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ARTICLE

# Out-of-Court Workout based on the Guidelines and the Alternative Dispute Resolution Scheme for Business Reorganisation in Japan

**Dr Shinjiro TAKAGI**,[1] Advisor, Nomura Securities Co. Ltd, Tokyo, Japan

## 1. Out-of-court workout with multiple financial creditors

In Japan, there are two statutory reorganisation schemes, the Civil Rehabilitation Law of 1999 and Corporate Reorganisation Law of 2002. In addition to these two statutory reorganisation schemes, a Commission was established and organised by the National Bankers Association, the Federation of Economic Organisations and other relevant organisations which, in turn, established the Guidelines for the Out-of-Court Workout in 2002. The Guidelines were drafted referencing the INSOL 8 Principles and have been utilised to reorganise many distressed corporations.

### *1.1. Process of out-of-court workout based on the Guidelines*

The procedure established by the Guidelines 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 exposures. The application must be accompanied by documents that describe the causes of the debtor becoming financially distressed and a proposed reorganisation plan. The proposal should include not only a business reorganisation plan but also a debt restructuring plan. The 'main creditor bank' then investigates the documents and the reorganisation 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 have been met and agrees that the plan can be acceptable to all other non-main banks whose debts are to be forgiven under the reorganisation 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 are 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, 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 reorganisation plan. During the standstill period, the relevant creditors should refrain from any collection efforts, enforcement or realisation of secured rights, improvement of their exposures in relation to other relevant creditors, and should 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 reorganisation plan grant their consent to the proposed plan, the reorganisation plan becomes authorised and the debts owed to the relevant creditors will be changed according to the provisions contained in the plan. If one or more creditors refuse 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.

*Notes*

1 The author was Chair of the Committee for Guidelines of Multi-Creditors Out-of-Court Workout established by the National Bankers' Association and others in 2001, and also the Chairperson of other two committees organised by Ministry of Economy, Trade and Industry from 2001 to 2003 – the Advisory Committee regarding Law Reformations including Corporate Reorganisation Law and the Drafting Committee of Guidelines for Early Business Revitalisation.

### *1.2. Requirements for a reorganisation plan provided by the Guidelines*

The Guidelines are designed to facilitate multiple financial creditor workouts to rehabilitate corporations burdened with enormous amounts of debt. In contrast to the INSOL 8 Principles, the Guidelines provide for substantial requirements for the reorganisation. 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 an 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.

## 2. New statute to facilitate an out-of-court workout

It is a fact that it is not very easy to obtain unanimous consent of all relevant creditors in out-of-court workout processes. Even during the out-of-court workout stages, a sizable amount of loans need to be provided by banks to finance operating overhead costs of the debtor corporations. If unanimous consent is not reached, the debtor should convert the process to a statutory reorganisation proceeding to avail itself of the majority rule contained in the court-supervised reorganisation 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 as a means to facilitate out-of-court workouts, whereby court approval to a proposed restructuring plan can be obtained when the majority of creditors agree to the proposed plan. An out-of-court workout can be approved and implemented albeit reticent minority creditors refuse to consent to the plan, and the debts owed to dissenting creditors can be impaired according to the court-approved plan, cramming them down.

The Revised Law on Special Measures for Industrial Revitalisation (RLSMIR) was enacted in 2007 and its Chapter 4, which was drafted according to the recommendation made by the study group established by the Ministry of Economy, Trade and Industry and the Ministry of Justice, provides for the measures to facilitate out-of-court workouts by bridging the gap between statutory reorganisation proceedings and workouts. The devices provided in the RLSMIR are as follows.

### *2.1. Organisation for alternative dispute resolution proceeding specialised in business reorganisation*

In Japan, several organisations have been and will be organised under the Law to Facilitate the Use of Proceedings for Alternative Dispute Resolution of 2004 (LFUPADR). These organisations may be specialised in dispute resolution proceedings outside official judicial systems on various matters including civil, commercial, intellectual property, security transactions and domestic matters. The Minister of Justice (MOJ) may certify an organisation when it is satisfied that an applicant organisation meets the requirements regarding the fairness of proposed rules for the proceedings and the capability and integrity of the staff, such as arbitrators and conciliators, provided by the LFUPADR. If an alternative dispute resolution (ADR) proceeding is commenced by a certified fair and respectable organisation upon filing a petition by a party to open a case, some legal effects such as tolling statute of limitation would result.

In addition to being certified by MOJ, an ADR institution which is specialised in business reorganisations in conducting out-of-court workouts with multi-creditors to rehabilitate business corporations under RLSMIR may be certified by the Minister of Economy, Trade and Industry (MOETI). To be certified as an 'ADR institution for business reorganisations' both under LFUPARD and RLSMIR, both by the MOJ and METI, the applicant organisation must operate the workout proceedings based on its own rules that must be fair and equitable. The rules are expected to be substantially similar to the aforementioned Guidelines for the Out-of-Court Workout of 2002. The proposed conductors who preside over the workout proceedings operated by the applicant organisation must be well-seasoned professionals with a good reputation.

