

**THE CURRENT SITUATION AND FUTURE
CHALLENGES OF COURT-SUPERVISED AND
PRIVATE BUSINESS REVITALIZATION
IN THE UNITED STATES AND JAPAN**

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INTRODUCTION

After the Korean War, Japan – which had been defeated in World War II – continued on its path to robust economic growth, and, during the 1980's, the expression “Japan As Number. 1” became known around the world.¹ This prosperity, however, was not enduring. In 1989, after the collapse of the bubble economy, a long depression began.

Japanese-style management, which had supported the economy until the 1980's, utilized the main bank system on the financial side and involved the lifetime employment system and affiliation *keiretsu* (a network of enterprises) on the business administration side. After the collapse of the bubble, however, Japanese-style management gradually collapsed. Main banks could not function as such any longer because the strength of this sector had declined due to bad debt disposal, a situation that lasted for a long time. If a main bank cannot function as a main bank any more, the distressed company that relies on it cannot but fail later on.

The lifetime employment system, which diminishes the ability of the labor force to move between and among companies, hampers any shift of people to new industries if their sector happens to be in a decline. Moreover, the seniority-based promotion system reduces the potential for young and talented individuals to flourish and encourages business administration according the customs of old men. These two entrenched systems, then, can hardly nurture exceptional people with the managerial experience they need to become useful as turnaround managers at times of crisis.

In Japan, the birthrate is declining, and the proportion of the elderly in the population is growing at the fastest rate in the world. Japan has also piled up a huge sum of national bond balance. Thus, for the moment, there is no hope that income and costs can be in equilibrium. As

¹The book *Japan As Number One: Lessons for America*, by Harvard's Ezra Vogel, published in the late 1970's, introduced and popularized this expression.

for the pension system, the rate of nonpayment of premiums by young people is high and increasing; this is because they believe that, upon retirement, they will not receive benefits that are proportional to their premiums.

Because of the declining birthrate and the growing proportion of elderly people who feel insecure about their future, the individual propensity to savings will not decrease greatly. On the other hand, companies are paring down investments in excessive supply structures. The government as a consumption and investment entity already has a large national bond balance, and it cannot afford to continue high levels of consumption and investment. Although exports are necessary for a country like Japan, which does not have many natural resources, they cannot be expected to grow very rapidly because this would lead to new concerns about trade friction.

During the 1990's Japan had to tackle writing off bad debts in earnest to avoid triggering a financial crisis. While the nation accelerated disposal of the nonperforming loans, it simultaneously had to proceed with business reorganization to avoid serial bankruptcy. In this connection, Japan enacted and revised bankruptcy legislation (e.g., the Civil Rehabilitation Law) and founded the Industry Revitalization Corporation.

Disposal of the nonperforming loans of big banks was finally settled in 2005, when the economy got on track to recovery as well. Disposal of the nonperforming loans of local banks, however, is not yet settled. At the same time, how best to proceed with business reorganization in ordinary times will be a concern for the foreseeable future.

In this paper, I will present and explore some solutions to the problems of business reorganization. In Chapter 1, I will address Japan's bubble economy, its emergence, its collapse, and the aftermath. In Chapter 2, I will discuss the reasons for Japan's failure in its efforts at business reorganization. Chapter 3 will cover reform since the collapse of the bubble economy.

In Chapter 4, I will present some case studies from the United States and Japan. And in the conclusion, I will propose some solutions to Japan's remaining economic woes.

CHAPTER 1

JAPAN'S BUBBLE ECONOMY:

ITS EMERGENGE, COLLAPSE, AND AFTERMATH

After the collapse of Japan's bubble economy in 1990, the nation experienced one of the lowest economic growth rates among the advanced nations. A major factor in the recession was asset deflation. Stock prices continued to fall after 1990; in addition, starting in the follow year, land prices began their sharp decline. Although the Japanese Government undertook large-scale measures to boost the economy several times in the 1990's, they were insufficient.

