

PACIFIC OVERTURES:
ACQUISITIONS OF FINANCIALLY
DISTRESSED COMPANIES' ASSETS IN THE
UNITED STATES AND JAPAN

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Sakai & Mimura, composed of 13 Japanese attorneys and one American attorney, provides legal advice to both local and international clients for general commercial transactions, and in the insolvency field has acted for debtors, creditors, DIP lenders, debt traders, and "sponsors", in addition to official court appointment of individual attorneys of the firm as trustee, supervisor, or other official insolvency proceeding position. More information about the firm, its attorneys, and past representations are displayed in the firm's website at www.sakailaw.com.

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I. Introduction

In free market economies like Japan and the United States, asset acquisitions are a primary means of business expansion. Strategic buyers will often acquire assets of competitors or other companies to expand sales volumes, to enter into new lines of business or to expand their geographical scope. Financial buyers will purchase assets of companies primarily to secure a high return on their investment, either by retaining the acquired business or by later selling it at a profit. With the ongoing recovery of the Japanese economy and the increased value of the yen against the American dollar, Japanese companies are in an advantageous position to enter the American market or expand their existing presence there by acquiring the assets of American companies. Similarly, the Japanese market continues to afford investment opportunities for American companies eager to acquire Japanese businesses for strategic or financial reasons. One example is the acquisition of Long Term Credit Bank by Ripplewood Holdings.

For these strategic and financial buyers, acquiring the assets of financially distressed businesses is a specialized form of this growth strategy. There are many reasons why businesses encounter financial problems in market economies. The quality of management may be poor, which has resulted in excessive expenditures and unrealistic business strategies in a weak economy. The company may have suffered significant losses from an extraordinary event, such as a large money judgment entered against it in litigation. The company's main customer may have decided to switch suppliers, disposed of its business line that provided a market for the company's products or gone out of business altogether. Where the financially distressed company's core business is sound and its productive assets, such its manufacturing facility and equipment, are intact and in good working order, a strategic buyer may have an opportunity to acquire this business as a going concern at a bargain price. How these acquisitions may be made on both sides of the Pacific Ocean is the topic of this article.

II. Purchasing Assets of Financially Distressed Companies in the United States

In the United States, there are three primary methods by which assets of financially troubled companies may be purchased. These methods are (i) by private agreement with the seller; (ii) by purchase at a foreclosure sale conducted by the distressed company's secured creditor; and (iii) by acquisition in the seller's bankruptcy case. As will be demonstrated below, the third method, acquisition of assets pursuant to an order of the bankruptcy court, is often the quickest and most efficient means by which a buyer may acquire assets and the related business on a going concern basis with little or no interruption of the troubled company's operations.

A. Asset Sales by Private Agreement

1. Sale Negotiations and Mechanics. In the United States, a financially troubled company may sell its assets to a strategic or financial buyer through private negotiations. Once the primary terms of the sale transaction, such as the purchase price, representations and warranties and the identity of the assets to be sold, are negotiated by the parties, the understanding of the parties will be memorialized in a written asset purchase agreement executed by buyer and seller. At the closing of the transaction, the seller will deliver to the buyer bills of sale to the personal property and deeds to the real property and the buyer will then take physical possession of those assets. These transactions have been facilitated by the relatively recent repeals by most of the states of their bulk sales laws. These laws required the asset purchaser to send written notice to the seller's creditors of the proposed sale well in advance of the closing of the sale. Upon receiving such a notice, creditors often threatened litigation against the purchaser or would file an involuntary bankruptcy petition against the seller in an effort to halt the sale. When faced with these threats from creditors, asset purchasers unwilling to make payments on claims would often terminate the asset purchase agreement and walk from the transaction.

Even though most bulk sales laws have been repealed, other entities will often be involved in the sale process prior to the execution of an asset sale agreement. For example, the purchaser may wish to retain all or a portion of the seller's management and work force and will negotiate with these individuals and, perhaps, their unions regarding the terms and conditions of future employment. The seller's financing bank and other creditors may hold security interests and liens in the real and personal property that is the subject of the asset purchase agreement. The buyer and seller must come to terms with these creditors concerning the termination or continuation of these interests and liens in order for the sale to close. Similarly, the lessors of equipment and real estate may be entitled to terminate their leases upon an asset sale; these creditors must be dealt with especially when the buyer wishes to continue some or all of these leases in its new operations. Finally, most state laws require that a proposed sale of a significant portion of a corporation's assets must first be approved by a majority of the company's shareholders. Alternatively, a company's operating agreement or its corporate bylaws may require supermajority or unanimous approval of all shareholders or members of the entity upon such a sale. If these affirmative votes cannot be obtained, the subject assets cannot be sold via private agreement.

