DISTRESSED M&A

Japan

Consulting editor

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Distressed M&A

Consulting editors

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Quick reference guide enabling side-by-side comparison of local insights, including market climate and legal framework; transaction structures and sale process; due diligence and mitigation of related risks; valuation and financing; documentation; regulatory and judicial approvals; dispute resolution; and recent trends.

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MARKET CLIMATE AND LEGAL FRAMEWORK

Market climate

How would you describe the general market climate for distressed M&A transactions in your jurisdiction?

The general market climate in Japan since the onset of the covid-19 pandemic seems to be that most players have been taking a wait-and-see approach to see if any material changes occur in the distressed M&A market. This is partly because the Japanese government has taken holistic measures to provide a financial stimulus to many companies in financial distress to prevent them from going bankrupt. The government has asked financial institutions to help the liquidity of distressed debtors, which has led to their taking an amenable stance to rescheduling or refinancing. Given this, in contrast to the market expectations immediately after the pandemic occurred, we have seen fewer cases of distressed M&A than had been expected.

Having said that, a few observations should be made on the distressed M&A deals during this tumultuous time. First, we have seen restructuring cases involving companies that had been suffering from financial distress before the pandemic occurred (particularly large corporations). Second, a few industries, such as energy providers, hotels, food services, tourism and weddings, have seen a huge decline in turnover, heightening the need for restructuring existing debts or raising new funds. Third, and most importantly, the financial stimulus provided by the government will probably result in a certain number of companies being unable to repay their debts in the future, given their inability to generate cash flow after the pandemic settles down. This will probably lead to more distressed M&A deals as an essential part of the entire debt restructuring market.

Law stated - 30 September 2022

Legal framework

What legal and regulatory regimes are applicable to distressed M&A transactions in your jurisdiction?

As set out below, different legal regimes apply to out-of-court workouts and in-court restructurings.

Out-of-court workouts

A distressed debtor commonly seeks to reach a negotiated agreement with its creditors outside the court to avoid statutory insolvency proceedings. The general consensus among practitioners is that an out-of-court restructuring or workout is preferable to statutory insolvency proceedings to preserve a debtor's going-concern value and reduce the restructuring costs. Therefore, an increasing number of debt restructuring cases in Japan have recently been handled out of court rather than filing for in-court restructurings. Out-of-court workouts regularly require distressed M&A transactions given that a new owner capable of turning the debtor’s distressed business around is routinely required as an essential part of the entire debt restructuring.

For out-of-court workouts, there are three major schemes commonly available in Japan: Turnaround ADR, SME Revitalization Support Council and Out-of-Court Workout Guideline for SMEs.

Turnaround ADR

Turnaround ADR, now commonly used for large corporations, was introduced in 2008 through an amendment to the Act

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on Special Measures for Industrial Revitalisation and Innovation (currently the Act on Strengthening Industrial Competitiveness) to facilitate out-of-court early debt restructurings under mediators licensed by the Ministry of Economy, Trade and Industry and the Ministry of Justice. The Japanese Association of Turnaround Professionals (JATP) is the only licensed organisation that can mediate Turnaround ADR cases thus far.

Turnaround ADR can be defined by several important aspects. First, by its nature as an out-of-court workout, no court is involved in the process. Instead, usually three disinterested and experienced mediators chosen by the JATP (typically two lawyers and one accountant) preside over the process by scrutinising a restructuring plan made by a debtor and chairing multiple creditors meetings. Second, as opposed to in-court restructuring, only financial creditors, typically banks, are involved in the process. After the standstill is agreed to by the financial creditors participating in Turnaround ADR, a debtor is not required to pay loan principals during the process, which can stabilise the debtor's liquidity during the process. On the other hand, a debtor can, and is also expected to, pay trade creditors in the ordinary course of business and operate the business in the same manner as before to keep the going-concern value. Third, contrary to in-court proceedings, Turnaround ADR proceeds in secret except for some cases involving listed companies. This confidentiality can minimise the potential deterioration of a debtor's business value that might be triggered through public disclosure. Fourth, and most importantly, a debtor needs unanimous consent from all participating banks to finalise a deal, which is in practice the most significant challenge involved in Turnaround ADR. No majority voting is implemented in Turnaround ADR.

In the process of Turnaround ADR, after the debtor makes a formal application to the JATP and the JATP accepts it, the debtor and JATP send a standstill notice in their joint names to the financial creditors that the debtor wants to invite to Turnaround ADR. The standstill notice is a unilateral notice sent from the debtor and JATP to ask financial creditors to refrain from collecting loan principals, even due and payable, by, among other things, exercising set-off, requiring collateral or guarantee, receiving payment, enforcing their security interests, and filing a petition for compulsory execution, provisional attachment or any type of insolvency proceedings. The standstill notice expires at the time of the first creditors' meeting, but it is usually extended until the third creditors' meeting with the creditors' consent. Generally, the standstill notice is not deemed to be an event of default or a credit event under financing documents including CDS.

There are three types of creditors' meetings held under Turnaround ADR. At the first creditors' meeting, three mediators chosen by the JATP are approved by participating financial creditors if they are satisfied with those mediators supervising the process. Also, at the first creditors' meeting, the notice of standstill sent by a debtor beforehand must be confirmed by the participating financial creditors, and they decide when the standstill period will be extended until. In almost all cases, participating financial creditors agree to extend the standstill period until the end of the third creditors' meeting. Then, at the second creditors' meeting, the debtor will propose a detailed plan to participating financial creditors. The mediators scrutinise the plan details from an objective viewpoint and submit their own report to participating financial creditors on how fair and economically reasonable they consider the plan to be. Upon receiving the mediators' report, the participating financial creditors consider whether to accept the plan. At the third creditors' meeting, final votes of the participating financial creditors are taken on the plan. If all vote for the plan, the plan is approved and the debtor will implement it accordingly. However, if any of them votes against the plan, Turnaround ADR ends in failure. The debtor has two alternatives if any of them objects to the plan. The first is to utilise an in-court special mediation proceeding presided over by a judge to reach a consensus with respect to the dissenting creditor but the dissenting creditor is not compelled to accept the plan. The second is to file for in-court insolvency proceedings.