Land and Stock Prices (Trillion Yen)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989				
Land	751	847	907	945	979	1060	1327	1733	1922	2242				
Stock	112	128	130	171	212	254	394	485	681	854				
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Land	2452	2272	2060	1970	1911	1827	1793	1753	1681	1607	1538	1443	1371	1299
Stock	521	508	369	397	473	468	426	366	306	515	423	374	379	480

Japan's System of National Accounts (SNA) "National Economic Accounting."

The asset-inflated economy started with the Plaza Accord of September 1985, in which the financial authorities of five countries (the United States, Japan, Germany, France, and Britain) declared that they would unite in an effort to correct the high dollar. Because of the sharp appreciation of the yen in the late 1980's, the export-led growth of the Japanese economy, decelerated rapidly. To shift to an economy driven primarily by domestic demand, the government adopted an ultra-easy money policy. Given the extraordinarily low interest rates,

companies borrowed huge sums of money from banks to undertake business diversification and invest in stocks and land. As a result, the Nikkei Stock Average soared, and, between 1980 and 1990, land prices more than tripled. Because of this appreciation of assets, companies repeated buying and selling cycles of land and stocks.

A rise in property and inheritance taxes, however, produced vociferous condemnation from people who were forced to sell their family's land and homes, even if they lived there. The government, which was criticized by the Diet and the mass media, took some measures, such as control over banks' loans on real estate, introduction of new land tax systems, and a freeze on bidding on real estate held by the government and the JNR Settlement Enterprise. The subsequent collapse of the bubble economy, however, caused a precipitous deterioration of the financial situation of companies and increased the large sum of bad bank loans.

CHAPTER 2

THE REASONS FOR FAILURE IN BUSINESS REORGANIZATION

Low Capital

Many Japanese companies kept aiming at stable stock dividends regardless of earnings. In Japan before the bubble, fewer companies increased capital by issuing new shares at market price, bonds with stock purchase warrants, or convertible bonds than in the United States. Therefore, their capital was lower than that of their American counterparts. As for financial assets, in the United States, from the macro-economic standpoint, bank deposits account for 13.7 percent and stocks for 61.7 percent, while the respective figures for Japan are 37.1 percent and stocks are 32.2 percent.

Corporate managers in Japan who value the protection of existing stockholders have not increased capital positively, but have relied on debt from banks for business expansion. Banks also lent large sums of money to companies against the background of a high savings ratio. The Bank Law and the Antimonopoly Law restricted the share-holding ratio of one company by one bank to 5 percent or less to place a limit on the power of the banks. Low capital suited not only the companies, but the banks as well. Once the economy went into a slowdown, distressed companies with low capital adequacy all at once began to live off their capital. As a result, initiation of the reorganization by the banks began to play a key role. Reorganization related to the financial soundness of distressed companies, however, tended to be insufficient, because the banks were concerned with increasing the collection of their debts. While distressed companies were somewhat forced to make inadequate reorganization plans again and again, their financial condition gradually deteriorated. Therefore, the payoff rate of general unsecured claims became about 20 percent through legal liquidation.

The Main Bank System

A bank that lends the most money to a company is called that company's "main bank." In Japan, when the financial condition of a company deteriorates, the main bank sends it a director to assist on the financial side. At the same time, non-main banks cannot ascertain information about the financial condition of the distressed company very well. (In the United States, on the other hand, banks do not send directors to distressed companies because this would be considered a conflict of interest.) When financial conditions deteriorate further, the main bank and the debtor company often settle on a plan to ask other banks for support. In such cases, the non-main banks insist that the main bank take more responsibility because of the dispatch of the director and the relative monopoly on information. As a result, the main bank has to agree to waive more debt than the non-main banks to obtain the consent of all of the banks with regard to financial support in the business reorganization plan.

Negative Concepts About Legal Procedures

If a business reorganization plan is not settled between the banks and the debtor, the procedures might shift from a private arrangement to legal liquidation or reorganization. Not only the debtor company, but also the banks, might suffer severe damage. When there were legal liquidations after the collapse of the bubble economy, the value of real-estate collateral decreased by a third, a half, or more; as a result, the dividends and payments to the banks were reduced. At a legal business reorganization as well as a legal liquidation, the financial situation of a company that applied for bankruptcy deteriorated further because the mass media put the label “bankrupt” on it and suppliers insisted on cash dealings. Negative concepts in Japan about legal business reorganization disrupted the process. In the United States, on the other hand, when a distressed company applies for Chapter 11, the attitude is more positive, because this is thought to be a first step toward reorganization.