2. Risks of Sale. Even if the seller's shareholders, members, secured creditors, employees and lessors consent to the proposed asset sale, there are risks inherent such a private transaction that militate against its successful conclusion. As mentioned previously, unsecured creditors of the seller may decide to file an involuntary petition against the seller and seek the appointment of a bankruptcy trustee in order to halt the sale before closing. Unsecured creditors may decide to take this action if they do not trust management or if they believe that other creditors are being improperly preferred at their expense. In addition, both state law and federal bankruptcy law permit creditors and a bankruptcy trustee of the seller to avoid fraudulent transfers of property made by the bankrupt before the bankruptcy case was commenced. If the seller was insolvent at the time of the sale or was rendered insolvent by the sale, then the asset sale may be avoided under these laws if the price paid for the transfer was less than reasonably equivalent value for the property sold. To protect a buyer from these challenges, it will often

insist upon receiving current appraisals to establish that fair value was exchanged between buyer and seller. However, because these sales are accomplished by private agreement without any court involvement in the process, no fail-safe means exist by which a purchaser can totally immunize itself from a fraudulent transfer challenge once the sale closes.

B. Foreclosure Sales of Assets

Under American law, secured creditors holding security interests and liens in the real and personal property of a financially troubled debtor may, upon the debtor's default, repossess this collateral and dispose of it by public or private sales. If the creditor's liens and interests are senior in priority to all others in the property, the property may be conveyed to a third-party purchaser free and clear of all other interests in that property including junior liens. Often, strategic and financial buyers will negotiate with foreclosing secured creditors to purchase the collateral at foreclosure sales. If the debtor or a third party continues to operate the business pending closing of these sales, the going concern value of the debtor's enterprise may be preserved and the property transferred to the buyer on a "turnkey" basis.

1. Sales of Personal Property. A secured creditor holding security interests in the debtor's personal property will be required to foreclose upon and sell this property after the debtor defaults on its credit and security agreements in accordance with the provisions of Article 9 of the Uniform Commercial Code, which is in effect in all 50 states, Puerto Rico and the U.S. Virgin Islands. Under Article 9, a secured creditor may repossess its personal property collateral or leave that property in place prior to the foreclosure sale. Upon taking possession, the secured creditor is obligated to take reasonable care of that property prior to sale. The sale of this collateral may take place ten days after written notice of the sale is sent to the debtor, other parties liable for the debt and other creditors holding security interests in the property to be sold. Once the sale occurs, the debtor and all other parties holding security interests junior in priority to those of the foreclosing creditor are immediately extinguished and the buyer will take this property free and clear of these interests at the sale's closing. The buyer and the foreclosing creditor will often enter into an agreement requiring the buyer to make an opening bid to purchase the assets at the foreclosure sale and specifying the terms of the bill of sale to the personal property to be delivered at closing. If the assets will be operated by the secured creditor, the buyer or a third party pending the foreclosure sale, the debtor may execute an agreement to surrender those assets to the secured party and the new operator will normally execute a management agreement providing for the operation of the business pending the sale's closing.

2. Sales of Real Estate. Foreclosure sales of real estate are more complex and time-consuming than sales of personal property. First, there is no uniform law governing foreclosure of real estate; every state law is unique. Some states permit a secured creditor to foreclose and sell the real estate without the intervention of a court if the mortgage contains a "power of sale" permitting the mortgagee to sell privately upon the mortgagor's default and if the sale is properly advertised and conducted. Other states, however, permit foreclosure and sale of real property only after the secured creditor commences a judicial foreclosure action and the court enters judgment permitting the sale after trial. In a contested judicial foreclosure proceeding, this process may take more than one year from start to finish. Finally, some states grant to the owner of the property a right of redemption which permits the owner to remain in

possession of the property for a period of time (often 6 months to one year) after the foreclosure sale. If, during this period, the owner tenders payment of the debt to the secured creditor, the foreclosure sale is nullified and title will be restored to the landowner.

3. Risks of Foreclosure Sales. While foreclosure sales of personal property may be accomplished in prompt fashion after default with no redemption rights to consider, there are certain factors that militate against these sales. First, the foreclosure sale can extinguish only those interests and liens in the collateral that are junior to those of the foreclosing creditor. Where a senior lien is present, the buyer must enter into a separate agreement with the holder of that lien providing for its payment or other treatment acceptable to it. Otherwise, the senior lender may commence its own foreclosure proceeding and thereby extinguish the buyer's title to the property. In addition, the debtor may be unwilling to operate the business pending the sale of the assets and the foreclosing secured creditor may also be unwilling to take this action. This often occurs where the debtor's business involves environmental hazards involving potential significant liabilities for operators, such as metal-plating operations. If these operations are not continuously maintained up to the closing, the going concern value of the debtor's enterprise may substantially diminish prior to the foreclosure sale.