SME Revitalization Support Council

The Council supports out-of-court workouts for small and medium-sized corporations. The Council, an organisation established under the Act on Strengthening Industrial Competitiveness, is located in each prefecture to support the preparation of restructuring plans and coordination between the SME's debtors and its financial creditors. In most cases, the SME's restructuring plans are some sort of rescheduling of financial debts, but they sometimes involve

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distressed M&A transactions through either raising new equity or selling assets.

The process starts with an initial consultation where a debtor (or a bank) contacts the Council located in each prefecture to obtain advice from turnaround specialists of the Council (eg, those from banks, certified tax accountants and certified SME consultants). The consultation is followed by assistance in preparing and reviewing a restructuring plan if the Council finds it appropriate to provide such assistance, even though it is the debtor's responsibility to prepare a restructuring plan. The fact that the Council examined a restructuring plan with its own experts and found no issue with the plan (eg, the feasibility of the plan, equal treatment among creditors and the economic rationale in comparison with the relevant alternative, such as insolvency proceedings) can provide a measure of comfort to financial creditors whose claims are subject to the adjustment pursuant to the plan. The plan examined by the Council will be proposed to the financial creditors and a creditors' meeting will be convened where they will vote on the plan. If all of them agree to the plan, the plan will be approved and implemented accordingly.

Out-of-Court Workout Guideline for SMEs

As an alternative to obtaining advice from the SME Revitalization Support Council, SMEs in financial distress may also seek a voluntary out-of-court workout arrangement in compliance with the Out-of-Court Workout Guideline for SMEs. The Guideline, drafted by seasoned lawyers, bankers and scholars, endorsed by the Japanese Bankers Association, and issued in March 2022, is expected to be widely used by financially distressed SMEs given the limited workforce held by the SME Revitalization Support Council as against the number of SMEs in need of assistance. The purpose of the Guideline is to clarify the procedural rules for rehabilitating or liquidating financially distressed SMEs through a voluntary arrangement. The Guideline has no legally binding effect; however, the parties involved are expected to comply with it. The Guideline provides not only for rehabilitation-type out-of-court procedures but also for liquidation-type out-of-court procedures.

The first step under the Guideline is that, while consulting with its own experts, such as lawyers, certified public accountants, tax accountants, as necessary, an SME should select disinterested third-party support experts (those experts, such as lawyers and certified public accountants, who are certified as qualified to conduct rehabilitation-type procedures and liquidation-type procedures under the Guideline) from the published list of experts. Then the SME needs to inform its main financial creditors of its intention to use the rehabilitation-type procedures under the Guideline and obtain the consent of all the main financial creditors for the appointment of the selected third-party support experts. After obtaining such consent, and if the third-party support experts believe that it is not inappropriate to assist the SME's rehabilitation while taking the views of the main financial creditors into consideration, the SME may ask the third-party support experts for assistance in carrying out the procedures under the Guideline. The SME may then ask the financial creditors for a certain period of standstill if it considers it necessary to stabilise the liquidity. The SME needs to draft a restructuring plan with the assistance of its own experts (not the third-party support experts), and then the third-party support experts examine and provide an objective assessment report on the fairness and feasibility of the plan for the review of the financial creditors whose rights are subject to change under the plan. The creditors' meeting will then be held where the SME will explain the plan, the third-party support experts will explain their own assessment of the plan, and the participants will agree on the deadline by which the financial creditors need to vote on the plan. If all participating financial creditors vote for the plan and the third-party support experts confirm in writing their approval of the plan, the plan comes into effect. The rights of the participating financial creditors will be changed in accordance with the provisions of the plan.

In-court restructurings

Japanese insolvency law recognises four types of in-court procedures, each governed by separate legislation, and which can be categorised into one of two general types, depending on whether the aim of the proceedings is to

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liquidate a debtor (liquidation-type proceedings) or rehabilitate a debtor (rehabilitation-type proceedings). The general and common form of liquidation-type proceedings is bankruptcy proceedings under the Bankruptcy Act. The purpose of the bankruptcy proceeding is to liquidate the company by converting its assets into cash and distributing the cash to creditors in a fair and equitable manner (ie, on a pro rata basis). Bankruptcy proceedings are usually used only when none of the other insolvency proceedings is viable. Special liquidation proceedings under the Companies Act are the other type of liquidation proceedings, which can only be used by stock corporations and have different characteristics from bankruptcy proceedings in several aspects; for example, in special liquidation proceedings, unlike bankruptcy proceedings, there is no claim determination process. Rehabilitation-type proceedings consist of civil rehabilitation proceedings under the Civil Rehabilitation Act and corporate reorganisation proceedings under the Corporate Reorganisation Act. Civil rehabilitation proceedings apply to all types of companies, including stock corporations, partnerships and limited liability companies, whereas corporate reorganisation proceedings are only open to stock corporations. The aim of civil rehabilitation proceedings is to turn around the debtor's business based on a rehabilitation plan that restructures only pre-commencement unsecured debts, with secured debts excluded (although it is well established for a debtor to strike a deal with secured creditors outside the proceedings). Civil rehabilitation proceedings are often referred to as debtor-in-possession (DIP) proceedings. In general, the management of a debtor as a debtor-in-possession will continue to operate the debtor's business, being overseen by a supervisor appointed by the court. In contrast, in corporate reorganisation proceedings, the trustee appointed by the court administers and disposes of the debtor's assets, and both unsecured and secured claims are subject to the proceedings.

Law stated - 30 September 2022

Main risk in distressed M&A transactions

Summarise the main risks to all parties involved.

