Special Comment

Assessing The Corporate Insolvency Regime In Japan

Product Of The Insolvency & Bankruptcy Committee

I. Introduction

More than a decade of poor economic performance in Japan has resulted in considerable financial distress amongst the Japanese corporate and financial sectors. Despite the prolonged and severe stress that the Japanese economy has endured, however, bond defaults and corporate bankruptcies in Japan remain remarkably low. The comparison is even more striking when measured against the level of defaults experienced during the recent, modest economic contraction in the US.

This phenomenon begs for an answer to some important questions: Are credit risks genuinely low in Japan? Are creditors adequately protected in the Japanese insolvency system? How does the extra-legal systemic support in Japan impact bankruptcy practices and creditor rights in reality?

This special comment, the first of a series of Moody's reports to assess the insolvency regimes in the Asia-Pacific region, focuses on how the changing economic, financial, and social forces in Japan are affecting its insolvency regime and bankruptcy practices, and in turn how the changing insolvency laws and practices impact creditor rights and debt recovery prospects.

Some of the key findings of this report include:

- Japan's current insolvency regime is a complicated system consisting of five separate legal proceedings. Significant progress has been made in reforming the regime in recent years, but there is still considerable room for further improvement of its efficiency and effectiveness.
- The formal legal proceedings are often bypassed; informal negotiations among the parties, known as “private arrangements” (shiteki-seiri), are more common than formal proceedings.
- Japan's insolvency laws afford creditors, particularly secured creditors, substantial legal protection. In practice, however, social, financial and relationship constraints often limit creditors' ability to enforce their legal rights.
- The traditional corporate governance structure of cross shareholding and main bank support have had a profound impact on insolvency legislation and practice in Japan, which emphasize cooperation over confrontation and rescue over resolution, sometimes even at the expense of impairing creditor rights and undermining debt recovery prospects.
- Ironically, Japanese banks, as the major creditors, are to some extent compounding the corporate insolvency problem as the banks' own fragile financial condition, coupled with weak credit discipline, impedes their ability to take early decisive actions to deal with nonviable corporate debtors. Bank forbearance also overrides the benefits of smaller, homogeneous creditor groups.
- Dominance of bank lending has resulted in the underdevelopment of the domestic corporate bond market in Japan. The lack of a high-yield debt market has so far retarded the use of subordination and other structural complexities often seen in more developed markets, although this is changing slowly.
- The Japanese government plays a highly visible role in the insolvency regime. Its active involvement facilitates the resolution of corporate insolvency but also adds a degree of uncertainty in the restructuring outcome, which could weaken the predictability of the insolvency regime.

1. Moody's also published a series of reports reviewing the insolvency regimes in Europe. The first report, “Bankruptcy & Ratings: A Leveraged Finance Approach for Europe – UK versus France and Germany”, was published in March 2000, followed by reports on individual insolvency regimes in France, Germany, Italy, and The Netherlands. In December 2003, recent changes in UK insolvency laws were discussed in a special comment titled “Bankruptcy & Ratings: A Leveraged Finance Approach for Europe, Part VI, UK Insolvency Regime: Implications of the Enterprise Act 2002.”
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II. The Link Between Bankruptcy And Ratings

It is Moody’s position that a good understanding of the bankruptcy regime is integral to credit risk assessment and, by extension, to the assignment of credit ratings. This is because Moody’s ratings are in essence a measure of expected credit loss. Expected credit loss is the product of the probability of default and the severity of loss in case of default. Mathematically, expected credit loss is expressed as follows:

\[ \text{Credit Loss Rate} = \text{Default Probability} \times (1 - \text{Recovery Rate}) \]

Obviously, both default and severity of loss are directly linked to the bankruptcy legislative framework of a given jurisdiction, but much more importantly to the specific practices in that particular jurisdiction. Moody’s probability of default analysis is comprised of analyzing an issuer’s market position, financial strength and other fundamental factors. The severity of loss analysis, which takes on particular relevance for lower rated issuers due to the increased probability of default, is primarily a consideration of what an investor is likely to recover in the case of a default.

To the extent that all classes of creditors are affected by a bankruptcy event, the probability of default will be the same across the issuer’s debt obligations. The severity of losses is often a function of contractual and structural factors as well as indenture and credit agreement covenants, which are either directly governed or heavily influenced by bankruptcy legislation, procedures or practices in a given jurisdiction.