As previously noted, there is often substantial delay in conducting a foreclosure sale of real estate. A foreclosure sale by advertisement pursuant to a power of sale in the mortgage may be halted if the owner or another secured creditor commences a court action to enjoin the foreclosure sale. If the mortgage may be foreclosed upon only by judicial action, this litigation could stretch out for years. Finally, the existence of the owner's redemption rights will delay the transfer of possession to the real estate after the foreclosure sale is conducted.

C. Sales of Assets Pursuant to Bankruptcy Court Order

1. In General. Within the last ten years, failing businesses have increasingly used the extraordinary powers of American bankruptcy courts to sell assets free and clear of claims and interests. Troubled companies will negotiate with an interested buyer the terms and conditions of an asset sale prior to filing a bankruptcy petition. Once this agreement has been finalized, the purchaser will be required to become the initial (or stalking-horse) bidder at an auction sale conducted pursuant to bidding procedures to be established by the bankruptcy court. Thereafter, the seller will file a petition for reorganization under Chapter 11 of the Federal Bankruptcy Code and the seller's motion to establish bidding procedures and to authorize the sale of assets free and clear of claims and interests at a court-supervised auction. The debtor's management, which will continue to operate the debtor's business after the Chapter 11 petition is filed, will decide which bid to accept at the auction and, thereafter, requesting the bankruptcy court to confirm the sale to the winning bidder. Upon the entry of the court's order confirming the asset sale, the seller and buyer will be free to close the transaction.

2. Protections for Bidders. Companies interested in acquiring the assets of a financially troubled company by means of a sale approved by the bankruptcy court will approach the seller to negotiate the terms of the asset purchase agreement prior to or after the seller has sought bankruptcy court protection. These negotiations over price, representations and warranties and conditions precedent and subsequent to the sale will proceed as if the seller will remain outside the jurisdiction of the bankruptcy court. However, there will be certain

provisions unique to a bankruptcy sale that a seller will seek to obtain during negotiations at subsequent hearings before the bankruptcy court. These special provisions involve bidding and other sales procedures and sales free and clear of claims and interests.

A stalking-horse bidder will normally request that the bankruptcy court approve a “breakup” or “topping” fee in the event that his bid is not accepted. This bid protection device is meant to compensate the bidder for its due diligence and legal expenses, which may be substantial in large Chapter 11 cases. The amount of this fee, normally payable to the losing bidder from the asset sale proceeds, is usually expressed as a percentage of the initial bid. Most bankruptcy courts will approve these fees if they fall within the range of one to three percent of the initial bid. In order to ensure that this amount is available to pay the breakup fee, the second bid at the auction must be in an amount not less than the breakup fee. This device is known as a “topping” bid. Once the topping bid is made, additional bids may be made in different increments.

In addition to bid protection, the stalking-horse bidder will negotiate for inclusion of financial standards for competing bidders. For example, in order to participate at the court-ordered auction sale, competing bidders may be required to deposit with the debtor cash in a fixed amount prior to the auction and to present proof that they have the financial ability to close the sale if their bid is selected as the winning bid. This proof may consist of a written commitment by a financial institution for financing the purchase price or by delivery of a letter of credit in a certain amount. These requirements have the intended effect of limiting the bidders to those who are “real” and not just fanciful. Entities other than the stalking-horse bidder, such as the unsecured creditors’ committee and the secured creditors whose collateral will be sold, are also likely to insist on the inclusion of financial standards in the bidding procedures governing the auction.

Stalking-horse bidders will also negotiate for the broadest possible language in the asset purchase agreement and the sale order describing the claims and other interests that the assets will be sold free and clear from. Unlike foreclosure sales of real and personal property conducted under state law, bankruptcy sales will discharge essentially all liens and security interests in the subject assets, transferring those interests to the sale proceeds. Buyers will commonly request that assets be sold free and clear of all environmental liabilities, tax liens, pension obligations, employee claims, tort liabilities and real estate transfer taxes. Concurrently with this request, the stalking-horse bidder will work with the debtor to ensure that all holders of these affected claims and interests receive written notice to enable them to file objections to the proposed asset sale. If no objections to the sale are filed by holders of these claims and interests, the buyer will be in a position to argue that these claim and lien holders are precluded from challenging the transfer of assets at a later date.