For buyers considering purchasing distressed assets, the main risks commonly seen in both out-of-court workouts and in-court restructurings involve, among others, the limited due diligence with which buyers are requested to make a risk assessment, in that the amount of information provided by sellers is limited and the time to complete due diligence is short, and little or no protection of indemnities is available against sellers, depending on how the distressed M&A transactions are structured (eg, selling good assets to buyers while leaving others, including debt, behind).

For sellers who need to either sell all or substantially all their assets to buyers or raise new equity from investors, the major risks that commonly apply to out-of-court workouts and in-court restructurings are the deal certainty and the risk of liquidity shortfall before closing. Sellers must control the degree of certainty to close the deal by negotiating the closing conditions and the scope of termination rights given to buyers in definitive agreements. Further, sellers must pay strict attention to their liquidity until closing on a constant basis, and there are some cases where sellers may need to ask buyers to provide bridge loans (for in-court restructurings, DIP financing) to allow them to remain afloat until closing.

In addition to the above risks that apply both out-of-court and in-court, buyers in out-of-court workouts should be aware of the clawback risk in asset sales where the proceeds paid by buyers may be deemed to be lower than the fair market value of the assets that buyers bought from sellers who later went into in-court proceedings. Equity deals will not entail the clawback risk in which sellers issue new equity to investors in exchange for a cash injection from investors. Another disadvantage for buyers in out-of-court workouts is the lack of the court's approval to effectuate the contemplated transaction, which in practice diminishes the clawback risk.

Buyers may need to offer a price somewhat higher than the fair market value to the extent necessary to preclude subsequent clawback actions.

On the other hand, a few risks are associated with deals structured under insolvency proceedings. First, the filing of insolvency proceedings may potentially lead to a deterioration of the going-concern value of sellers. Although

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depending on various factors, including the identity of buyers, the extent of protection of trade claims and the speed at which deals are consummated, some customers may cease trading with sellers, particularly if they are not comfortable with selected buyers; some suppliers may cease to provide goods and services if their trade claims that arose before the commencement of insolvency proceedings are not paid in full; and some employees may leave for another company. Second, in-court deals are often sought through an auction process to secure the highest or best offer attainable with the aim of maximising the recoveries for the creditors.

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Director and officer liability and duties

What are the primary liabilities, legal duties and responsibilities of directors and officers in the context of distressed M&A transactions in your jurisdiction?

Directors of a financially troubled company still owe fiduciary duties to the company (not to the creditors) under the Companies Act; however, it should be noted that there is no specific provision governing directors' liabilities in distressed situations, unlike the concepts of wrongful trading or fraudulent trading in the United Kingdom. Once a company files for the DIP type of insolvency proceedings, in addition to the fiduciary duties owed to the company, the directors owe the duty to carry out their business or administer or dispose of their assets in a manner fair and sincere to all the creditors under insolvency law. Under the trustee-type of insolvency proceedings, the court-appointed trustee owes fiduciary duties to all creditors under insolvency law.

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Differences from non-distressed M&A

In general terms, what are the key legal and practical differences between distressed and non-distressed M&A transactions in your jurisdiction?

First, the speed at which deals are consummated is vital in distressed M&A situations, particularly if the company is likely to face a liquidity crisis or breach financial covenants provided for in financing documents. The time constraints from this perspective often lead potential buyers to conduct limited due diligence within a tight time frame. Second, in distressed M&A deals, an auction process is often implemented to avoid the clawback risk and maximise the recoveries for creditors. Third, definitive agreements in distressed M&A deals differ from those in non-distressed M&A deals in various ways; the negotiation of definitive agreements in distress M&A deals is often focused on the scope of closing conditions, representations and warranties, termination rights, and indemnities. In particular, in the trustee-type of insolvency proceedings, the representations and warranties accepted by the court-appointed trustee tend to be considerably limited given that the trustee does not necessarily have in-depth knowledge of the company's business before being appointed. An escrow arrangement to avoid the issue around limited indemnities is sometimes concluded, especially in cross-border distressed M&A deals. Fourth, if the whole deal package requires debt restructuring, such as rescheduling, refinancing, debt write-off or debt-for-equity swap, the deal dynamics become multi-party negotiations where the negotiations are essentially between the selected buyer and the financial creditors via the company.

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Timing of transactions

What key considerations should be borne in mind when deciding when to acquire distressed companies or their assets?

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Out-of-court workouts

The advantages of out-of-court workouts in comparison with in-court restructurings include a lower risk of business value deterioration and a higher likelihood of proprietary (non-auction) deals. On the other hand, the disadvantages of out-of-court workouts include the clawback risk, the risk of making an offer at a higher price to avoid the clawback risk, and the requirement for unanimous consent from financial creditors if debt restructuring is sought as a part of the overall deal. In Japan, there is no majority voting mechanism available, unlike the scheme of arrangement or the restructuring plan in the UK.

In-court restructurings

The advantages of in-court restructurings as compared with out-of-court workouts include, among others, the absence of clawback risk with the court's approval for debtors to sell their assets to buyers, the availability of the majority voting mechanism to effectuate debt restructuring if there is any dissenting creditor, and the availability of operational restructuring by terminating unnecessary executory contracts and rightsizing employees (which is particularly relevant in share deals where buyers subscribe for new shares of distressed debtors). The disadvantages include a higher risk of deterioration of the debtors' business value associated with insolvency filings, which may lead to lower recoveries for creditors and a higher likelihood of conducting an auction process, which in turn may lead to buyers offering a higher price to secure the winning bid.

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TRANSACTION STRUCTURES AND SALE PROCESS

Common structures

What sale structures are commonly used for distressed M&A transactions in your jurisdiction? What are the pros and cons of each, and what procedures and legal requirements apply?

