Debtor-in-possession proceedings in Japan - an opportunity for distressed investors or a cautionary tale?

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Introduction

There has been a rise in distressed situations in Japan in recent years – since 2010, Elpida Memory, Inc. ("Elpida"), Victor Company of Japan, Limited, Takefuji Corporation, Japan Airlines Corporation, AIFUL Corporation and Willcom, Inc. have all become subject to insolvency procedures in Japan. This trend looks set to continue as many areas of Japanese industry continue to come under pressure. This, of course, presents investment opportunities for those willing to consider distressed situations. However, it is important that any potential investor understands the legal and cultural complexities in Japan before committing to any investment decision that from an analysis of the financial data alone seems to promise a significant return.

In this article we take a brief look at an insolvency proceeding that has been introduced recently in Japan and has garnered a lot of attention – "debtor in possession" corporate reorganization proceedings ("DIP Proceedings"). After summarising its key elements, we set out a short critique of DIP Proceedings and highlight issues that creditors should be wary of.

DIP Proceedings

Corporate reorganization proceedings in Japan are court supervised proceedings designed to rehabilitate a company which, although in financial difficulty, has promising prospects of recovery. The proceedings aim to rebuild the company while at the same time adjusting the interests of the creditors, shareholders and other interested parties.

Under "traditional" corporate reorganization proceedings, the court will appoint an attorney to act as trustee and the trustee will manage and operate the debtor. Therefore, the existing management of the company will cease to have management and operational control over the company. However, since 2009, the Tokyo District Court has started to adopt "debtor in possession" corporate reorganization proceedings as an alternative to the traditional style of proceedings, where the court will appoint one or more members of the existing management of the company as trustee(s). In DIP Proceedings, the existing management will therefore continue to manage and operate the company under the supervision of the court.

A brief outline of the different stages in DIP Proceedings

- *Preliminary consultation with the court* – Before filing a petition for the commencement of reorganization proceedings, it is common for a debtor (or its attorney) to have preliminary consultations with the court.

- *Petition for the commencement of reorganization proceedings* – Once a debtor has filed a petition, the court will issue a preservation order prohibiting the debtor from paying any debts and an examination order and supervision order to begin administering the debtor's assets and its business.

- *Court order for the commencement of reorganization proceedings* – If the court is satisfied that the requirements to commence reorganization proceedings are met, it will issue an order of commencement of reorganization proceedings. Following this, creditors will file their claims and the debtor will investigate its assets and liabilities, conduct a full valuation and draft its reorganization plan. Once the reorganization plan is submitted to the court, the court will refer the plan to a resolution of the interested parties.

- *Implementation of Reorganization Plan* – If the plan is approved by resolution of the requisite number of interested parties, the court will issue an order of confirmation of the reorganization plan and the debtor will proceed to execution of the reorganization plan. Once the plan is fully executed, the court will conclude the reorganization proceedings and the debtor can resume normal business operations.

Criticism

Recently, following the adoption of DIP Proceedings by Japanese corporates such as Elpida (2012) and Takefuji Corporation (2010), DIP Proceedings have received much criticism from creditors. These criticisms particularly call into question the fairness in the treatment of creditors and the availability (or lack of) information to those involved in the proceedings.

In July 2012, an opinion paper was submitted by creditors of Elpida stating that they could not agree with the debtor's proposals regarding its corporate reorganization and that they would have no choice but to consider petitioning for bankruptcy/liquidation proceedings. Secured creditors also

expressed to the trustee, Mr Yukio Sakamoto, that there were growing concerns with the manner in which the proceedings were progressing. The opinion paper came immediately after the announcement of the sponsorship deal with Micron Technology, Inc. The creditors asserted that the selection process of the sponsor lacked transparency and further stated that the basis of the valuation of the debtor was unclear and was carried out by an unknown entity.

A group of unsecured creditors (comprising foreign investment funds) also asserted that the debtor's proposals regarding its corporate reorganization was inadequate and the valuation was too low and did not reflect the true market value of the debtor. One unsecured creditor stated that the reorganization plan proposed by the debtor would result in a 17% recovery for bondholders and that under an alternative plan, the realisation could be above 40%. Elpida declined to comment on such assertions.

This dissatisfaction of creditors has led to creditors questioning the fairness of corporate reorganization proceedings in Japan and it has been said that this may be attributable to the adoption of the so-called DIP Proceedings by the debtor. Under traditional corporate reorganization proceedings, the court will appoint a third-party attorney to act as trustee to administer the process. By comparison to civil rehabilitation proceedings, where the debtor has greater control over the process, it was generally thought that creditors had more confidence in the fairness of traditional corporate reorganization proceedings even though their rights can be relatively restricted under such proceedings. Despite limited rates of recovery in some cases, very few creditors would question the proceedings.

Under DIP Proceedings the debtor can impose greater restrictions on the rights of creditors compared to private restructurings or civil rehabilitation, much in the same way as with a traditional corporate reorganization. At the same time, as the trustee is usually a member of the management of the debtor or an attorney selected by the management of the debtor, the proceedings are administered by the existing management of the debtor. Therefore, under DIP Proceedings, the debtor is seen to benefit from the up-sides of both traditional corporate reorganization and civil rehabilitation proceedings. This may be another factor that has called into question the fairness of the treatment of creditors and sponsors and has been raised as an issue ever since the implementation of DIP Proceedings in January 2009.

There has also been a great deal of criticism, particularly from investors and interested parties outside of Japan, that access to information has been very restricted. In the case of Elpida, the debtor was publishing certain information relating to the proceedings in both Japanese and in English on their website. However, up-to-date financial information and court-filed documents have only been available to creditors and interested parties, who are only permitted to examine (and copy) the physical documents on-site at the court.

Perhaps much of the criticism from creditors (in particular those based outside of Japan and more familiar with proceedings in other jurisdictions) is based on a comparison with the US Chapter 11 proceedings, where there is a general prohibition on the alteration of creditors' rights and in a similar way to DIP Proceedings in Japan, the debtor (or its management) would prepare its reorganization plan. However, by contrast to DIP Proceedings, the accessibility of information is far greater than in Japan and, the debtor and creditors are on a more equal footing and are able to cooperate in preparing the debtor's reorganization plan.

Furthermore, in the US a formal creditor committee would be formed under the supervision of the Department of Justice, comprising attorneys, accountants and other professional groups and the committee would ensure the accessibility of information relating to the proceedings. The creditor committee would look to obtain non-public information from the debtor in considering the assets and liabilities of the debtor and investigating its business outlook.

A creditor committee may be formed in Japan under DIP Proceedings but this requires agreement by a majority of creditors and is therefore uncommon in practice. Even if a creditor committee was formed, there is no obligation on the trustee to disclose information to the committee.

Conclusion

When approaching distressed situations in Japan potential investors should perhaps exercise a degree of restraint and caution. For non-Japanese investors, certain features of insolvency procedures in Japan may come as a surprise. The procedures can lack transparency. They may appear to treat creditors unfairly. There may be difficulty accessing relevant information. The debtor may have greater power and autonomy than expected. Ultimately, valuations and thus returns may be lower than anticipated. This may be a reflection of a stakeholder mentality in respect of companies in Japan – that in any given situation the decision-makers are trying to achieve an optimum outcome for as many different interested parties as possible. That said, over the forthcoming years there should be plenty of distressed situations in Japan that represent excellent investment opportunities provided that investors spend time getting to understand the context as well as the legal framework in which such situations arise and are dealt with.

Further information

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