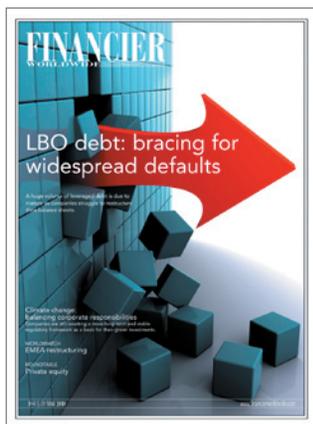


INDEPTH

NAGASHIMA OHNO & TSUNEMATSU

RESTRUCTURING IN JAPAN



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BY SELINA HARRISON



In January 2010, bankruptcies among Japanese companies reached a two-year low, but many businesses continue to suffer amid the current turmoil. In fact, reports suggest that corporate debt in Japan has reached its highest level since World War II. In the country's largest ever corporate failure, Japan Airlines Corp. (JAL) filed for bankruptcy protection with liabilities of around ¥2.3 trillion. The government was quick to supervise the restructuring of its national airline, providing an abundance of capital and legal support to try and minimise the impact of JAL's collapse on the economy. In a country where the number of court-supervised bankruptcies is notoriously low due to the stigma surrounding corporate failure, which compels executives to do nothing until liquidation becomes the only option, it is hoped the government support provided to JAL, and to other companies since then, will encourage struggling businesses to restructure their operations as early as possible.

Until recent years, bank driven out-of-court refinancing was the most common restructuring method for distressed businesses in Japan. Lately, several out-of-court debt adjustment procedures have been adopted to reform the insolvency and restructuring regime, and promote clear and transparent processes for all creditors. One example is the use of turnaround alternative dispute resolution (ADR), established in 2008. Under Turnaround ADR, all creditors must unanimously consent to the proposed business revitalisation plan in order to effectuate a change in the terms and conditions of the debt. Turnaround professionals act as mediators between the debtor and the

creditors. Another example is the introduction of the Enterprise Turnaround Initiative Corporation (ETIC) in 2009. ETIC not only acts to adjust debt but can also make equity investments or purchase loans.

Government bodies shake up the market

Japan now relies heavily on these quasi-governmental turnaround bodies, which can help ailing companies through their restructuring processes and get their creditors to consent to refinancing or reorganisation plans. Interestingly enough, these institutions are today the driving force behind many restructuring cases. At the same time, the new out-of-court debt adjustment procedures provided under ETIC and ADR offer new options for Japanese companies to restructure. There are even cases where some of these tools are used in combination. For example, in the cases of both Japan Airlines and Willcom, the companies first applied for Turnaround ADR and then proceeded to use other corporate reorganisation procedures. It has also been reported that both companies expect to use ETIC funds in their respective reorganisation plans.

Another interesting feature of recent restructuring activity in Japan is that both small and large corporations are using these restructuring procedures, which were initially set up for small to medium enterprises (SMEs). In fact, even some special purpose companies (SPCs) and Japanese real estate investment trusts (J-REITs) are following this trend – the case of the New City Residence Investment Corporation being one example. This trend undoubtedly began with the ETIC involvement in the restructuring of JAL. Although ETIC was

initially created to cushion the local economy from the impact of SMEs' failures, the volume of JAL's debt was such that the Japanese government determined a bank-dictated restructuring would not be enough and bailed out the airline instead.

The collapse of JAL has and will continue to have a huge impact on the Japanese economy going forward. Furthermore, it has put into question the government's policy of developing airports in Japan and has raised doubt over how companies, linked to airports that were closed as part of JAL restructuring, will survive. "It remains to be seen whether many local SMEs around smaller airports and their suppliers, which suffered from the shutting down of unprofitable routes or planes, will now have a chance of being rescued either through the ETIC or another body. Despite all the help and assistance, these Japanese governmental rescue vehicles offer, axing 50 national and international routes and dedicated freight forwarders means that the grounds for business for many of these suppliers might just cease to exist," asserts Dr Annerose Tashiro, a partner at Schultze & Braun. However, the implementation of ETIC is generally considered to have been beneficial for distressed companies so far, as it can use its funds for equity investment or debt purchase in restructuring cases, thereby providing companies with a better standing and stronger position towards employees and creditors. Furthermore, ETIC is expected to take on the role of a mediator in out-of-court restructurings. This is important as the volume of companies that receive assistance should help to stabilise the national economy. The presence of government-backed institutions also establishes competition against domestic or international private equity or hedge funds looking to acquire struggling Japanese businesses.