Out-of-court workouts

Listed corporations

The deal structure commonly seen in out-of-court workouts for listed corporations (large corporations in most cases) is the third-party allotment (share purchase deal), where a distressed company issues new shares to the selected buyer, whether strategic or financial, and the selected buyer subscribes for these shares at the price agreed between them. The typical result of the share purchase deal is that the buyer becomes the majority shareholder (the new owner) of the company, and the incumbent managers are replaced with new managers upon closing, who are made responsible for implementing the business turnaround plan. Importantly, in many cases, the issuance to the buyer constitutes an advantageous placement in which the new shares are issued to the buyer at a discounted price fairly lower than the market price, thereby requiring a special resolution at the shareholders' meeting (ie, two-thirds of the voting rights of those shareholders present or by proxy) pursuant to the Companies Act. Since share purchase deals, except for those involving contracts with change of control provisions, do not involve the assignment of contracts from the company to the buyer, the consent of the contractual parties is not required, which would be needed if contracts were to be assigned.

Unlisted corporations

In addition to the share purchase deals mentioned above, the structure frequently sought for unlisted corporations (SMEs in many cases) is an asset sale, where the buyer can select the assets and liabilities of the seller that it wants to

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take over, which can mitigate to some extent the risk resulting from the limited due diligence carried out by the buyer, and the assets and liabilities remaining with the seller are subject to subsequent liquidation or winding-up. In practice, the consent of the creditors whose liabilities remain with the seller is essential in pursuing such an asset sale. Specifically, given that there were fraudulent cases where sellers (oldco) sold their good assets with certain liabilities (critical trade claims in many cases) to buyers (newco) while leaving other liabilities (financial debts in many cases) behind at sellers (oldco), which resulted in impairing the interests of the remaining creditors, the amendment to the Companies Act was introduced in 2016 to protect the sellers' remaining creditors. The amendment provides that, if a seller transfers its business with the knowledge that it would adversely affect the creditors whose liabilities are not assumed by a buyer, those creditors may demand payment of those liabilities to the buyer in an amount not exceeding the value of the assets acquired by the buyer.

In-court restructurings

There are two major structures often seen in in-court restructurings. One is capital contribution (ie, the third-party allotment of shares) pursuant to the restructuring plan, where, in accordance with the terms and conditions of the restructuring plan, sellers (debtors) issue new shares to buyers and buyers subscribe for them in exchange for new funds to sellers. In the capital contribution in the plan, the closing conditions under the share purchase agreement include the approval by the statutory majority of the creditors of the restructuring plan and the confirmation order entered by the court becoming final and binding.

The other, which has been seen more frequently in recent cases, is the sale of assets before the restructuring plan is proposed (ie, out-of-plan asset sale or pre-plan asset sale), where sellers (debtors) sell all or substantially all their assets to buyers before the restructuring plan is proposed (often immediately upon the filing of insolvency proceedings, particularly in pre-packaged deals), subject to the court's approval of the sale. This out-of-plan asset sale (or pre-plan asset sale) is the Japanese equivalent of Section 363 sales in the US Chapter 11.

An out-of-plan asset sale (or pre-plan asset sale) generally provides significant advantages in several aspects. First, it is quicker than the capital contribution in the plan given that there is no need to wait until the plan is proposed, approved by the creditors and confirmed by the court, which can mitigate the risk of the business value deterioration triggered by the filing of insolvency proceedings. Second, by its nature as an asset sale, it allows buyers to take over the assets and liabilities that they want to take over; that said, buyers should be mindful of how costly and time-consuming it will be to transfer the title or ownership of each asset to buyers. It should also be noted that even the capital contribution in the plan can also protect buyers from exposure to pre-commencement liabilities to the extent that those liabilities are reduced through the debt write-off pursuant to the plan. Third, an out-of-plan asset sale (or pre-plan asset sale) is covered by court protection in the form of the court's approval to effectuate the asset sale, which, in practice, reduces dispute risks such as the clawback risk. Fourth, although sellers (debtors) need to hear the creditors' opinions before filing a petition to seek the court's approval, creditors are not required to vote on the out-of-plan asset sale (or pre-plan asset sale) as opposed to transactions provided for in the plan. However, as in normal asset sales, asset sales involving the assignment of contracts require the consent of the contractual counterparties, which will play an important role when buyers find value in sellers based on their existing contracts. In contrast, the capital contribution scheme requires no assignment of contracts; that said, change of control provisions (if any) will need to be addressed. Further, as it does not involve a change in entities, the capital contribution scheme is usually adopted where sellers have a non-transferable licence required for continuation of the business.

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Packaging and transferring assets

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How are assets commonly packaged and transferred in a distressed M&A transaction in your jurisdiction? What procedural, documentary and other requirements apply?

Out-of-court workouts

Capital contribution (ie, third-party allotment) is regularly utilised for listed companies where buyers have no need to take over part of the sellers' assets. Carve-outs (ie, selling assets as the package directly to buyers) or hive-downs (ie, packaging assets to the SPC held by sellers and selling the shares in the SPC to buyers) are commonly used when sellers need to sell part of their business (typically non-core business). The decision on whether to proceed with carve-outs or hive-downs is made by the board of directors, and, in certain circumstances, they require approval at the shareholders' meeting pursuant to the Companies Act. For unlisted companies, the asset sale to package and transfer certain assets and liabilities to be acquired and assumed by the buyer is common. When certain creditors remain at sellers after the asset sale, their consent to the asset sale is crucial.

In-court restructurings

The best practice in in-court restructurings are pre-packaged transactions, where, before the filing of insolvency proceedings sellers (debtors) negotiate and execute a definitive agreement with buyers selected through a pre-petition marketing process, and the contemplated transaction is consummated promptly upon the filing of insolvency proceedings, subject to the court's supervision and approval and in accordance with insolvency law. This approach has the distinct advantage in terms of speed, cost and a lower risk of business value deterioration. A 'stalking-horse' bid is sometimes, albeit not commonly, seen, in which, typically sellers select initial buyers called a 'stalking horse' before the filing of insolvency proceedings and after the filing of insolvency proceedings conducts a market check to see if there are any prevailing bids. Buyers who made the highest or best offer wins the bid.

