preside over the out-of-court workout in the pre-insolvency stage without any court order. With submission of a notice to the court in the competent jurisdiction and registration with the company recording office regarding the appointment of an administrator, creditors are required to stay from making any collection efforts to allow the debtor to be ring-fenced for one year during which an out-of-court workout is drafted and negotiated. The Court can approve the plan if it is agreed by creditors with claims more than 75% of total debts of relevant classes to apply the Corporate Voluntary Arrangement of the Insolvency Act of 1986 or the Scheme of Arrangement of the Company Act.

C. French new draft law for pre-insolvency workout

The Draft French Law, which is expected to be enacted by the end of 2004, sets a provision for an appointment of a "*mandataire ad hoc*" by a commercial court to preside over the out-of-court workout as a pre-insolvency proceeding. The commercial court can approve the plan if it is agreed by creditors with claims more than 75% of total debts without opening a plenary insolvency proceeding. The commercial court can also approve the priority of DIP financing made during the course of workout. These above English and French statutes can be interpreted as a codification of out-of-court workout. Many Asian countries and other developing countries have adopted similar out-of-court workout schemes under recommendations made by the IMF and other international organizations. The out-of-court workout is gaining increasing ground world-wide.

D. Resolving problems regarding haus bank system in Germany

The New German Insolvency Law (Insolvenzordnung) was enacted in 1994 and became effective in 1999. One of the main purposes of the new law was to establish new reorganization proceedings. The reason why it took as long as four years until

the law became effective after its enactment was that the German Federal Judicial Administration Office wanted to ensure that a sufficient number of court staff and facilities were in place to meet expected use of the new reorganization proceedings. However, neither this expectation nor the increase in the number of court personnel and facilities materialized. The number of reorganization cases in Germany remained less than 0.4% of all insolvency cases. In 2003, only 162 cases of all 39,320 insolvency cases were converted to Insolvenzplan cases in Germany. In contrast, in Japan, the total number of civil rehabilitation and corporate reorganization cases was around 1,000 while the number of the straight business bankruptcy cases was about 10,000 in 2003.

The most important reason why reorganization cases did not become popular in Germany was a very strict obligation conferred on the part of the directors of business corporations in filing insolvency proceedings. Directors who fail to file a petition for an insolvency proceeding within three weeks of becoming aware of illiquidity or insolvency over-indebtedness can be criminally sanctioned or held personally liable to creditors for increasing damages due to the delayed filing. In a case where the management's effort to rehabilitate the troubled debtor corporation during the critical period did not ultimately succeed, the management can be sanctioned severely both in civil and criminal cases, with an effect that the management may be tempted to select an easier way to file a petition for insolvency proceeding without taking the trouble of reorganizing the corporation.

When requirements are met, a court issues an opening order upon filing the petition to commence an insolvency proceeding and appoints an insolvency administrator to deprive the management of the right to operate the debtor's business and dispose of its assets. A creditors' meeting will be held three months from the beginning of the proceeding, when creditors will decide whether the debtor corporation should be liquidated or reorganized by a resolution. However, an insolvency administrator, who is a lawyer, is generally not very keen to continue the debtor's business because he/she fears he/she may have to accept a personal liability for the administrative expenses incurred by the continued business operation. Lack of a DIP financing super priority system may be another reason why the reorganization cases are so few in Germany. Bankruptcy still carries a stigma in Germany to some extent although the situation may be changing.

In Germany, the relationship between a main bank and its customer (debtor) corporation is said to be closer than that in Japan. One of the major differences between the Japanese main bank system and the German haus bank system is that Japanese main banks sent their employees as executives, directors and high rank officials of debtor corporations, while German haus banks did not. German haus banks stopped the practice of sending their employees as members of the supervisory boards of debtor corporations almost ten years ago because it was prohibited to utilize the information obtained through board membership to monitor the operation and financial status of debtors in order to avoid conflicts of interests. In addition, all financial institutions have established their own special inspection teams to monitor their debtor corporations according to the recommendation