Besides financial support from the ETIC, an over-indebted or illiquid company has the chance to wipe out all outstanding shares in formal restructuring proceedings (and with court approval) under the Corporate Rehabilitation Law. This concept is unused in most parts of the world, although many professionals in Europe and the US are familiar with the benefits of debt-for-equity swaps as a necessary and effective tool. "As far as the Japanese law goes, this procedure is rather radical," asserts Ms Tashiro. "Shareholders are deprived from their rights and debtor-in-possession financing can result in the withdrawal of all shares, later allotted to a new buyer or equity investor. But for companies that depend

on licences, stock listings, etc., the preservation of the legal entity is particularly essential for the restructuring process and the investor.” JAL’s restructuring, for example, involved the elimination of all 380,000 outstanding shares under this procedure. This element of insolvency reform implemented in 2002 helps to speed up the restructuring process, as it also involves a pre-packaged reorganisation plan, besides share-withdrawal and debtor-in-possession financing.

Overcoming restructuring challenges

Apart from JAL, several other high-profile companies have recently restructured their operations. These include mobile phone company Willcom Inc., owned by private equity firm the Carlyle Group, which filed for bankruptcy protection in February, as well as Aiful Corporation, a consumer loan institution, which was forced to restructure its operations due to mounting debt. The company entered consensual business revitalisation procedures in September last year and utilised Turnaround ADR – all 65 financial institutions involved unanimously consented to the business revitalisation plan proposed by Aiful. The loan debt subject to the revitalisation plan was about ¥279.1bn, the largest amount of company debt ever associated with a successful use of Turnaround ADR. Tomohiko Iwasaki, a partner at Nagashima Ohno & Tsunematsu explains that Aiful mainly applied for Turnaround ADR as customers continuously demanded the return of excess interest payments, also known as the grey-zone interest refunds issue. “This issue is unique to the Japanese consumer finance business and was caused by the enactment of ambiguous legislation and a change of court precedents. To overcome this situation, Aiful

asked to reschedule the repayments in the plan, and all of the creditors consented,” he says. The Aiful case also became notorious in connection with the discussion on whether a ‘credit event’ should be recognised at the time of the ADR application or when a reorganisation plan is established. Controversy aside, the Aiful case is an example of how distressed companies can utilise Turnaround ADR to successfully restructure.

The course of events leading a company to experience financial difficulty differs from one case to another. Besides the grey-zone interest refunds issue in the Aiful case, another common problem is when large volumes of debt are hidden in employee obligations like pension plans and retirement allowances. “Potential causes of insolvency are numerous and complex; hence why, in any turnaround case, it is essential to start by identifying the main causes for the debtor’s financial difficulties, and then establish a business turnaround plan allowing the debtor to recover. But this plan must also make sense to lenders in terms of economic interest, while maintaining the company’s reputation,” asserts Mr Iwasaki. For example, applying for a Corporate Reorganisation procedure or for a Civil Rehabilitation procedure, both of which are court-controlled, is strongly associated with the notion of being insolvent or bankrupt, although the debtor may only be seeking to restructure rather than liquidate. “To avoid creating such an unfavourable impression and to preserve its business value, a struggling company may prefer to utilise out-of-court debt adjustment options, such as Turnaround ADR or ETIC. On the other hand, an advantage of court-controlled restructuring procedures is that the court has the power to issue orders against lenders,” explains Mr Iwasaki.

But between the two court-controlled restructuring procedures, there are several distinguishing aspects, such as the prohibition of foreclosure on collateral and the recognition of potential claims by the debtor itself. Again, it is crucial to analyse the situation of the debtor correctly and then choose the most appropriate procedure for implementing the turnaround plan. Such challenges are exacerbated for foreign companies, as Japan is a very different market with its own rules, explains Ms Tashiro. “It is difficult as a foreigner to survive in Japan even without an economic downturn. But whenever foreign companies were successful, they adapted their products and adjusted their services to the Japanese taste, needs or wishes. One will never be successful in Japan without a precise study of the market and customers’ requirements. Respecting this is the key, particularly in a recession,” she adds. Taking into account Japan’s current economic situation and the fact that there is now a wide range of legal tools for restructuring, it is almost inevitable that such activity will continue to increase, notably among mid-size and small businesses. However, the interests of lenders surrounding debtors tend to differ substantially nowadays, as some lenders secure their own positions by using credit default swaps, while others purchase loan receivables from the primary lender on a discounted basis, or obtain a non-recourse secured loan. The existence of these different positions will make it difficult to establish a business turnaround plan that is acceptable to every lender and therefore to successfully complete the restructuring process. However, restructurings supported by government institutions in the last year or so have demonstrated that there can be a practical and solid approach to refinancing necessities. ■



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