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Transfer of liabilities

What legal requirements and practical considerations should be borne in mind regarding the acceptance and transfer of any liabilities attached to the distressed company or assets?

The capital contribution scheme

In out-of-court workouts, buyers assume all liabilities of the sellers (ie, companies that issue new shares for which buyers subscribe). In in-court restructurings, with certain exceptions, the liabilities that buyers are required to assume are limited to post-commencement liabilities, which constitute administrative expenses (or common-benefit claims) under insolvency law, and pre-commencement liabilities, the amount of which will be modified (ie, written-off) pursuant to the plan approved by the creditors and confirmed by the court.

The asset sale scheme

In both out-of-court workouts and in-court restructurings, buyers can choose which liabilities they will assume under asset purchase agreements. That said, it should be noted that there is some restriction on the transferability of pre-commencement debts (typically trade claims) in in-court restructurings in light of the equal treatment principle among creditors, which is premised upon the notion that inequality among creditors arises when part of the pre-commencement claims assumed by buyers will later be paid in full by them, while those remaining with sellers

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(typically financial claims) will be subject to the write-off pursuant to the plan. The restriction, although applied on a case-by-case basis, might not apply to cases where it is evident that buyers' assumption of such debts is required for commercially justifiable reasons (eg, trade claims of critical suppliers that play an important role in maintaining the value of sellers), and therefore, the assumption of such debts is a prerequisite of the buyers' offer, and no reduction in the offered price is made due to the buyers' assumption of such debts (in other words, it is not the case that the creditors of such debts (typically trade claims assumed by buyers) are paid in full in exchange for lower recoveries of claims remaining with sellers (typically financial claims). Further, as outlined above, the law that restricts fraudulent asset transfers, whether in the form of business transfers or corporate splits, which adversely affect the interests of the sellers' remaining creditors, came into effect in 2016.

Generally, Japanese law does not recognise the concept of successor liability, with the exception of the secondary tax liabilities where buyers must pay sellers' tax liabilities as the secondary taxpayer in certain circumstances if sellers (original taxpayers) are in arrears with their tax liabilities. In particular, in distressed asset sales, secondary tax liabilities can be found under the National Tax Collection Act, where buyers paid no consideration or significantly lower consideration to sellers, or where sellers establish their wholly owned subsidiaries to which sellers transfer the assets to be acquired by buyers and then buyers acquire from sellers the shares in those subsidiaries.

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Consent and involvement of third parties

What third-party consents are required before completion of a distressed M&A transaction? What are the potential consequences of failure to obtain these consents? In what other ways are third parties commonly involved in the transaction?

What sets distressed M&A deals apart from non-distressed M&A deals is creditors' involvement. In distressed M&A deals involving a restructuring of funded debts, whether structured as out-of-court workouts or in-court restructurings, consents from financial creditors are crucial. Financial creditors monitor the auction process led by the debtor and its financial advisor and express their views on which buyer should be selected in the interest of maximising their recoveries. This is particularly true where some type of adjustment of financial debts is required, such as rescheduling, refinancing, debt-for-debt swap, debt-for-equity swap or debt write-off. Without their consents, which must be unanimous in out-of-court workouts and by a statutory majority in in-court restructurings, distressed M&A deals as part of the entire debt restructuring will not be consummated.

Third-party consents required in non-distressed M&A deals will also be required in out-of-court workouts, such as the consent by the contractual parties to the assignment in asset sale schemes, the consent by the authorities to the transfer of licences in asset sales (or buyers' obtaining new licences from the authorities), the consent by the contractual parties in capital contribution schemes if the contract includes a change-of-control provision, and the resolution at the shareholders' meeting by a statutory majority of existing shareholders to approve the deal (in many cases involving distressed companies, two-thirds of the voting rights of those shareholders present or by proxy). The consent or approval additionally required in in-court restructurings is, for the out-of-plan asset sale (or pre-plan asset sale), the court's approval to execute the deal, and, for the capital contribution in the plan, the creditors' approval and the court's confirmation order. However, in both the out-of-plan asset sale (or pre-plan asset sale) and capital contribution in the plan, the shareholders' approval is not required if the company is balance-sheet insolvent (meaning its liabilities exceeds its assets).

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Time frame

How do the time frames and timelines for the various transaction structures differ? Can these be expedited in any way?

For out-of-court workouts, capital contribution is generally quicker than an asset sale, under which it takes some time for the title or ownership of each asset to be transferred to buyers. That said, in most distressed cases, the capital contribution for listed corporations requires a resolution at the shareholders' meeting, which usually adds a few months to closing.

For in-court restructurings, the Tokyo District Court has issued a standard timeline of approximately six months from the filing to the confirmation order by the court on the plan, which may be shortened or extended on a case-by-case basis. The practice in in-court restructurings to shorten the timeline up to closing is a pre-packaged filing, where, before filing insolvency proceedings, sellers (debtors) negotiate and execute definitive asset sale agreements with buyers selected through a pre-petition marketing process, and an out-of-plan asset sale (or pre-plan asset sale) is implemented promptly upon the filing of insolvency proceedings, subject to the court's approval.

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Tax treatment

What tax liabilities and related considerations arise in relation to the various structures for distressed M&A transactions in your jurisdiction?

The asset sale structure in many cases provides a tax advantage to buyers, as they can use the value of the goodwill acquired from sellers as a tax-deductible expense. The capital contribution structure may provide buyers with certain tax benefits if they are allowed to use the tax-loss carry forwards accrued in the issuing company, subject to the general caveat that this requires careful tax planning with tax advisors. Further, in distressed M&A transactions combined with debt restructuring that involves debt write-offs, the tax treatment on debt write-offs (ie, the gain on debt forgiveness for the debtor and the loss on debt forgiveness for the creditors) should be taken into account. Further, the risk of secondary tax liability should be taken into account in devising a transaction scheme.

