Recent reforms of Japanese insolvency laws

Japan has reformed and refined its insolvency laws between 1999 and 2005. The Civil Rehabilitation Law (Civil RL) was enacted in 1999 replacing the former Composition Law of 1922. The Law for Recognition and Assistance to Foreign Insolvency Proceedings (LRAFIP) was enacted in 2000 erasing its notorious territorialism and adopting most of the provisions of the UNCITRAL Model Law. In 2002, the new Corporate Reorganization Law (Corporate RL), completely revised the former Corporate Reorganization Law of 1952. The new Bankruptcy Law (BL) was enacted in 2002 reforming the former Bankruptcy Law of 1922 completely. The new Company Law (CL), which is a revision of former Chapter II of the Commercial Code (CC), eliminated the Corporate Arrangement Procedure which existed in the CC since 1938 but was made unnecessary by the Civil RL and the new Corporate RL for business reorganization. The CL also revised the Company Special Liquidation Procedure adopted in 1938 and included in the CC.

The law reforms such as above have been made to speed up insolvency proceedings, enable easier use of statutory proceedings at early stages and meet the standards of improved insolvency procedures developed in industrial countries in recent years.

In Japan, there are two reorganization proceedings: the Civil Rehabilitation Proceeding and the Corporate Reorganization Proceeding. While the Civil RL is designed to rehabilitate over-indebted individuals or small- and medium-sized corporations (SMEs), the Corporate RL is designed to reorganize larger distressed business corporations. The “debtor in possession (DIP)” is allowed to continue the business operation and dispose of its assets in civil rehabilitation proceedings. In normal corporate reorganization proceedings, the debtor is deprived of the power to operate the business and dispose of assets, replaced by a court appointed trustee. Only in exceptional cases, a court may appoint an incumbent management as a trustee. For example, a manager who was appointed prior to the filing of the petition to commence the corporate reorganization
proceeding for the purpose of turning the troubled corporation around may be appointed as a trustee by the court. While secured creditors are automatically stayed from realizing their secured rights subsequent to the commencement of the corporate reorganization proceeding, a court may prohibit a secured creditor to commence or continue the realization procedure of its secured rights only for causes at the request of the debtor. In most corporate reorganizations, the rights of stockholders are wiped out when creditors’ rights are impaired, but owners of enterprises may remain in their position in civil rehabilitation cases.

The new Company Law of 2005 also provides for several useful tools to reorganize troubled business corporations including 100% amortization of issued stocks by a majority resolution of a stockholders meeting at out of court workout stages without resorting to any statutory insolvency proceeding.

*The Guideline for Out of Court Workout*

In Japan, the Guideline for Out of Court Workout was established in 2001 by the Japanese Bankers’ Association, the Japan Federation of Managers of Business Corporations and other relevant organizations, assisted by the Bank of Japan (Japanese central bank), the Financial Services Agency, the Ministry of Economy, Industry and Trade and other governmental units, referencing the INSOL 8 Principles. Like the London Approach, which is essentially an unwritten rule, the Guideline is not a statute but rather a gentlemen’s agreement that is expected to be observed by creditor financial institutions and other relevant creditors.