DIP Financing

Debtor-in-possession-financing (DIP financing) is financing to a distressed company that is engaged in business reorganization. Section 364 of Chapter 11 provides for the priority status of the DIP lender. Section 364 (a) states that, without the court’s approval, a debtor can obtain unsecured credit in the “ordinary course of business” as an administrative expense. Section 364 (b) stipulates that, with the court’s approval after notice and hearing, a debtor can obtain unsecured credit as an administrative expense that is one of the actual, necessary costs and expenses of preserving the estate under section 503 (b) (1). Section 364 (c) provides that, if a debtor is unable to obtain unsecured credit, with the court’s approval after notice and hearing, a debtor can obtain credit: 1) with priority that is called super-priority over any or all administrative expenses, 2) and/or secured by a lien on unencumbered property of the estate, 3)

or secured by a junior lien on pre-encumbered property of the estate. Section 364 (d) provides that, if a debtor is unable to obtain credit otherwise, with the court's approval after notice and hearing, a debtor can obtain credit secured by a senior (a so-called "priming" lien) or equal lien on pre-encumbered property of the estate if there is adequate protection for the pre-holder of the lien.

Section 361 defines three methods of "adequate protection" under Section 364: (1) a cash payment or periodic cash payment; (2) an additional or replacement lien; and (3) such other relief that will realize the indubitable equivalent of the pre-holder of the lien.²

The expenses and claims below have priority in the following order: (1) administrative expenses under (1) (A), (2), and (6) of Section 503(b); (2) other administrative expenses; (3) unsecured claims allowed under Section 502(f); (4) (a) wages, salaries, or commissions, including vacation, severance, and sick leave pay, and (b) sales commissions by an individual or by a corporation with only one employee; (5) contributions to an employee benefit plan; (6) unsecured claims of persons (a) engaged in the production or raising of grain, (b) engaged as a

²See *In re Ames Dep't Stores, Inc.*, 115 B.R. 34, 37 n.3 (Bankr. S.D.N.Y. 1990) ("A court... may not approve any credit transaction under subsection (c) unless the debtor demonstrates that it has reasonably attempted, but failed, to obtain unsecured credit under sections 364(a) or (b)."); *In re Crouse Group, Inc.*, 71 B.R. 544, 549 (Bankr. E.D. Pa. 1987) (same).

To obtain financing pursuant to Section 364(c) of the Bankruptcy Code, some courts apply a three-part test, requiring the debtor in possession to show that:

(a) It could not obtain unsecured credit under section 364(b) – i.e., by allowing a lender an administrative claim;

(b) The credit transaction is necessary to preserve the assets of the estate; and

(c) The terms of the credit transaction are fair, reasonable, and adequate given the circumstances of the debtor-borrower and the proposed lender.

See *In re Crouse Group, Inc.*, 71 B.R. at 550. When scrutinizing a debtors' business decision, such as the type and scope of a DIP facility, bankruptcy courts routinely defer to the debtor's judgment, including the decision to borrow money on certain terms, so long as the decision at issue "involve[d] a business judgment made in good faith, upon a reasonable basis, and within the scope of [such debtor's] authority under the [Bankruptcy] Code." *In re Curlew Valley Assocs.*, 14 B.R. 506, 513-14 (Bankr. D. Utah 1981); accord *Group of Institutional Investors v. Chi. Mil. St. P. R. Co.*, 318 U.S. 523, 550 (1943); *In re Simasko Prod. Co.*, 47 B.R. 444, 449 (D. Colo. 1985) ("Business judgments should be left to the board room and not to this Court.").

\\PdxInt33\BK\Active Cases\UAL-United\Court Documents\First Day Pleadings 12-08-02\Source Docs\53 (A) - DIP Financing Motion 1300.doc.

fisherman; (7) unsecured claims of individuals who deposit money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided; (8) taxes; (9) unsecured claims based upon any commitment by the debtor to a federal depository institution's regulatory agency to maintain the capital of an insured depository institution; and (10) claims for death or personal injury resulting from the operation of a motor vehicle.