Law stated - 30 September 2022

Auction versus single-buyer sale process

What are the respective pros and cons of auction sales and single-buyer sales? What rules and common practices apply to each?

Auction process

Auction sales offer the advantage of being transparent. Specifically, auction sales ensure that sellers attain the highest or best offer, thereby making it easier for sellers (debtors) to provide creditors whose claims are subject to debt adjustment with the convincing justification that a particular offer from the selected buyer would be in the best interests of the creditors. In practice, therefore, an auction process reduces the clawback risk. Depending on various factors, such as how imminently debtors may face a liquidity shortfall, how attractive their business would be in the industry and where financial creditors stand on the necessity for the marketing test, debtors must determine how robustly they will proceed with an auction process. Some form of auction process, whether limited or comprehensive, is almost inevitable if a debt-for-equity swap or debt write-off is contemplated under the restructuring plan.

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Auction sales, however, have the disadvantage of being costly, time-consuming and having a higher risk of sensitive information leakage. The process typically encompasses retaining a financial advisor, providing a teaser and information package to potential buyers, allowing due diligence to be conducted (including on-site visits), inviting a binding offer and negotiating and entering into definitive agreements with the selected buyer. The entire process takes considerable time and cost. Potential buyers often include strategic buyers competing in the same industry, raising the issue of disclosing sensitive information to competitors. From the perspective of buyers, an auction process generally creates a competitive environment that sometimes makes it strategically difficult for bidders to ask for full-blown due diligence and more contractual protections, such as more unrestrained rights to walk away from deals with more relaxed termination rights and closing conditions, and more protected indemnities. A stalking-horse bidder that executed the asset purchase agreement pre-petition may not be chosen as the final purchaser after a higher or better offer comes up during the market check.

Single-buyer process

Although it has the disadvantage of not ensuring that the highest or best offer is attainable, the single-buyer process has the benefit of enabling distressed M&A transactions to be conducted as quickly and cost-effectively as possible by cutting a deal with a single buyer. The process generally gives more leverage to the buyer on the terms and conditions negotiated into definitive agreements. That said, single buyers should be mindful of how the price is agreed, bearing in mind the higher risk of clawback.

Two-prong criteria

More recently, practitioners have advanced the two-prong criteria to help determine whether an auction process is necessary for particular distressed companies. The first prong is to determine whether it is appropriate that a particular case requires the creation of a competitive environment through an auction process in light of various factors, including the size of the debtor (ie, whether the debtor is too small to be an attractive investment), the nature of the debtor's business (ie, whether it is difficult to find multiple buyers because the nature of the debtor's business is too specific), the dependency of the debtor's management on specific individuals (ie, whether, and the extent to which, the value of the debtor's business depends on the capabilities of the current management) and the time available for an auction process to run its course (ie, when the debtor may face a liquidity shortfall, and whether, and the extent to which, the value of the debtor's business could deteriorate if it takes time to select a final buyer). The second prong is that, if after taking these factors into account, it is determined appropriate not to create a competitive environment through an auction process, the 'reasonableness criterion' applies, under which the single-buyer sale is presumed to be reasonable unless there is any specific evidence to establish that the process was biased (eg, if the incumbent manager selected a single-buyer based on personal gain); if an auction process is required due to the factors above, the 'rigorous criterion' applies, under which a strict assessment is made of how robust and comprehensive the process was to enable multiple buyers to make offers, and whether the bidder who offered the highest or best price was selected.

Law stated - 30 September 2022

DUE DILIGENCE

Key areas

What are the most critical areas of due diligence in a distressed M&A transaction?

The business and financial due diligence focuses on what factors caused the debtors to be in financial distress, what measures can be taken to turn them around and how pressing their liquidity issue is. The legal due diligence generally

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centres around the legal aspects that affect the business value of the debtor, such as reviewing material assets, contracts and employees that buyers will acquire.

Importantly, the scope of the legal due diligence highly depends on what transaction scheme will be adopted. For instance, the asset sale scheme, whether structured in out-of-court workouts or in in-court restructurings, does not usually require a careful review of whether liabilities (whether actual or contingent) exist to the extent that buyers do not assume them. This is also true in the capital contribution in the plan under insolvency proceedings, in which the pre-commencement liabilities can be subject to write-off pursuant to the plan. However, buyers must scrutinise whether contingent liabilities may exist when pursuing the capital contribution scheme in out-of-court workouts given that they take over sellers as the entities. Further, the asset sale scheme requires a careful review of how the proceeds from the asset sale will be applied to avoid the clawback risk because one of the requirements for fraudulent conveyance is that the sale had a real risk of the debtor concealing, gratuitously conveying or otherwise disposing of the asset in a manner prejudicial to its creditors.

If buyers are to provide rescue financing (including debtor-in-possession financing) as part of the deal, the securities and relevant collateral provided to existing lenders are also reviewed to assess what collateral can be provided to secure the rescue financing.

Law stated - 30 September 2022

Searches

What searches of public records should be conducted as part of a due diligence exercise in distressed M&A transactions in your jurisdiction?

Public records commonly searched during due diligence include the corporate registry, the real property registration, the security interests registration (only available for assignment of claims and transfer movable assets, both of which are utilised to create security interests) and the intellectual property registration. There are no public records for litigations and disputes searches.

Law stated - 30 September 2022

Contractual protections and risk mitigation

What contractual protections and other strategies are commonly used to mitigate diligence gaps in a distressed M&A transaction?

The limited due diligence conducted by buyers may lead to buyers offering a discount on the price. In cross-border deals, an escrow arrangement is often seen as a measure to mitigate the risk from the limited due diligence, while this is still quite rare in domestic deals. Warranty and indemnity insurance is rarely found in domestic transactions. Indemnities provided to buyers are limited or even expire at closing; therefore, it is crucial for buyers to have the right to walk away from the deal through the closing conditions (including the breach of representations and warranties as well as covenants) and the termination rights (including the long-stop date).