III. The Socio-Economic Backdrop Of The Japanese Insolvency Regime

No insolvency regime can exist independent of its social and economic environment or free from its cultural and historical roots. In reviewing the Japanese insolvency regime, Moody’s has found that certain characteristics of the Japanese credit market, its unique corporate governance system, and the role of the government have had a profound impact in influencing and shaping its insolvency laws and practices.

Dominance Of Bank Lending Has Led To Underdevelopment Of Bond Market

As in any insolvency regime, creditors are often the most important players in the resolution of corporate insolvency. The history and structure of a country’s credit market thus have important implications on the orientation and efficiency of its insolvency regime.

Despite Japan’s tremendous economic growth since the 1960s, the development of its financial markets has been unbalanced. While the stock market has experienced remarkable growth, the corporate bond market, outside the public sector, has lagged far behind. New financial products or techniques have also been slow to develop. As a result, corporate Japan continues to turn to their relationship banks as the primary funding source since the corporate bond market lacks depth. According to the latest available data (as of March 31, 2003), outstanding corporate bonds, excluding public sector and asset-backed securities, amounted to approximately 67 trillion yen, compared to total outstanding bank loans of approximately 395 trillion yen. As illustrated in Exhibit 1, bank lending clearly dominates corporate borrowing in Japan.
In addition, government regulations prohibit lower-quality issuers from accessing the public bond market, and as a result, a high-yield bond market has failed to develop in Japan. Current market practices are such that issuers with ratings of higher than single-A from any rating agency have relatively easy access to the corporate bond market while lower-rated investment grade issuers still can issue bonds but with less accessibility. Issuers rated below investment grade are essentially shut out of the corporate bond market. Consequently, only companies considered to have an acceptable credit quality can issue publicly-placed bonds in Japan.

**Main Bank-Based Governance Structure Impedes Resolution Of Corporate Insolvency**

Japan’s insolvency regime and business practices are deeply influenced by its corporate governance system based on cross-shareholdings and long-term relationships among a group of firms, or keiretsu. Often at the center of the keiretsu is a large bank, known as the main bank, which is not only the largest creditor to group companies, but often holds shares of, and seconds its officers to, other keiretsu members. This arrangement allows the main bank to monitor firms and exercise a degree of corporate governance in the absence of an external board of directors. While this main bank system was regarded as a strength of the Japanese industrial structure that freed Japanese companies from the pressures and demands of a short-term and arms-length lending relationship, the protracted economic crisis has revealed serious deficiencies in the main bank-based corporate governance structure.

The main bank system has often led to lax monitoring and questionable lending and investment decisions. In the US and UK, bankruptcy proceedings and debt restructuring processes are often driven by bank creditors, which are usually vigilant and proactive in taking prompt actions to deal with credit deteriorations in order to maximize their recovery. In Japan, however, the main bank system and the closely-intertwined relationship between borrowers and creditors have made it difficult and often impossible for main banks to take early decisive actions and seek effective remedies. It should be noted that the main bank system does not necessarily exist only in a keiretsu group. Many companies, such as those in the construction industry, do not belong to a keiretsu, yet still rely on the main bank system.

Ironically, in Japan, bank creditors themselves are to some extent part of the insolvency problem. This is because the banks’ own weak financial condition has severely impeded their ability to exercise their creditor rights and limited their options in dealing with troubled borrowers. Japanese banks by and large lack the capital to write off problem loans and thus have little internal incentive to liquidate or restructure nonviable firms since these actions could result in a reduction of their capital base, which in turn could invite regulatory intervention in the banks themselves.
The Government’s Visible Hand

In most developed countries with a relatively well-functioning court system, the government typically leaves bankruptcy-related matters in the hands of the judiciary system. In Japan, however, the government plays a much more visible role in the bankruptcy regime, as in the rest of the economy. Not only has the Japanese government been the driving force behind recent initiatives to reform the bankruptcy regime, governmental bodies and regulators have also been involved in certain specific corporate insolvency cases, as well as various bail-out and recapitalization schemes for Japanese banks and insurance companies.

In Moody’s view, the heavy involvement of the Japanese government stems from two important and inter-related reasons. On the one hand, given the magnitude of the financial distress in the Japanese economy, the government is keen to avert a systemic crisis. On the other hand, for historical reasons, the Japanese government has for decades practiced a form of “state-led” capitalism and thus has a tradition of promoting its social and developmental goals through selective policy-making.