3. Sales Free and Clear. Sales of assets in bankruptcy court may be made free and clear of claims and interests provided that at least one of the five elements set forth in section 363(f) of the Federal Bankruptcy Code is satisfied. These five elements are as follows:

- (a) applicable non-bankruptcy law (e.g., state law) permits such a sale;

- the sale;
- (b) the holder of the claim or lien sought to be discharged consents to the sale;
 - (c) the interest is a lien and there is “value” in the assets to be sold;
 - (d) the interest is in bona fide dispute; or
 - (e) the holder of the interest could be compelled in litigation to accept money in lieu of the interest.

In many situations, holders of security interests and liens in the assets to be sold will consent to the asset sale - - these creditors are more interested in cashing out than in retaining their liens on assets of a troubled company. In any event, if one of these five preconditions is satisfied and if the bankrupt seller can establish a sound business reason for the sale, a successful bidder may purchase assets in an expedited manner - - perhaps even as early as 30 to 60 days after the seller files its bankruptcy petition - - and will not be subject to any redemption rights otherwise granted by state law.

Finally, purchasers of assets under section 363(f) of the Bankruptcy Code will acquire those assets free and clear of any existing successor liability for existing claims otherwise imposed by nonbankruptcy law on a buyer. For example, in many states, a purchaser of assets that continues the same enterprise of the seller may be subject to products liability claims against the buyer arising prior to the sale. If these creditors have received notice of the bankruptcy case, are participating in the bankruptcy case or have had the opportunity to so participate, these claims will not follow the assets into the hands of the purchaser.

III. Purchasing Assets of Financially Distressed Companies in Japan

A. In General

In Japan, a new trend in insolvency cases has developed permitting the sale of the debtor’s assets in the absence of a reorganization plan. As discussed below, this trend has changed the traditional nature of Japanese insolvency practice and has attracted to Japan foreign investors interested in acquiring assets of financially distressed companies in Japanese insolvency proceedings.

B. Traditional Japanese Insolvency Practices

1. Liquidation. Under prior liquidation practice in Japan, the procedures were extremely simple and straightforward. The liquidator would sell the assets and collect claims and receivables and then distribute the proceeds among the creditors in accordance with the priority of the claims on a pro-rata basis.

2. Reorganization. Under prior reorganization procedures, the trustee would evaluate the assets of the debtor and distribute that value to creditors. The amount paid could not theoretically be less than the value of the assets of the debtor determined as of the commencement of the insolvency proceedings. The funds for this distribution and payment were

obtained through (i) sales proceeds of “surplus” assets, i.e., those assets not necessary for the continued operation of the debtor, and (ii) the future income of the debtor.

During the reorganization proceedings, a plan would be formulated under which the existing capital was ordinarily cancelled without any compensation to the stockholders. On exceptional occasions, the business of the debtor was sold to a third party. Those who acquired the newly issued shares of the reorganized debtor or business from the debtor were commonly called ‘sponsors’. Sponsors acquired the debtor’s business or assets through the reorganization process and, consequently, would attempt to enhance the enterprise value of the debtor during the reorganization process. However, there were a number of problems with this procedure:

(a) Under older reorganization practices, the debtor’s assets were often assessed a value significantly lower than their true liquidation value of the particular assets, the ultimate effect of which was to reduce distributions to creditors, typically to the lender whose loans were secured by the property.

(b) Even where some goodwill value is recognized, the artificially low valuation did not often reflect the future cash flow of the debtor after the business improved.

(c) Under an installment payment plan, pre-bankruptcy claims were paid in full (after forgiveness under the plan). The idea of exiting the case through refinancing did not develop in Japan due to the practice of paying no interest upon payments made under the plan. The source of payment of unsecured claims was the debtor’s future income, and excess cash created from sale of assets. Where most of the assets were collateralized, asset sale proceeds were applied only to pay the secured claims, especially under the deflation economy. The bankruptcy proceedings terminated only after the payments had been substantially completed under the plan. The amount of future income was generally very small compared to the pre-commencement claims after forgiveness and, as a result, the case would remain open for an inordinately long period of time, sometimes for 10-15 years, before creditors were paid substantially in full and the case could be closed. The longest installment in Japan under the plan was 19 years. In addition, no interest would be paid on pre-commencement debts during this period, even if a claim was oversecured.

(d) From the viewpoint of the sponsors, installment payment plans were not especially attractive because the debtor was subject to the stigma of bankruptcy and could not exit from the proceedings for a very long time. Consequently, debtor companies and their trustees often experienced difficulties in obtaining sponsors. On the other hand, there would be less competition for sponsors that often resulted in bargain purchase opportunities.