Law stated - 30 September 2022

VALUATION AND FINANCING

Pricing mechanisms and adjustments

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What pricing methods, adjustments and protections are commonly used in the valuation of distressed M&A transactions in your jurisdiction and what are the pros and cons of each? How are they used to balance the interests of the parties?

In the capital contribution structure, the price at which the new shares will be issued is fixed when the share purchase agreement is entered into by and between sellers (issuing companies) and buyers (subscribing investors). In the asset sale structure, no common practice has yet been established. However, it appears that the locked-box method is preferred compared to the working capital adjustment, as the latter takes time and cost to prepare a closing balance sheet despite the sellers' distressed situation, which delays the distribution of the finalised sale proceeds to their creditors.

Law stated - 30 September 2022

Fraudulent conveyance

What rules govern fraudulent conveyance of distressed assets sold undervalue in your jurisdiction? How can clawback risks be mitigated when negotiating the deal price?

Insolvency law (ie, the Civil Rehabilitation Act for civil rehabilitation proceedings, the Corporate Reorganisation Act for corporate reorganisation proceedings, and the Bankruptcy Act for bankruptcy proceedings) addresses a fraudulent conveyance of distressed assets that could have been avoided if the debtor was insolvent when the sale was made and knew that the sale would adversely affect the interests of the creditors. However, it will not apply to the buyer who did not know, at the time of the sale, that the sale would adversely affect the interests of the creditors. Further, if the debtor has received a reasonable value from the buyer for selling its asset, the sale can be avoided only if the sale had a real risk of the debtor concealing, gratuitously conveying or otherwise disposing of the asset in a manner prejudicial to its creditors by realising real property or otherwise changing the type of the property by such disposition; the debtor, at the time of the sale, intended to conceal or otherwise dispose of the proceeds or any other property that the debtor received as value for the sale; and the buyer, at the time of the sale, knew that the debtor intended to conceal or otherwise dispose of the asset.

Insolvency law only applies if the debtor has initiated insolvency proceedings; however, as described above, even before the filing of insolvency proceedings, the Companies Act also protects the interests of the sellers' remaining creditors in asset sales by providing that, if a seller transfers its business with the knowledge that it would adversely affect the creditors whose liabilities are not assumed by the buyer, those remaining creditors may demand payment of their liabilities to the buyer in an amount not exceeding the value of assets acquired by the buyer.

A procedural measure to mitigate the clawback risk where the debtor is or is likely to become insolvent is to conduct an auction process to ensure that the highest or best offer is obtained, which would be deemed a reasonable value, making it highly difficult to establish fraudulent conveyance. Contractual measures to mitigate the clawback risk involve the seller's representations and warranties to the effect that the seller is not insolvent at the time of the sale or likely to be insolvent for the foreseeable future and that the seller has the intention of utilising the proceeds from the asset sale for the agreed purpose (eg, making repayment to all the creditors), obtaining a third-party valuator's opinion that the agreed price is within the price range of the seller's fair market value, and the seller's post-closing covenant that the seller must utilise the proceeds from the asset sale for the agreed purpose.

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Financing

What forms of financing are available and commonly used in distressed M&A transactions? How can financing be secured?

In distressed M&A transactions, whether in out-of-court workouts or in in-court restructurings, new rescue facilities are sometimes advanced by banks or selected buyers to bridge the time gap between when debtors face a liquidity shortfall and when the contemplated transactions can be consummated. The bank that advances rescue loans is often the main bank (the lead bank), the balance of which is usually the highest of all the banks. However, a third-party financier is also occasionally involved in the distressed financing market. The buyer is regularly asked to fill the time gap above as part of the deal and if the rescue loan is provided by the buyer, it normally follows a debt-for-equity swap at closing. Whether provided by banks or buyers, collateral to create security interests is routinely required.

Unlike US Chapter 11 proceedings, there is no concept of super-priority and priming lien. The financing advanced in insolvency proceedings (referred to in practice as debtor-in-possession (DIP) financing) has priority as an administrative expense (ie, common-benefit claim) but not the highest priority among the administrative expenses.

The financing advanced during Turnaround ADR or SME Business Rehabilitation Support Co-operative, referred to in practice as Pre-DIP financing, can be given preferential treatment among pre-commencement claims even when the workout fails and the debtor initiates insolvency proceedings if certain requirements are met, including all the participating creditors agreeing to give the Pre-DIP financing preference over their claims.

Law stated - 30 September 2022

Pre-closing funding

What provisions are typically agreed to secure pre-closing funding of distressed businesses and assets?

In addition to the usual terms and conditions of normal financing (eg, the principal amount, interest, the maturity date), DIP financing or Pre-DIP financing documents routinely include covenants such as the obligation to regularly report on the liquidity and financial performance, the status of the auction process to select a buyer and the status of communications with creditors and the court (if applicable); the obligation to obtain prior consent from the financier on the plan that will be proposed to the creditors; and the obligation to obtain consent when filing for insolvency proceedings (if applicable).

Law stated - 30 September 2022

DOCUMENTATION

Closing conditions

What closing conditions are commonly agreed in distressed M&A transactions? How do these differ from non-distressed transactions?

Closing conditions are regularly at the forefront of contract negotiations given that the indemnity is limited in distressed situations. The negotiation dynamics are such that the seller wants to limit the closing conditions to reduce deal uncertainty, while the buyer wants to ensure the right to walk away from the deal for fear of unidentified risks due to the limited due diligence. The closing conditions commonly negotiated in distressed situations include consent from financial creditors where the restructuring of their debts is required, consent from the debtor-in-possession (DIP)

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financier or Pre-DIP financier (if applicable), shareholders' approval at the shareholders' meeting (particularly in the capital contribution structure), the court's or the court-appointed officer's approval (in in-court restructurings), the approval by the relevant authorities of foreign investment, business licence and competition law, consent to assignment from contractual parties of material contracts, retention of personnel (including the key-person provision) and the material adverse effect provision, the scope and exceptions to which are always subject to negotiations.