Although DIP financing has been provided since the 1978 Bankruptcy Reform Act, it grew in size and importance in the early 1990's.

Chatterjee et al. (2004) noted that, in the United States between 1988 and 1997, an average of 30.4 percent of firms filing for Chapter 11 obtained DIP financing representing total loans of \$10,798 million. The number of firms obtaining DIP financing increased from nearly 30 percent in the early 1990's to around 45 percent in the late 1990's. The proportion of loans to total assets also increased.

Chatterjee concluded that the positive stock price reaction to DIP financing announcements reflects the benefits of DIP financing. These benefits can come from a better probability of a successful reorganization and/or earlier bankruptcy resolution for DIP firms (Dahiya et al., 2003), more monitoring and/or certification by DIP lenders (Dhillon et al., 1995), and/or the higher probability of a successful reorganization as suggested by Carapeto (2003).

In Japan, Article 119 (5) of the Civil Rehabilitation Law provides that the claim right based upon borrowing of money and other acts by a rehabilitation debtor in relation to its properties after commencement of rehabilitation proceeding is a common benefits claim. Article 120 provides that, with the court's approval, a debtor can obtain unsecured credit as a common benefits claim after filings, but before commencement of the rehabilitation proceedings. Article 121 provides that: (1) a common benefits claim shall be repaid as needed without rehabilitation

proceedings, and (2) a common benefits claim shall be repaid in preference to rehabilitation claims that result from a cause before commencement of rehabilitation proceedings.

The first substantial DIP financing in Japan involved Footwork Express, which filed for Civil Rehabilitation on May 4, 2001 and obtained DIP financing from the Development Bank of Japan and Fuji Bank on May 23, 2003.

Debt Waiver by Suppliers

Not only banks, but also suppliers, might be asked to agree to debt waiver at legal reorganization. Major suppliers' claims are not protected, though a small claim might be completely protected to save labor costs involved in possible negotiations and to promote promptness in the reorganization procedure. Therefore, suppliers do not accept dealings with the debtor company or request cash dealings after the ailing company files for legal reorganization.

Earnings Less Than Collaterals

Often, managers are not greatly interested in earnings. If a company produces goods, it can sell them during a period of rapid economic growth. Therefore, managers are generally more interested in expansion of sales. In addition, sales growth accompanies earnings growth by advantage of scale. Many companies started business diversification that did not yield a synergistic effect with an original core business, while banks had a strong desire to lend money during the boom period. Many companies poured profits or human resources into a non-core business that failed.

Bad Management Skills

In many cases in Japan, management did not have good skills. A number of managers in Japan seemed to think their responsibilities were minimal because they thought that their reward was slight and that they were only salaried employees. Therefore, they had little incentive to initiate a major reform. If there had been more Japanese with the abilities and attitude of Carlos Ghosh, for example, who is credited with reviving Nissan Motor Co., the situation would have been much improved.

Problems Particular to Small and Medium-sized Companies

What I have described above basically applies to large companies. Small and medium-sized companies, however, account for 97 percent of the number of companies and 70 percent of the employees in Japan. Dictatorial managers with no ability to analyze earnings have been in charge of many small and medium-sized Japanese companies. Moreover, in many cases, because the manager, his relatives and/or friends have used real properties as collateral, he has tried to maintain his management powers, almost literally, to his dying breath. In fact, when some small and medium-sized companies went bankrupt, their managers committed suicide on the next day.

CHAPTER 3

REFORM SINCE THE COLLAPSE OF THE BUBBLE ECONOMY

Government Policy

Disposal of non-performing loans should proceed further under market discipline and strict asset evaluations in accordance with successive government policies: specific targets should be set for removing non-performing loans from balance sheets, and the functions of the Resolution and Collection Corporation (RCC), including trust, should be aggressively utilized. At the same time, the securitization and liquidation of these claims and other assets should be promoted.