made by the BAFIN (German Federal Financial Service Agency). The inspection team is expected to advise a distressed debtor corporation to draft a reorganization plan by bringing in external professional advisors as soon as the team becomes aware that the financial and operational status of the debtor is worsening. If the debtor neglects the teams' advice and fails to take the needed reorganization steps, the banks will collect debts owed by the debtor by refusing to roll over the debts and/or applying foreclosure of securities. Drafted reorganization plans may provide rescheduling of repayment dates, partial debts forgiveness, new additional lending, etc., but debt equity swaps are not popular in Germany. This is because there are risks that, if a financial institution owns stocks more than 10% of issued stocks of the debtor company, the debts owed by the debtor to the financial institution may be regarded as disguised capital and thus subordinated to other debts owed to other financial institutions.

Out-of-court workouts with multiple financial creditors are usually done without public announcement in Germany, except for large cases. The directors are obliged to report at their shareholders' meeting when the amount of capital is reduced by half. This obligation indicates that in general German management has to take appropriate steps at an early stage to recover financial stabilities. Nevertheless, it is a universal fact of life that a collapse comes to surface all of a sudden; the German new insolvency law may not be a very effective tool to reorganize the troubled corporation.

VIII. More Flexible Court Administration of Statutory Reorganization Proceedings Are Preferable

Obtaining unanimous consent to the reorganization plan under the out-of-court process is not easy even for the IRCJ which enjoys strong Japanese government support. To make it easier to obtain consent in workout in Japan, it appears vital that Civil Rehabilitation and Corporate Reorganization Laws, which provide for statutory reorganization proceedings, should be interpreted and applied as flexibly as possible.

When a pre-negotiated plan is agreed by the majority of creditors as required by the statutes for approval by the court, the debtor can file a petition for a statutory proceeding to opt out minority and stubborn creditors. But upon filing of the petition for a statutory proceeding, a court issues a temporary restraining order which prohibits the debtor from paying all pre-petition debts including debts owed to trade creditors with the exception of a small amount of debts paid in the ordinary course of business. And after issuance of the opening order to commence a reorganization case, the debtor is automatically prohibited paying all debts owed before the opening of the case with the same exception by statutory provisions. It may become difficult for the debtor corporations to continue their business because trade creditors tend to refuse supply of goods and services that are necessary to continue the debtors' daily business. This will deteriorate the debtors' enterprise value.

In the case of an out-of-court workout with multiple financial creditors, relevant financial creditors usually agree to pay trade debts in full during the course of the workout and in its reorganization plan as well. Therefore, my proposal is as follows. In the case where an out-of-court workout is converted to a statutory reorganization proceeding, because minority creditors do not consent to the proposed plan but more than sufficient number of majority creditors, whose acceptance is required for the court approval of the plan to cram down minority creditors, agree, the court should permit the payment of trade debts in full, thus changing the present practice of prohibiting all payments of old trade debts. In the United States, federal bankruptcy courts usually issue a first day order to permit payment of pre-petition trade debts owed to critical vendors after initiation of a statutory proceeding.

The debts owed by a reorganizing debtor during the course of a out-of-court workout as a DIP financing to defray operating expenses should not be impaired, whereas other pre-petition debts are allowed to be impaired in the converted statutory reorganization proceeding. Rather the DIP loans should be treated as administrative expenses like the DIP financing loans extended after opening of the converted case. The court should permit payment of debts owed by pre-petition DIP financing in full according to terms of the DIP financing contract agreed between the DIP financer and the debtor.

To obtain unanimous consent more easily and successfully in an out-of-court workout with multiple financial creditors, it is critical to make it easier to use a statutory reorganization proceeding by taking advantage of the majority rule. Stubborn minority creditors may come to know that they are objecting in vain, when the case is converted to a statutory reorganization case. My recommendation is that Japanese judicial society should interpret and apply statutory reorganization proceedings to be more flexible to facilitate reorganization of distressed debtors at an early stage. Otherwise, law reformation may be needed.

In conclusion, I would like to claim that the question of "How many large cases have been dealt with by the IRCJ?" is not crucial; what is crucial is "Can the IRCJ change Japanese culture to enable early reorganization?"—and we have so many challenges ahead.