When a “main bank” or banks that have the largest exposures against the distressed debtor corporation are satisfied with the proposed reorganization plan prepared by the debtor to be fair, equitable and feasible, the main bank will send notices of a “standstill” requesting other creditors to refrain from taking any *de facto* and legal collection efforts including realizing secured rights to relevant creditors who are mostly banks and other financial institutions. Within two weeks after the issuance of the notice, the debtor convenes a creditors meeting where the creditors may or may not consent to the extension of the standstill. If the creditors agree, the standstill period can be extended for up to three months after the date of the first creditors’ meeting. At the meeting, the creditors appoint a panel of professional advisors consisting of lawyers, accountants and business consultants. It may also appoint a creditors’ committee. Upon the completion of the first meeting of creditors, the appointed panel of the professional advisors conducts examination of the proposed reorganization plan with a view to report on its fairness,
equitableness and feasibility to creditors at the second meeting of creditors that will be held one month after the first meeting. After intensive investigation to the proposed plan, the panel of professional advisers make an evaluation report of the plan which is distributed to creditors prior to that meeting. At the third meeting of creditors, creditors vote for or against the plan. The plan provides for financial restructuring by means of debt-for-equity swaps, partial debts forgiveness, rescheduling payments dates and infusing new capital. The plan also provides for business or operational restructuring by means of merger and acquisitions, sale or liquidation of non-core businesses and so on. Unanimous consent of all creditors is required for successful completion of the workout. Even when the majority of creditors agree to the plan, a few stubborn creditors can still block the workout so that the debtor may have to file a petition to convert the workout into a statutory reorganization proceeding where majority rule is applied to cram down the holdout creditors. About 30 large business corporation groups have been restructured using the Guideline for Workout in 2001 and 2002. The Industrial Revitalization Corporation of Japan, a government backed asset management company created for the purpose of facilitating prompt disposal of non- and poor-performing loans and simultaneously revitalizing ailing business corporations, has successfully assisted 41 large corporation groups to reorganize them using scheme similar to the Guideline in 2003 and 2004. New acquisition of troubled companies by the IRCJ has stopped since March 2005 because of its sunset clause. Since then, ten large cases have been resolved by out of court workout adopting the Guideline. Fortunately, it was only a few cases that failed to obtain 100% consent and were converted to Civil Rehabilitation or Corporate Reorganization proceedings. One could argue, however, that it may become more difficult to obtain an unanimous consent in future out of court workout processes in light of increasing degree of involvement of a wide variety of players such as hedge funds.

An out of court workout is an excellent tool to revitalize an ailing company at early stage before its enterprise value was deteriorated.

Problems in converted statutory reorganization cases

In most cases, financing is extended during the workout negotiation period with the understanding by the other relevant financial creditors that claims owed by these financing providers should be repaid prior to all other claims. However, claims incurred before the commencement of the statutory reorganization process, i.e., pre-commencement financing, as opposed to post-commencement financing, are not
regarded as administrative or common interest claims in converted statutory reorganization cases. In large reorganization cases, huge amount of financing is provided during workout negotiation stages. Financial institutions are reluctant to provide such a huge amount of financing at workout stages in fear of the risk that the pre-commencement claims can become impaired in a subsequent statutory reorganization.

Trade creditors who are not relevant creditors in the usual out of court workout cases using the Guideline are paid their claims in full in the ordinary course of business during the negotiation period of the workout. They supply goods, materials and services with an expectation that they are sure to be paid in full. However, the trade debts owed before the commencement of a statutory reorganization proceeding may not be treated as administrative or common interest claims in converted statutory reorganization cases and may be impaired by the reorganization plan. Trade creditors may refuse to supply goods and services in fear of these risks in converted cases even at the time an out of course workout is pending.

To resolve these matters, it may be desirable to enact a new law similar to the U.S. Pre-packaged Chapter 11, the English Enterprise Act of 2002 or the New French Commercial Law of 2005. Despite my efforts of persuading the Japanese law society to enact such kind of new statute, it may be difficult to realize such kind of new legislations in a short period of time. I should not stop my effort of making a new law in order to facilitate successful completion of workouts.

Cross border workout

The number of cross border out of court workout cases involving numerous foreign financial creditors is increasing tremendously. I have no specific proposition so far. I would like to emphasize that practitioners and lawmakers around the world should be aware of the need of certain legislative framework to support and encourage the out of court workout restructuring as suggested in the Recommendations 160-168 of the “UNCITRAL Legislative Guide for Insolvency Law” as well as Principles 25-26 of the “World Bank Principles and Guidelines for Effective Insolvency Procedures”.