Bankruptcy Law

Based on the policy set by the cabinet, the government and the Diet enacted some new laws, amended some laws, and created some new tools for rapid business reorganization. The corporate reorganization procedures prepared to date involve three legal arrangement measures: the corporate arrangement procedure in the Commercial Law, the composition procedure in the Composition Law, and corporate reorganization in the Corporate Reorganization Law. As for the composition procedure and the company arrangement procedure for small and medium-sized companies, it was difficult to use them and they were behind the times; the corporate reorganization procedure for large companies, on the other hand, was used frequently.

The Civil Rehabilitation Law, which is prompt and functional for small and medium-sized companies, was enacted in December 1999 (enforcement as of April 2000), and the Composition Law was abrogated. In December 2003, the Corporate Reorganization Law for large companies was completely revised to promote prompt business reorganization

(enforcement was in April of the following year). The Private Arrangement Guideline, which adjusts interests among banks in a private arrangement, was created in September 2001. The Industrial Revitalization Corporation of Japan, whose mechanism of reorganization reduced the gap between legal reorganization and a private arrangement, was established in April 2003.

Civil Rehabilitation Law

After the Civil Rehabilitation Law was enforced, about 1,000 applications a year were filed. Recently, though, the number of applications has decreased. After filing, procedures were started in 90 percent or more of the cases, and, in 70 percent or more, the rehabilitation plan was approved. After approving the rehabilitation plans, successful conclusions were reached in about 80 percent. Courts focused on accelerating procedures by promptly posting changes on bulletin boards and improved civil rehabilitation procedures greatly and flexibly.

Courts elected supervisory committees promptly in many cases in Japan, but the operation was different depending on the court. The Sapporo court, for example, did not elect a supervisory committee if it could avoid doing so. On the other hand, a manager can stay on after an application for Chapter 11 in the United States. All creditors' execution rights are prohibited automatically upon applying for Chapter 11. Even if a time limit of claims is reached, the execution of rights is prohibited outside the Chapter 11 procedure. As a result, a distressed company does not need repay its debts, and its financing situation may improve. Whether a similar effect of automatic stay of Chapter 11 can be achieved in Japan depends on the operation of the Civil Rehabilitation Law by the courts. Although an individual stay instruction and an individual cancellation instruction are fulfilled in the Civil Rehabilitation Law, courts seldom issue an inclusive prohibition instruction.

Corporate Reorganization Law

As for the Corporate Reorganization Law, there were 45 applications in 2004 and 63 in 2003. I cannot assess its effect clearly, because not many years have passed since this statute was enforced in April 2003.

The difference between the corporate reorganization procedure and the civil rehabilitation procedure is as follows: the former is that an administrator is selected to act as manager, and the latter is that the current manager can continue to manage the company (debtor-in-possession). The corporate reorganization procedure restricts all rights of claims about secured credits, preferential credits, unsecured general credits, and stockholders' rights. The exercise of rights of the secured credits cannot be prohibited in the civil rehabilitation procedure. In the corporate reorganization procedure, all stockholders' meetings cease, and the authority of the board of directors and directors is suspended. Because the rights of stockholders, who are subordinate to creditors, can be reduced easily, amalgamations, divisions, and transfers of operations can be easily undertaken.

Private Arrangement Guidelines

A private arrangement could prevent a decrease in a company's business value because a debtor could maintain its brand image. A private arrangement, however, requires considerable time and labor for negotiations and does not have much transparency or fairness. The "Guideline Society Concerning Private Arrangements" was established in June 2001 to broaden the common views of parties concerned, to set up target companies, and to make reorganization plans. As a result, the "Guideline Concerning Private Arrangements" was created in September 2001. The private arrangement guideline has the feature of a gentleman's agreement between banks and debtor companies and it asks for voluntary observance of its rules because it has no legal force.

To put a private plan into practice, the agreement of all banks is necessary. As of the end of March 2005, only 18 companies had used this strategy; this is because main banks must assume a heavy responsibility as before.