C. Recent Insolvency Practices

1. Change in Environment

(a) Debt trading by foreign investors is placing enormous pressure on debtors to make early distributions to creditors.

(b) The desire of foreign investors to become sponsors has caused significant amounts of capital to flow into the Japanese distressed market. These investors' behavior, ways of thinking and vast skills in reorganizing financially troubled businesses are now being introduced to Japanese insolvency practice.

(c) The trend of early filing and quick exit has been advanced as banks dispose of their non-performing loans on an expedited basis under strong pressure from the Financial Services Agency.

(d) As deflation continues to plague the Japanese economy, debtors do not expect that their debt burdens will ease while they prolong their bankruptcy proceedings and extend the time of their payments.

2. Recent Insolvency Practices

(a) Liquidation. In Japan, liquidation through sale is no longer limited to real estate and tangible personal property. Claims, receivables, loans and businesses are now often sold. The turning point was the Crown Leasing Corporation (CLC) case in 1997. In this Chapter 7-type US\$10 billion bankruptcy case, the trustee sold the debtors leasing assets through an auction to the Orix Group for approximately US\$3 billion. The transaction involved not only the leasing claims but also all the elements of the leasing business, including the existing leasing contracts, and contracts with vendors and employees. Overseas financial assets booked at the headquarters were also sold in bulk. Non-performing loans, real estate and financial assets held by overseas subsidiaries were also sold in bulk to Bankers Trust, Goldman Sachs and other investors at various auctions.

(b) Reorganization. Trustees in corporate reorganization cases and debtors in possession in civil rehabilitation cases now often sell their businesses rather than reorganize them through the traditional type of plan, under which the debtor retains the business and pays the pre-commencement claims in installments. The purchasers (or "sponsors") calculate the future cash-flow of the debtor and, on this basis, establish a purchase price for the debtor's business assets. With limited competition, the prices will often be lower than the fair market value. In addition, sponsors can acquire the debtor company soon after the debtor exits from the reorganization proceedings.

Corporate reorganization law in Japan was reformed in 2003. Before the reform, it was unclear whether or not a sale of business was permissible outside of the plan. However, the Japan Leasings case in 1998 set the precedent for substantial businesses being sold other than through a plan. In this US\$25 billion bankruptcy case, the trustee obtained the court's approval to sell the leasing business to GE Capital before the plan had been formulated. The new Corporate Reorganization Law enforced in 2003 now expressly permits such sales of businesses outside of the plan, where necessary for the reorganization, *i.e.*, before the plan is formulated and approved by creditors. These sales can be accomplished by obtaining the bankruptcy court's approval for the sale. In deciding this issue, the court will listen to the voices of the creditors and the union, and will require compliance with other procedural requirements. See, Part E(2)(c) herein.

(c) Prepackaged Proceedings. In order to maintain and prevent injury to the enterprise value of the debtor, a ‘pre-packaged’ proceeding has been introduced to Japanese insolvency practices and is becoming increasingly popular. Japanese pre-packaged proceedings are different from prepackaged Chapter 11 plans often used in the United States. A Japanese bankruptcy court cannot confirm a plan that has been voted for and approved by the creditors pre-petition. In the context of Japanese insolvency practices, a pre-packaged proceeding means determination of a sponsor prior to the filing of the proceeding and, if necessary and feasible, pre-arrangement of debtor in possession financing. Such pre-packaged proceedings are becoming increasingly popular and recognized in Japanese insolvency practices. Pre-packaged arrangements facilitate the smooth flow of the case, minimize the injuries caused to enterprise value, and enable the debtor to make a quick exit from the proceeding. The factors that are increasing the popularity of this trend include the increase in potential sponsors and also the increase in financial advisors who assist the debtor in organizing such pre-arrangements. As investors realize that sponsorship of distressed companies may often be quite profitable, the competition is getting fierce, particularly for the more lucrative target companies and those with valuable assets. Occasionally, disputes arise in relation to the determination of the sponsor. In the case of Tohato, a well known confectioner with established brands, the debtor company conducted an auction in order to find a sponsor. A Japanese fund was selected as the sponsor pre-petition, but the unsuccessful bidders at the auction offered higher prices post-petition after the petition had been filed. After big arguments, the supervisor forced the debtor to conduct the auction again. As a result, the same fund was the winning bidder the second time around, but was required to pay a much higher price for the same assets.

D. Impact of New Bankruptcy Legislation

New bankruptcy legislation has just been enacted by the Japanese Diet, and is expected to become effective in January 2005. This new legislation makes the following changes to existing practice.

