INSOLVENCY & RESTRUCTURING - JAPAN

Potential introduction of cram-down rules in out-of-court workouts

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Introduction

In out-of-court workouts in most jurisdictions, a debtor must obtain consent from all relevant creditors for a restructuring plan to be binding. Therefore, even if the restructuring plan is drafted in a reasonable manner and most creditors agree to it, a debtor cannot implement the plan if a few unreasonable creditors do not agree, unless the debtor abandons efforts to have such unreasonable creditors bound by the plan and revises it to exclude them – which is possible only if the remaining creditors accept such a revised plan. The same applies in Japan.

However, discussions recently took place between government authorities (including the Financial Services Agency and the Ministry of Economy, Trade and Industry) and restructuring experts, regarding the potential introduction of cram-down rules into alternative dispute resolution (ADR) for business turnaround, an out-of-court workout procedure where a restructuring plan becomes binding on all relevant creditors once a majority of them agree to it.

Business turnaround ADR

Business turnaround ADR is a method overseen by the Japanese Association of Turnaround Professionals(1) which can be used to restructure an insolvent business by forming an agreement between it and its creditors that includes debt write-offs and the rescheduling of debt payments. Business turnaround ADR does not involve court procedures and is considered to be a useful tool for out-of-court workouts in Japan. In business turnaround ADR, the debtor can choose to invite only financial creditors to participate, and need not invite trade creditors; further, the procedure is confidential, so the debtor can avoid unnecessary disruption to its business. These benefits elevate business turnaround ADR over statutory insolvency proceedings such as civil rehabilitation or corporate reorganisation proceedings, where all creditors must be involved in front of a public court and the process inevitably impairs the business and assets of the debtor. If, in addition to these benefits, dissenting creditors can be bound by the restructuring plan supported by the vast majority of creditors, business turnaround ADR can be still more useful. This background gave rise to the above discussions.

Potential legislative approaches

Three approaches are being discussed for the introduction of cram-down rules into business turnaround ADR:

- requiring court approval for the cram down;
- commencing an amended short-form rehabilitation procedure if the debtor fails to obtain consent from all creditors; or
- introducing an accelerated business rehabilitation procedure.

Court approval model
Under the court approval model, a debtor that failed to obtain consent from all relevant creditors in business turnaround ADR would be entitled to submit a motion for approval of the restructuring plan to the court. On the court's approval, the restructuring plan would become binding on dissenting creditors that were involved in the business turnaround ADR.

This model would allow the debtor to achieve a quick business turnaround since, following the creditors' meeting for the resolution of the plan, the plan would:

- be approved by the court within two weeks to one month; and
- become binding and effective within one to two months.

Further, under this model, the procedure would not be connected to statutory insolvency proceedings (which in principle are open to the public), so it would remain confidential.

However, one of the difficulties with this model is the legal justification for imposing the restructuring plan on dissenting creditors where they have not gone through the statutory insolvency proceedings – that is, why must the dissenting creditors be bound by the court-approved plan?

Further, under this model, the claims of dissenting creditors would be subject to a haircut or rescheduling as provided in the restructuring plan approved by the court, which could potentially breach the protection of property rights guaranteed by the Constitution.

In addition, the constitutional guarantee of equal treatment under the law may also become an issue, since only financial creditors (and certain others) would be bound by the court-approved restructuring plan, while other creditors would be exempt.

Further issues include:

- the scope of the creditors to be bound;
- whether the binding effect of the restructuring plan should extend to those creditors that have withdrawn from the business turnaround ADR; and
- whether such cram-down rules would negatively affect the use of business turnaround ADR.(2)

Amended short-form rehabilitation procedure model
Under the Civil Rehabilitation Act, a short-form rehabilitation procedure concludes faster than normal civil rehabilitation proceedings and can be applied where the creditors holding three-fifths or more of the amount of the filed claims agree to the rehabilitation plan and the short-form rehabilitation procedure application. Confirmation and determination of the filed claims is omitted from this procedure, enabling rapid conclusion. However, the debtor is not released from unfiled claims (unlike under the normal civil rehabilitation procedure, where the debtor is released from unfiled claims); such claims are subject to change under the general effect of the rehabilitation plan, which applies to all creditors.