The Industrial Revitalization Corporation of Japan

The Industrial Revitalization Corporation of Japan (IRCJ) was established on April 16, 2003, and it began business operations on May 8. As of March 31, 2005, the final date when support decisions by the Industrial Revitalization Corporation Law expired, the IRCJ had supported 41 distressed companies. Except for Kanebo and Daiei Inc., most of these firms were small and medium-sized. The IRCJ procedure is: (1) a prior consultation for business reorganization by a debtor company or a main bank; (2) due diligence from various viewpoints such as financial and legal affairs; and (3) making and deciding on a business reorganization plan. The IRCJ has about 150 directors and employees including lawyers, certified public accountants, licensed tax accountants, and workers on loan from the national tax authorities. Because it is, so to speak, a department store for business reorganization, it can solve various kinds of problems promptly and appropriately while making business reorganization plans.

Adjustments with non-main banks start immediately after the support decision of the Industrial Revitalization Committee, which is composed of seven specialists. If they all agree to a business reorganization plan, non-main banks can apply for purchase of their credits in the amount after deduction of the debt waiver to the IRCJ. To buy credits, the IRCJ borrows funds from banks at a very low interest rate because of the government guarantee. Non-main banks must agree to the debt waiver to keep their credits. The IRCJ sometimes sends its employees or people from outside the IRCJ as directors to the supported companies. The former manager must retire, unless his or her responsibility is small or nonexistent. The stockholders often assume

responsibility. The IRCJ can not only buy claims from non-main banks, but can also finance supported companies. The IRCJ must sell off all rights such as claims and stocks to a sponsor within three years after buying the claims. When banks agree to debt waiver based on the business reorganization plan of the Industrial Revitalization Corporation Law, both the bank and the debtor can write it off as a loss.

The standard for supporting companies is the same for the Industrial Revitalization Corporation Law and the Revised Industrial Revitalization Law. Therefore, if the debtor supported by the IRCJ applies for the Revised Industrial Revitalization Law, the debtor usually can get favored tax treatment.

According to criteria for delisting from the Tokyo Stock Exchange, if liabilities in excess of assets of the company continue for two terms, the stock is delisted. When the debtor is supported by the IRCJ and it has a business reorganization plan whereby it can change the current bad situation to one in which assets exceed liabilities within a year, the Tokyo Stock Exchange will postpone the delisting for one year.

Role of the IRCJ

Because in a business reorganization plan the amount of an unsecured general debt waiver is assigned, the IRCJ does not want the responsibility of the main bank.

The IRCJ and the main bank jointly create an exit strategy after the IRCJ buys credits from the non-main banks. Because of asymmetric information, the gap between the bid price of sponsor candidates and that which the banks usually hope for is very large. If the IRCJ stands between banks and investors in a market and informs the investors about a business reorganization plan adequately, the investors can sit down at the negotiating table with ease. Thus, the cost to the banks and the investors for the negotiations can be reduced.

CHAPTER 4

CASE STUDIES

Kmart

Kmart Corporation and 37 related companies, which form a major discount chain in the United States, applied for Chapter 11 on January 22, 2002. Kmart opened its first shop in Michigan in 1962, grew rapidly afterwards, and, in just 10 years, expanded to about 700 stores. While rival companies introduced computers in their stores, Kmart met opposition from their employees and failed to create an efficient sales strategy. Kmart fell behind Wal-Mart, which had a better range of products, and Target, which had fashion merchandise as a feature. As a result, Kmart became the third most important discount chain in the country. Due to a defeat in price wars with Wal-mart and the previous year's slump in impulse shopping sprees immediately before Kmart applied for Chapter 11, its credit rating was reduced, the financial situation deteriorated, and the stock price declined as well. Kmart fell into arrears with its weekly payments to Fleming Companies, a major food wholesaler. With a liability of about \$11.3 billion, Kmart's bankruptcy became the largest among all U.S. retailers.

In Japan, the conditions for applying for bankruptcy require that the company be insolvent or has (or potentially has) liabilities in excess of assets. Therefore, there is a possibility that an application for bankruptcy could be rejected in Japan. On the other hand, federal bankruptcy law in the United States does not require any reason for bankruptcy.