1. Treatment of Secured Claims. Secured creditors will not be stayed from enforcing their liens in the debtor’s property once the bankruptcy proceeding is commenced. In most current cases, however, secured creditors have been cooperating with the trustee to sell the collateralized assets free and clear of liens and interests to third parties. Upon the closing of such a voluntary sale, the trustee will turn over the sales proceeds to the secured creditors in accordance with their priorities after carving out 5-10% of those proceeds for the benefit of the bankruptcy estate. The trustee, however, sometimes faced difficulties when a junior lien holder demanded unreasonable amounts of payments in exchange for its consenting to the release of its lien. Under the new law, the trustee can compel a voluntary sale by offering the sales amount less the proposed carve-out. Such offered payment is deposited with the court and then distributed by the court among the secured creditors in accordance with their priorities. Secured creditors may challenge such an offer, either by foreclosing the lien, or by purchasing or having a third party purchase the assets for such price as is 5% or more higher than the offered sales price.

2. Characteristics of Bankruptcy Sales

(a) The seller will be the trustee, who will normally be a trustworthy attorney, but the transaction will be ordinarily on an as is basis, and no or little representations and warranties will be made by the trustee.

(b) The sales price is often lower than the fair market value, due the above insufficiency of representations and warranties, and less competition.

(c) The asset sale may not be avoided later in the bankruptcy proceeding.

(d) Creditors' committee, if one is formed, will not have a significant role to play in the sale proceedings.

(e) The bankruptcy court must approve the sale in order for it to close.

E. Reorganization Proceedings

1. Comparison of Corporate Reorganizations and Civil Rehabilitations. In Japanese corporate reorganization proceedings, secured creditors are prohibited from foreclosing their lien interests in the collateral, whereas under the civil rehabilitation proceedings, secured creditors are not so stayed. In corporate reorganization cases, unsecured preferred claims, such as claims for wages and retirement allowances, are treated as one of the categories of claims that are subject to the proceeding and are paid in accordance with the plan. In contrast, under civil rehabilitation proceedings, these claims are outside the scope of the plan and will not be affected by the proceedings. Accordingly, those rights can be exercised as the creditors wish.

In corporate reorganization proceedings, the court always appoints the trustees. In practice, upon official receipt of the petition for the proceedings, the court issues an injunction order under which an interim trustee is usually appointed from among experienced bankruptcy attorneys. During this injunction period, the court determines whether or not bankruptcy proceedings involving the target business will be commenced. If the bankruptcy court orders the case to proceed, the court will enter an order officially commencing the case and appointing the interim trustee as permanent trustee. If a sponsor has already been located and informally approved by the court by the time of commencement, the sponsor will ordinarily be requested to provide another separate trustee. The lawyer trustee is called the "legal trustee" and the sponsor's trustee is normally called the "business trustee." Usually, in civil rehabilitation proceedings, no such trustees are appointed and former management acts as trustee, continuing to operate the business of the debtor. In other words, civil rehabilitation proceedings are similar to Chapter 11 cases in the United States.

2. Corporate Reorganization Proceedings

(a) Grounds for the Proceedings. A debtor may file a petition seeking reorganization in the following two instances:

- (i) The debtor's business operations would be significantly impaired if the debtor were to pay its debts as they became due; or
- (ii) An event of bankruptcy is likely to occur with respect to the debtor corporation.

In the event of (ii) above, a creditor who holds claims equal to 10% or more of the paid-in-capital amount of the debtor, or a shareholder who owns 10% or more of the voting shares of all the issued and outstanding shares of the debtor, may also file the petition.

The court will issue an order commencing the corporate reorganization proceedings unless one of the following factors is present:

- The required court fees have not been paid.
- Bankruptcy, corporate reorganization, civil rehabilitation, company arrangement, or special liquidation proceedings are already pending and it is in the best interests of the creditors to allow these to continue.
- The court concludes that a corporate reorganization plan for continued operation of the debtor's business cannot be formulated or approved by the interested parties or confirmed by the court.
- The filing was made for unfair purposes or otherwise lacked good faith.

(b) Appointment of Trustees. As part of the commencement order, the court will appoint one or more trustees. The trustee will assume the authority of the former management to operate the debtor's business, taking on full responsibility for managing the company through formulation, confirmation and full performance of the corporate reorganization plan.

