

New sponsor election process for restructurings

July 15 2016 | Contributed by [Nagashima Ohno & Tsunematsu](#)

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It is common practice in many jurisdictions – including Japan – to elect a sponsor to finance a failing business in order to revitalise it. In many insolvency cases, such election is necessary for a successful restructuring.

Background

If a debtor must eventually file for an in-court restructuring procedure, the fairness and appropriateness of the sponsor's election will be examined in certain circumstances, including when:

- a court or supervisor must determine whether to grant a motion for approval of or consent to a sponsorship or asset transfer agreement in civil rehabilitation proceedings;
- a supervisor must determine whether to advise a debtor to terminate a sponsorship agreement that was entered into by the debtor before the insolvency filing in the context of a pre-packaged civil rehabilitation case; and
- a court or supervisor must determine whether to:
 - approve a rehabilitation plan that entails the election of a sponsor; or
 - consent to a proposal for such rehabilitation plan in a creditors' meeting.

The standards or criteria for electing appropriate sponsors in restructuring cases and the extent to which elections should be honoured during in-court restructuring procedures have long been discussed among Japanese practitioners, and several standards or criteria have been presented. Many such standards or criteria require an auction or a bidding procedure in principle, but do not strictly prohibit the election of a sponsor without such auction or bidding procedure in some instances. However, since a conservative approach has been adopted in actual restructuring cases, an auction or bidding procedure has been considered necessary in order to justify the election of a sponsor, irrespective of the debtor's size or the nature of the business. This has made it hard for some companies to elect sponsors and successfully achieve business restructurings. Ultimately, these standards or criteria have been said to be too strict for:

- small-sized debtors that have insufficient cash and time to complete an auction or bidding procedure; and
- debtors for which it is hard to find a sponsor due to the nature of their business.

In light of this, a study group comprising scholars, legal practitioners and turnaround specialists with expertise in insolvency and restructuring – as well as judges who handle insolvency cases for the Tokyo District Court and the Osaka District Court, who acted as observers – suggested a new approach to determine the appropriateness of a sponsor election procedure that is to be applied to all companies, irrespective of their size, industry and surroundings (the so-called 'double-standard approach'). The double-standard approach was developed to ensure that the election of a sponsor is appropriate. However, it is also suggested that a breach or violation of the approach does not necessarily mean that a sponsor election procedure is illegal.

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New approach

The 'double-standard approach' comprises two steps.

Whether an auction procedure is required to elect a sponsor should be determined in the first step, taking into account the various factors surrounding the debtor in question.

Based on the result of the determination, the following approaches will be applied in the second step to determine the appropriateness of the sponsor election procedure that was performed:

- If it is determined in the first step that an auction procedure is unnecessary, the sponsor election procedure will be deemed appropriate unless such election is clearly unreasonable (the 'reasonableness test').
- If it is determined in the first step that an auction procedure is necessary, an auction must be conducted – in principle – and the bidder that proposes the highest amount of support should be elected, thereby rendering the sponsor election procedure appropriate (the 'enhanced scrutiny test').

First-step consideration

In the first step, consideration must be given as to whether it is appropriate to have potential sponsors compete in their proposals. The factors to be considered are:

- the size of the business or debtor as an entity;
- the nature of the business;
- how dependent the business or debtor is on a specific person (eg, the founder); and
- how quickly the debtor must elect a sponsor in order to avoid irreparable harm to the business and succeed in the restructuring.

Each factor must be considered for the following reasons:

- If the size of the business or debtor is small, it would be reasonable to assume that the number of potential sponsors willing to participate in the bidding process would be small or – in the worst-case scenario – non-existent. Requiring an auction procedure in such situation would discourage potential sponsors, making it hard for small-sized debtors to find an appropriate sponsor. Conversely, a large-sized business or entity may have a better chance of finding a suitable potential sponsor.
- If finding a potential sponsor is hard due to the nature of the business it would be reasonable not to require an auction procedure for the same reason as above (eg, if the nature of the business is special, investors may not have any expertise or experience in investing in such business, which could discourage them from participating in the bidding process).
- If the business is dependent on one specific person (eg, the founder), there may be cases where it would be unreasonable to expect that the business's entire management structure be reformed, which may also discourage potential sponsors from participating in the bidding process.
- If the value of the business is diminishing rapidly and conducting a normal or usual auction procedure may cause irreparable harm to the business, there might be occasions when a normal or usual auction procedure to elect a sponsor should not be conducted.

While there have been discussions among scholars and practitioners, there has been no consensus as to which factor is the most important or how strictly the new approach should be applied. However, if an ancillary insolvency proceeding was filed in a foreign jurisdiction, the standard of reasonableness in such jurisdiction would likely be taken into consideration.

Second-step consideration

Reasonableness test

If it is determined in the first step that an auction procedure is unnecessary, the reasonableness test will be applied to determine whether the sponsor election procedure is appropriate. In the reasonableness test, the various factors to be considered to determine whether such election is clearly inappropriate include:

- the purpose of maintaining or expanding the business;
- the existence of synergies with the elected sponsor;
- whether employees will be retained;
- whether business relationships with vendors or customers will be maintained;
- whether collaboration with the elected sponsor will contribute to the debtor's local community; and
- whether the elected sponsor's business policy is appropriate.

An election procedure will be deemed appropriate unless it can be determined that it is clearly inappropriate.

Enhanced scrutiny test

If it is determined in the first step that an auction procedure is necessary, the enhanced scrutiny test will apply. In principle, an election will be considered appropriate if:

- the elected bidder offered the highest amount of support in the auction process (in which bidder proposals were compared); and
- no significant issue with electing the bidder was identified, including maintaining and expanding the business and maintaining employment and commercial relationships with vendors and customers.

The term 'highest amount of support' means the amount to be paid to the creditors, (ie, the amount of assets from which the creditors can expect payment, but not the exact amount detailed in each proposal). However, the issues listed in the second bullet point will usually affect the viability of the proposed restructuring plan and such findings are thus usually linked to the amount proposed by the bidder. Therefore, there is a small chance that issues or factors other than those linked to the proposed amount should be considered when determining the appropriateness of a sponsor election procedure.

Creditor involvement

Another question to be considered is how creditors can be involved in the new procedure.

Generally, the purpose of Japanese in-court restructuring procedures is to maintain fairness through supervision by the court and the court-appointed supervisor or investigator. Although creditors may vote for or against a reorganisation or rehabilitation plan, there are only a few occasions on which they can proactively become involved in the proceedings.

However, in existing practice courts can ask both creditors and debtors for their opinions in in-court procedures if there is a major creditor or major creditor group that could affect the result of a vote on a reorganisation or rehabilitation plan. Thus, such creditors may expect these communications to take place and expect the court, supervisor or investigator to ensure the fairness of the procedure through their supervision of and coordination with the debtor and relevant parties. In addition, there has been one case in which a debtor and the creditors reached an agreement using a mediation procedure. Thus, mediation can be another option for creditors that feel expressing their opinion to the court is insufficient and would prefer to be more proactive.

Further, in a recent case a creditor opposed the sponsor elected by the debtor and prepared and submitted to a creditors' meeting a rehabilitation plan that competed against that submitted by the debtor.

Comment

The number of cross-border insolvency cases in Japan has increased recently and hot topics being discussed among scholars and insolvency practitioners are how information should be shared with creditors involved in in-court procedures and how proactively creditors can be involved in the procedures. In light of the relevant arguments and precedents, including the cases mentioned above, creditors involved in Japanese in-court procedures should consider requesting that information be shared and that opportunities for discussions with debtors be provided.

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