Under the amended short-form rehabilitation procedure model, if a debtor failed to obtain consent from all creditors in the business turnaround ADR, the procedure would be elevated to a normal short-form rehabilitation procedure under the Civil Rehabilitation Act. A provision would be added to the act to allow the courts to approve payments to the creditors that did not participate in the business turnaround ADR (ie, commercial or trade creditors) before approval of the rehabilitation plan; under present laws, early payment is only available for creditors with small claims.(3) This arrangement would protect commercial or trade creditors with no involvement in the ADR procedure and avoid the unnecessary impairment of their business that would result from applying the civil rehabilitation procedure.

In the quickest scenario, following the first creditors' meeting, the rehabilitation plan would:

- be approved within one to one-and-a-half months; and
- become effective within two to two-and-a-half months.

Although not as fast as the court approval model, the debtor can complete restructuring relatively quickly.

The amended short-form rehabilitation procedure model is essentially an improvement on the current short-form rehabilitation procedure model. This means that it would be easier and quicker to implement than the court approval model. However, compared to the other alternatives, this model would provide fewer benefits beyond those provided by the existing legal framework. For example, it would be difficult to achieve the same confidentiality that could be expected from the court approval model.

Accelerated business rehabilitation model

The accelerated business rehabilitation model is one step advanced beyond the amended short-form rehabilitation procedure model. In short, this model would introduce new statutory insolvency proceedings in which the procedures are made simpler and less burdensome than those of the existing short-form rehabilitation procedure. If a debtor within the existing short-form rehabilitation procedure failed to obtain consent from all creditors, the procedure would be elevated to the new statutory insolvency proceedings.

In order to commence the existing short-form civil rehabilitation procedure, the debtor must first file for commencement of the normal civil rehabilitation procedure; it can then apply for the short-form civil rehabilitation procedure only after the end of the period for filing proof of claims. However, this two-step filing would not be required in the accelerated business rehabilitation model; the debtor could file directly for commencement of the accelerated business rehabilitation procedure, which would help to ensure timeliness.(4)

Under this model, haircuts and rescheduling would be made through the court procedure in which the creditors are involved. Therefore (as opposed to the court approval model), there would be less of a legal issue regarding the binding effect on dissenting creditors and fewer constitutional concerns. However, since this is a completely new statutory restructuring procedure, it could take a long time to realise.

Comment

As discussed above, each model has unique benefits and faces unique challenges for introduction into the Japanese legal system. Discussions are ongoing and no conclusions have been reached as yet. However, of the three approaches, the amended short-form rehabilitation procedure model would appear to be the most feasible, since it is essentially a small amendment of the existing procedure and presents fewer issues than the other two (although its benefits are limited in comparison).

Until the discussions are concluded and new legislation comes into effect, business turnaround ADR remains a useful tool for out-of-court workouts and the speedy accomplishment of business restructuring.

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Endnotes

(1) The Japanese Association of Turnaround Professionals is an independent association comprising more than 500 turnaround professionals – including lawyers, accountants, financial advisers, members of financial institutions and private funds – which was established in 2003.

(2) Under the current business turnaround ADR procedure, creditors can decide whether to participate in ADR proceedings. Therefore, there is concern that creditors may become unwilling to participate in business turnaround ADR if these cram-down rules are introduced.

(3) To be precise, under Article 85, Clause 4 of the Civil Rehabilitation Act, the court may allow the

debtor to pay to small-claim creditors only if:

- the payment will facilitate the rehabilitation procedure; or
- the business operations of the debtor will face substantial difficulties unless such payments are made.

In the amended short-form rehabilitation procedure model, the payment would be approved by the court for commercial or trade creditors with large claims.

(4) This procedure is derived from the accelerated safeguard proceedings in France.

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