(c) Requirements for Asset Sales. As previously stated, in order for assets to be sold in the course of reorganization proceedings, the bankruptcy court must specifically approve the sale. Under Japan's new Corporate Reorganization Law, section 46 explicitly permits the debtor to sell its business, not in accordance with the plan, but with the court's approval. Under the Corporate Law of Japan, a sale of a business requires a special resolution (more than 2/3 of affirmative votes at the shareholders' meeting, where the majority of shareholders are present or represented). However, if the court finds that the debtor company is insolvent (with liabilities of the company exceeding its assets), court approval acts as a substitute for the shareholder approval normally required under Corporate Law. However, the law requires a court to listen to the voices of the creditors and the union. A trustee may sell the assets free and clear by depositing with the court the value of the collateral as determined by the trustee. In the event of a dispute with regard to the valuation, the court will then determine the value.

Alternatively, the business may be sold through the plan. There are two forms of sale, one being the cancellation of stock in full without any compensation to the shareholders (which results in a sponsor becoming the sole shareholder of the new company upon its infusion of capital and for subscription of newly issued stock), and the other being the sale of assets.

(d) Formulation of Reorganization Plans. Creditors are also allowed to prepare and formulate competing plans of reorganization reorganization (though they have seldom done so in the past), and the deadline for the period for the trustee to file a plan usually continues for a period of 1 month or so after the creditors plan filing deadline.

(e) Treatment of Secured Claims. Secured creditors are stayed and prohibited from foreclosing upon their collateral, and there is no provision allowing secured creditors to obtain relief from the stay. Although the trustee will assign a value to this collateral, this valuation may be subject to dispute by the secured creditors. Once the collateral's value is finally determined, that amount will be paid to secured creditors in accordance with the plan. Payment is generally in long-term installments without interest, even in cases where the creditors are oversecured. Under the new legislation, a debtor may sell the business and assets free and clear, even if the security interest holder opposes the sale or the conditions of the sale, as long as the court is convinced that the sale is necessary for reorganization of the debtor's business.

(f) The Risk of Avoidance. Theoretically, if the case is converted from corporate reorganization to a liquidation proceeding, there is some risk that a previously approved asset sale can be avoided. However, in reality such a risk is virtually non-existent, because, in Japanese practice, it is unlikely that the bankruptcy court will later deny the approval decision once made by the corporate reorganization court.

(g) Examples of a Plan Sale of Assets. In the corporate reorganization case of Life Corporation involving indebtedness of US\$9 billion, the trustee sold the financial assets, including installment payment receivables, consumer loans and credit card receivables to Morgan Stanley, which subsequently securitized those assets. The creditors of Life received a lump sum payment under the plan and the case was terminated immediately after this distribution was made.

3. Civil Rehabilitation Proceedings

(a) Grounds for the Proceedings. The grounds for filing a civil rehabilitation proceeding, and the negative requirements for commencement, are similar to those for commencing a corporate reorganization proceeding.

(b) Retention of Management. Ordinarily, trustees are not appointed in civil rehabilitation cases; the debtor in possession continues to operate the business of the company and supervises its reorganization. The court usually appoints a supervisor from amongst bankruptcy lawyers to monitor the business operations and the insolvency practices of the debtor in possession. The debtor in possession evaluates the value of the assets, examines the claims and formulates a plan. The supervisor may request reports from the debtor or its directors

about the debtor's operations and financial conditions. The supervisor is also entitled to inspect the debtor's books, accounts, documents and other matters. The most significant aspect of the supervisor's power is that the law allows him to exercise the right of avoidance.

(c) Requirements for Asset Sales. The basic procedures for sale of assets and business are the same as for corporate reorganization. The business can also be transferred through the plan in two ways. One way is the cancellation of the existing stock and the issuance of new stock to the sponsor. The other possibility is to sell the business to the sponsor under the plan. Unlike for corporate reorganization, the pre-petition management will usually remain in the office in the civil rehabilitation proceedings, and therefore the sale of the assets requires cooperation of the directors. In exceptional cases where a trustee is appointed, the trustee takes over all the power of the directors, and thus may issue new stock and allot the same to any particular person.

(d) Treatment of Secured Claims. Secured creditors and unsecured preferential creditors are not stayed. Security interests can be extinguished by taking legally required proceedings, and the assets of the debtor can be sold free and clear of any encumbrances. In actual practice, however, such extinguishment proceedings are rarely used. Rather, the debtor negotiates with secured creditors over the valuation of the collaterals and also the terms and conditions for extinguishment, in order to facilitate sales of the assets.