Law stated - 30 September 2022

Representations, warranties and indemnities

What representations, warranties and indemnities are commonly given in distressed M&A transactions?

The representations and warranties in distressed M&A transactions are mostly the same as or slightly less stringent than those in non-distressed M&A transactions, except for cases where the trustee is appointed by the bankruptcy court. The representations and warranties made by the trustee are fairly limited given that he or she is appointed after the filing of insolvency proceedings, and therefore has little first-hand knowledge about the debtor's business and financial matters that would have otherwise been included in the representations and warranties in debtor-in-possession cases.

The scope of indemnities is very limited and often expires upon closing (except for carve-out cases where sellers with good assets are still able to indemnify after closing).

Law stated - 30 September 2022

Remedies for breach

What remedies are available and commonly sought for breaches of closing conditions, representations, warranties and indemnities in distressed M&A transactions?

As the indemnities provided to buyers are highly limited, the main remedy available to buyers is to walk away from the deal before closing on the ground that a closing condition (eg, a material breach of the representations and warranties or the covenants) is not satisfied.

Law stated - 30 September 2022

Insurance

Is warranty and indemnity (W&I) insurance available for distressed M&A transactions in your jurisdiction? If so, what provisions and exclusions are commonly included in W&I policies?

W&I insurance is rarely found in domestic distressed M&A transactions but is sometimes found in cross-border transactions.

Law stated - 30 September 2022

REGULATORY AND JUDICIAL APPROVALS

Merger control

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What merger control rules and filing requirements govern the acquisition of distressed businesses and assets in your jurisdiction? Is the 'failing firm' defence recognised in your jurisdiction?

The failing firm concept is recognised in Japan; however, in practice, it may not substantially reduce the need to demonstrate to the Japan Fair Trade Commission that a material adverse effect on the competitive environment is unlikely.

Law stated - 30 September 2022

Foreign investment review

Are distressed M&A transactions subject to foreign investment review in your jurisdiction? What rules, procedures and common practices apply?

Yes, distressed M&A transactions are subject to foreign investment review in Japan in the same manner as non-distressed M&A transactions. The Foreign Exchange and Foreign Trade Act governs foreign investment review in Japan.

Law stated - 30 September 2022

Bankruptcy court

What rules and procedures govern the bankruptcy court's approval of distressed M&A transactions in your jurisdiction?

Insolvency law applies: the Civil Rehabilitation Act for civil rehabilitation proceedings, the Corporate Reorganisation Act for corporate reorganisation proceedings, and the Bankruptcy Act for bankruptcy proceedings.

Law stated - 30 September 2022

DISPUTE RESOLUTION

Common disputes and settlement

What issues commonly give rise to disputes in the course of distressed M&A transactions and what practical considerations should be borne in mind when seeking to settle such disputes out of court?

Clawback litigation to avoid an asset sale that is valued below the fair market value or that adversely affects the interests of the seller's remaining creditors has sometimes occurred and it has been resolved through court rulings or settlements. The fact that there were many cases involving fraudulent transfers that adversely affected the interests of the creditors remaining at sellers led to an amendment to the Companies Act in 2016 to protect them.

Law stated - 30 September 2022

Litigation and alternative dispute resolution

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What litigation forums are used to resolve disputes arising from distressed M&A transactions in your jurisdiction and what procedures apply? Is alternative dispute resolution (ADR) commonly used?

The dispute resolution forum for distressed M&A transactions, agreed in definitive agreements between sellers and buyers, can be either the jurisdiction of a specific court or commercial arbitration, although it seems that parties generally prefer the court venue. If the restructuring plan contains distressed M&A transactions, litigations can also be brought by creditors by opposing the confirmation order entered by the bankruptcy court. The mediation procedure in lieu of court rulings is occasionally used in disputes between debtors and creditors or those among creditors (eg, secured creditors versus unsecured creditors) but is rarely used in distressed M&A transactions.

Law stated - 30 September 2022

UPDATE AND TRENDS

Recent developments and outlook

What have been the most significant recent developments and trends affecting distressed M&A in your jurisdiction, including any notable court decisions, regulatory actions and deals? What is the general outlook for future transactions?

The governmental financial stimulus to keep as many companies as possible afloat during the covid-19 pandemic has resulted in the need to deal with debt restructuring of those companies that owe an excessive amount of debt exceeding what they can repay going forward. The need to deal with the over-indebtedness issue will probably lead to more distressed M&A transactions.

Further, as the current out-of-court workout regimes (Turnaround ADR and SME Business Rehabilitation Support Co-operative) require unanimous consent of the creditors involved in the process to approve the debt restructuring in the plan, there have long been voices raised among practitioners for the need to implement the majority voting mechanism even in out-of-court workouts, referencing other countries' practices (eg, the scheme of arrangement and restructuring plan in the United Kingdom, the StaRUG proceedings in Germany, the accelerated safeguard proceedings in France and the joint administration proceedings in Korea).

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Jurisdictions

Jurisdiction	Firm
Austria	Wolf Theiss
Brazil	Machado Meyer Advogados
Bulgaria	Wolf Theiss
Canada	Cassels
France	JEANTET
Greece	VAP Law Offices
Hungary	Wolf Theiss
Japan	Nagashima Ohno & Tsunematsu
Netherlands	Van Doorne
Poland	Wolf Theiss
Portugal	PLMJ
Romania	Wolf Theiss
Switzerland	Walder Wyss Ltd
United Kingdom	Morgan, Lewis & Bockius LLP
USA	Cravath, Swaine & Moore LLP

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