Manville Corporation

Manville Corporation, whose headquarters were in Denver, CO, was a manufacturer and distributor of insulators and construction materials, including asbestos. As of 1982, about 15,600

people had filed suit with Manville because they had become sick from breathing asbestos. It was predicted that 32,000 new lawsuits would be filed during the next 20 years and the estimated cost would be about \$2 billion. Manville thought that this burden was too heavy to endure and, as a result, on August 26, 1982, applied for Chapter 11 to avoid having to pay injuries in future lawsuits. The company's properties were worth about \$2.2 billion, and its debt was about \$1.1 billion; thus, the value of the property in excess of the debt was about \$1.1 billion. On the other hand, the injured persons filed a motion to dismiss. The court dismissed this motion, ruling that the first purpose of the bankruptcy law was to offer open access to the bankruptcy procedure and did not require any reason for filing for bankruptcy. As a result, the victims of asbestos, including future victims, would get relief only from the \$2-billion fund pool financed by insurance at the time and the future profits of Manville. Thus, Manville extricated itself from the cost of lawsuits and compensation for damages both at that time and in the future.

Continental Airlines

On September 23, 1983, Continental Airlines filed for Chapter 11 in order to annul a labor contract. Although flights subsequently stopped for two days, on the third day, half of flights were restarted with the one-third of the employees, who had agreed to the new labor contract at about half their previous pay. According to the bankruptcy law, the trustee, subject to the court's approval, may assume or reject any executory contracts or unexpired lease of the debtor. Labor contracts fall into the executory contract category. On the other hand, the labor unions for the pilots and the cabin crews filed a motion to dismiss because of Continental Airlines' insincerity in filing to annul the labor contract. The court dismissed the labor unions' motion.

Matsuyadenki

Matsuyadenki Co. Ltd., a consumer electronics retailer in Osaka, filed for the Civil Rehabilitation Law on September 25, 2003. The next day, the IRCJ decided to support the ailing company. This case has the dual feature of applying the Civil Rehabilitation Law, that is, the legal procedure, as well as using the tool of a private arrangement, the IRCJ.

CONCLUSION

From the Company to the Business

The belief that real estate prices in Japan would continue to increase arose because this had continually been the case since World War II, and this illusion persisted until the collapse of the bubble economy. Japan has a scarcity of land that is suitable for habitation; thus, during the bubble economy, a number of people and companies went into debt to purchase land for the purpose of speculation and/or asset formation. Many banks placed significance on the mortgage collateral of a business without an examination of the profit performance. This is because they believed it would be possible to collect debts through mortgage collateral even if the company went bankrupt.

Banks should no longer lend money by depending on real estate security. An examination as to whether repayment by profits is possible is required. From now on, banks must pay attention to the business, not to the company.

Method of Loans Suitable for Business Reorganization

Syndicated Loans

The syndicated loan is a financing method that evolved from the bilateral loan. Under a syndicated loan, one bank or several banks (as the arrangers) organize other banks to grant loans to the same borrower under one loan set-up according to agreed-upon terms. With the rapid development of international trade and investment, the international demand for credit funds has also increased sharply. An individual bank, however, is often unable or reluctant to extend a huge amount of credit. To diversify risks, several banks join together to provide a loan under strict

rules and agreement. The syndicated loan thus comes into being. Because each bank shares information, participates in the loan on the same condition, and shares the risk, banks can decide on private reorganization early on by fair pro-rata loss sharing. It is also possible for banks to sell the loan easily to other banks.

Loan Covenants

A loan covenant is a loan contract clause, by which a debtor promises to maintain a concrete financial index beyond a fixed numerical value and to report it regularly. The creditor can revise the terms of the loan, if the concrete financial index becomes worse than the fixed numerical value. It is possible by covenants for the banks to suggest ways to improve the profits of the debtor at the very early stage before the debtor company goes bankrupt.

There are certain cash-flow indexes that can help predict the future of the business; these include: the capital adequacy ratio (equity capital/total assets), the capital adequacy ratio of the current price base (stock total market value/total assets), debt repayment years (liabilities with interest/business cash flow), and interest-coverage ratio (business cash flow/interest payments).