4. An Example of Asset Sales: Sale of a Golf Course Developer's Assets. Following the collapse of Japan's bubble economy, a number of golf course developers encountered financial difficulties and have filed petitions for reorganization. These companies obtained financing for the purchase or lease of land and for construction of the courses primarily from two sources: members and banks. Members were required to deposit some tens of thousands and, in some instances, hundreds of thousands, of dollars with golf course developers before the courses were completed and opened. Membership rights were composed of two elements: (i) a right in the deposit; and (ii) a right to play on the course. These membership rights were traded for ridiculously high prices far exceeding the deposit amount, and some investors were purchasing these membership rights merely as investments. Everyone, including the developers themselves, never imagined that these deposits would be refunded to members at a later date. In essence, all the people involved believed that the members would receive a higher return on investment by selling the membership rights in the market and that a large number of members would elect to do so.

Following the bubble economy's collapse, however, the market for the resale of golf course membership rights disappeared. Members then demanded the return of their deposits, which had the ultimate effect of causing many course developers to commence corporate reorganization and civil rehabilitation proceedings. In civil rehabilitation proceedings, secured creditors (primarily banks) were not prohibited from foreclosing their liens in the golf course assets but generally did not take this action. These creditors knew that their real estate collateral often consisted of mountains and steep hills having few productive uses. In addition, interspersed among the parcels of real estate subject to the bank's liens were other parcels leased from third parties and not pledged to the banks. As a result, any real estate foreclosure sales could be expected to result in deeply discounted sale prices. In addition, it was anticipated golf

course members would protest against the banks' attempts at foreclosure, which created another disincentive to sell collateral through legal process after the developer commenced a civil reorganization proceeding.

In these circumstances, debtors have often commenced settlement discussions with their lenders in the context of civil rehabilitation proceedings. Debtors will search for a suitable sponsor for assistance in restructuring and have often selected either Goldman Sachs or Lone Star for this role. Ordinarily, the golf course assets will be sold (sometimes at auction) as a business unit to a sponsor. These assets ordinarily consist of the land, clubhouse, equipment, employees, and the customer base. Before consummating the sale, the debtor and the sponsor will negotiate with the lenders/mortgagees concerning the value of the mortgaged assets, and will attempt to reach a settlement agreement. In most cases, members will recover only a portion of their initial deposit but their right to play golf on the course will be honored by the sponsor. Those who elect to remain as members will be required to deposit their distribution in the proceedings until their membership is terminated. Only those persons electing to terminate their memberships will be entitled to a distribution. The monies available for distribution to lenders and the terminating members will be derived from the sales proceeds of the golf course assets and new revenues generated by the sponsor's operations. The asset sale transaction will normally be concluded before the reorganization plan is formulated and confirmed by the court. As the number of bankruptcies of golf course developers increase, the practice described above is becoming the template for settlement and reorganization. Consequently, it has become easier to persuade banks and members to accept a restructuring scheme that involves substantial debt forgiveness.

IV. Conclusion

In the United States, a purchaser may purchase the assets of a financially distressed company by means of (i) a voluntary transfer; (ii) a foreclosure sale conducted under applicable state law; and (iii) a sale conducted by the bankruptcy court administering the assets of the distressed seller. The last type of sales, *viz.*, by means of a bankruptcy court order, may be accomplished quickly. Although assets can be sold pursuant to a reorganization plan approved by the seller's creditors and confirmed by the bankruptcy court, this is not commonly done. These sales are accomplished by a motion filed by the seller, which may be heard upon twenty-days' prior notice to the seller's creditors. In addition, a sale under section 363(f) of the United States Bankruptcy Code will discharge most liens and interests in the assets, thereby facilitating their prompt transfer. In short, bankruptcy sales of assets offer foreign buyers a quick and effective means of entering or expanding their existing presence in the American market.

Some fifteen years have passed since the bubble burst in Japan. Thousands of companies, from life insurance companies of more than US\$30-40 billion of debts to small and medium-sized companies, have become subjects of various types of bankruptcy proceedings. Because of this long history, the Japanese people are now accustomed to business failures and their consequences. Through those experiences, a kind of common understanding is gradually emerging: restructuring is preferable to liquidation after all. Financial institutions often feel morally obligated to cooperate with, or at least refrain from hindering, the restructuring efforts of the debtors. On the other hand, bankruptcy laws as well as corporate laws have been reformed

during the past several years, providing debtors and sponsors with a number of tools available for the reorganization of debtors in complicated cases. Actually, successful reorganizations are reported in Japan every week, often with the involvement of foreign financial investors. Hopefully, the final stage of Japanese banks' financial improvement has begun. In addition, more borrowers are expected to manage their own financial difficulties rather than just waiting to be saved at the last moment by outside intervention. Because of these recent structural and additional changes in Japan, foreign investors should definitely consider investing in the Japanese market, particularly by acquiring the assets of financially troubled enterprises.