Japanese Association of Turnaround Professionals (JATP) assisted by National Bankers Association, applied for a certified ADR institution with MOJ and MOETI. After reviewing the application, both MOJ and NOETI certified the applicant as an 'ADR institution for business reorganisation' in November 2008. According to the list of conductors attached to the application, candidates of conductors are well experienced and respected lawyers, accountants and consultants. The rules applicable to workout were drafted basically referencing the Guidelines for the Out-of-Court Workout of 2002. The only major difference between the rules and the 2002 Guidelines concerns the entity that is in charge of commencing the proceeding. That is, in the

case of the Guidelines, a main bank issues the notice of standstill to relevant creditors when commencing a workout proceeding under the Guidelines; whereas in the case of the ADR proceeding, the ADR institution, not a main bank, commences the case at the request of the debtor corporation to issue the standstill notice.

### *2.2. Facilitating the use of out-of-court workouts to reorganise ailing business corporations at an early stage*

No one would object to the statement that an out-of-court workout with multiple financial creditors, with the exclusion of trade creditors, is a more desirable tool than statutory reorganisation proceedings in reorganising a troubled debtor corporation with excessive debts, restructuring its debts and capital at an early stage, while minimising adverse effects on its enterprise value. However, unanimous consent to the reorganisation plan obtained from all creditors is indispensable for a successful workout, which is not easy in all cases. Section 49 of RLSMIR provides for a special court-involved mediation proceeding in case of minority creditors' objection to the proposed reorganisation plan in an out-of-workout proceeding operated by the certified ADR institution. When almost all creditors consent to the proposed reorganisation plan while minority creditors disagree, the debtor corporation may file a petition to open a special mediation proceeding with a court which has competent jurisdiction over the case. In mediation cases, a judge and two mediators may intercede and arrange the case, but in a case transferred from the ADR proceeding, a sole judge may hear the case without involvement of mediators under section 5-1 of Civil Mediation Law (CML). A judge is not obliged to do so, but this provision suggests that when the judge is satisfied that the plan is reasonable, equitable and feasible, and the workout proceeding operated fairly, he or she may issue a mediation order under section 20 of Special Mediation Law (SML) and section 17-2 of CML as soon as possible, say within one month after the petition was filed. The mediation order compels both parties, i.e. the debtor corporation and the reticent minority creditors, to accept the plan, which may be amended by the judge. Although the mediation order does not bind both parties, if the party (or parties) does not object within two weeks after the issue date of the order, a dissented creditor(s) would rarely object to the order and ultimately consent with the plan. These provisions included in LFUPARD, RLSMIR, SML and CML are expected to facilitate the greater use of out-of-court workout business reorganisation proceedings than previously.

### *2.3. Bridging the gap between out-of-court workout and statutory reorganisation proceedings*

Even during the out-of-court workout stages, a sizable amount of loans need to be provided by banks to finance the operating overhead costs of debtor corporations. At the first creditors meeting, participating creditors used to agree to give the same priority status to the debts incurred through the provision of pre-DIP finance during the workout stages as ordinary post petition DIP finance. When the dissenting creditors do not change their stance even after the aforementioned mediation proceeding, the debtor should convert the process to a statutory reorganisation proceeding in order to avail itself of the majority rule contained in the court-supervised reorganisation proceedings. However, the debts incurred through the pre-DIP finance provided before the filing of the petition to commence a statutory reorganisation proceeding would not be treated as priority status debts because they are pre-filing claims that, in theory, could be impaired by the reorganisation plan proposed in the converted reorganisation case. Should a pre-DIP financer refuse to provide money during the workout stage for fear that their debts would be subordinated by DIP financing loans and other administrative claims, the out-of-court workout cannot be used. To fill in this gap, sections 53 and 54 of the RLSMIR provide for a fair and equitable treatment of the pre-DIP financing debts in rehabilitation and reorganisation plans in the succeeding civil rehabilitation proceeding and/or corporate reorganisation proceeding. These sections provide that the courts should confirm the proposed rehabilitation or reorganisation plans upon due consideration of equitable treatment of the pre-DIP financing debts provided during the workout stages operated under the aforementioned certified ADR institution. Here again the Japanese legislature tries to avoid interfering with the judicial power directly. In a nutshell, the RLSMIR bridges the gap between the out-of-court workout and statutory reorganisation proceedings by saving the pre-DIP financers from a river of no return.

## International Corporate Rescue

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