Governance from the Outside

Once a company has liabilities in excess of assets, the rights of the stockholders are rapidly lost. It is important that, at the early stage before a company accumulates an excess of debt, the stockholders show governance and correct management problems in order to prevent the deterioration the value of the business. The capital can be eaten up in an instant, however, when a business achievement deteriorates. This is because the rate of capital is small in comparison with indirect finance in Japan. We must examine ways in which the enterprise can

raise capital to enhance the governance of the stockholders. In addition, it is indispensable to ensure information disclosure.

Banks (Creditors)

When the achievement of the debtor company deteriorates, banks (creditors) as main banks in Japan have sent officers and given financial assistance. Based on covenants at the early stage before the company falls into repayment difficulties, banks should monitor the financial situation of the enterprise, and it is necessary to make it reorganize its business promptly. Governance by banks is very important, because the indirect financial rate in Japan is very high.

Shift from the Lifetime Employment System and the Seniority System to the Merit System

Though it is difficult to predict exactly when, the Japanese management system will gradually shift from lifetime employment and seniority to the merit system. There is a growing possibility that a worker who comes from the outside will point out problems that older workers do not question. In addition, it may be possible that a major change will be brought about by appointing a younger individual as the person in charge.

Facilitating Private Reorganization

Participation of a Fair Third Party with a Neutral Position

The major problem with private reorganization is the difficulty of creditor adjustment. A main bank surely will be asked for larger debt forgiveness.

With no rationale in the reorganization scheme that a main has bank settled on, minor banks will oppose it to extract concessions; as a result, there is the possibility of falling into a prisoner's dilemma.

B bank	Cooperation	Defection
A bank		
Cooperation	A -2, B -2	A -3, B -1
Defection	A -1, B -3	A -3, B -3

The IRCJ buys a credit from non-main-banks and invests the money in a distressed company from a neutral and fair position. The IRCJ helps accomplish an adjustment between creditors by showing the validity of a reorganization scheme. There must be alternative mechanisms to lower the adjustment cost between creditors by enhancing the objectivity and validity of a property assessment and a reorganization scheme through participation of a neutral and fair third party with technical knowledge, such as a lawyer or a certified public accountant.

A Method That Gives Legal Effect to an Agreement Concerning Private Reorganization When It Shifts to Legal Reorganization

When the business situation of an enterprise deteriorates, pre-DIP financing and a commercial transaction are necessary in private reorganization to continue the enterprise's activities without damaging the business. The person who tries to finance it or supply goods at a private stage of reorganization will disappear, unless there is pre-DIP finance and commercial transaction credit priority when a private rehabilitation shifts to a legal reorganization.

Erasing the Negative Image of Legal Reorganization

Despite the positive effects of civil rehabilitation and corporate restructuring, such events are still reported by some of the mass media in Japan with headlines such as “virtual bankruptcy,” “failure,” and “liquidation.” Although these are sensational words and the response from readers may be intense, the mass media should minimize such terms and make efforts to concentrate on more accurate reporting.

Individual Guarantees to Small and Medium-sized Enterprises

Banks sometimes lend money to a small or medium-sized company on the security of its president’s individual property and his guarantee, in order to finance the enterprise. There have also been cases in which a mayor guarantees a joint public-private venture. Sometimes, however, this can obstruct prompt business reorganization, because the guarantor involved tries to resist business reorganization to avoid losing all of his property through a personal bankruptcy. Moreover, there is the problem of how to prevent unfairness in a director’s remuneration and dividends to the stockholders from a company. Nevertheless, it is desirable for banks to take a loan posture that does not depend on an individual guarantee. Once a bank accepts an assurance from an individual, the bank cannot release it easily. The bank often releases an individual guarantee if it bought the credit of the enterprise with the individual guarantee at a discount price and it can collect money beyond the purchase price.

Protection of a Credit of a Business Transaction

A strong supplier, such as an electronics maker, stops paper dealings and demands cash when rumors appear about the financial situation of an electric appliance store that is a customer. If the manufacturer does not deliver goods, it is obvious that a business cannot be continued any

more. With the permission of the court, it is possible with the Corporate Restructuring Law and the Civil Rehabilitation Law to pay back a small sum of credit to smooth the progress of the reorganization procedure to make the number of creditors decrease.

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