Moody’s notes that while averting a systemic crisis is an important and legitimate justification for government intervention, from a creditor’s perspective it could come at the expense of the independence and fairness of the insolvency system. Government-sponsored work-out arrangements, bail-out schemes, and bankruptcy proceedings not only impact the performance of the macro economy, they also affect the efficiency and fairness at a micro level. In addition, government interventions may create a degree of uncertainty and thus weaken the predictability of the bankruptcy system.

IV. Simple Debt Structure Reduces Contractual Complexities

Creditor rights and recovery prospects are governed by both statutes and contracts. A clear understanding of the salient features of credit contracts in an insolvency system is also essential to credit risk assessment.

In more-developed debt markets such as the US and UK, debt structural factors, such as subordination, holding company structure and guarantees, often have a significant impact on the level of recoveries for the various classes of claimholders. In Japan, however, the dominance of bilateral bank lending and the underdevelopment of the high-yield bond market have greatly diminished the structural complexities often seen in the US and UK that are intended to govern the loss-sharing arrangements among different classes of claimholders.

Debt Subordination Is A Rare Concept In Japan

Subordination is the concept whereby certain creditors choose to get paid after other creditors in the case of bankruptcy in exchange for a higher promised interest rate. In more-developed markets, subordination—which can take the form of structural, contractual, or effective subordination— is a widely used legal and finance technique often found in the high-yield debt market. Subordination allows for the creation of different layers of debt in a borrower’s capital structure to cater to the varying risk profiles of creditors and investors.

In Japan, however, no high-yield bond market exists as a result of government regulations that prohibit lower-quality issuers from accessing the public bond market. As a result, only investment-grade companies can issue bonds in Japan. In line with market practices in the US, investment-grade bonds issued in the Japanese domestic market are typically unsecured obligations of the issuers. Subordinated bonds are virtually non-existent, with the notable exception of banks and insurance companies that have issued junior subordinated debt as complementary regulatory capital. In bank lending, most bank loans to small and/or weak borrowers are secured but those to large and listed companies are usually not.

Generally speaking, most Japanese corporate borrowers have a simpler capital structure than their counterparts in more-developed markets. Structurally or contractually subordinated debt has been rarely seen while effective subordination is only selectively practiced. As a result, it has not been uncommon for Japanese corporate borrowers to have only one class of debt: in the case of large corporations, unsecured bank loans and unsecured bonds that legally rank pari passu with each other; and in the case of smaller companies, secured bank loans.

In Moody’s view, corporate Japan’s generally simpler capital structure should lend itself more easily to a consensual restructuring process as smaller creditor groups tend to create less divergent interests in the restructuring process. This could facilitate the rescue of viable companies in a timely manner, thus enhancing debt recovery prospects. However, as often happens in practice, the smaller creditor group, usually dominated by the issuer’s main bank, often leads to the forbearance of troubled borrowers and thus delays actions needed to deal decisively with nonviable companies.

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2. Structural subordination occurs when a holding company issues debt without guarantee by its operating subsidiaries whose cash flows are the source of payments for the holding company debt. Contractual subordination takes place when different classes of debt are placed in a contractual ordering such as senior, subordinated, or junior subordinated. Effective subordination is created through the grant of security interests in collateral to secure certain classes of debt. Other debt classes that are unsecured become effectively subordinated to the secured debt. These forms of subordination are not mutually exclusive and often co-exist in a borrower’s capital structure.
**Loose Covenants Afford Limited Creditor Protection**

Moody’s considers covenants in credit agreements and bond indentures important not only for protecting creditor rights, but also in affecting the likelihood of default and severity of credit losses.

In Japan, bank lending is conducted primarily on a bilateral basis, where many banks lend to the same borrower simultaneously but each bank signs the Agreement of Bank Transaction (Ginko-Toribiki-Yakujosho) individually. Most Japanese banks adopt a standard version of the Agreement of Bank Transaction prepared by the Japanese Bankers Association. While bilateral loans continue to dominate bank lending in Japan, the syndicated loan market has experienced rapid growth in recent years. Statistics from the Bank of Japan indicated that syndicated loan volume reached approximately 15 trillion Yen in 2002, compared to virtually zero a few years ago.

Credit agreements for syndicated loans often adopt a standard version of the Syndicated Loan Agreement prepared by the Japan Syndication and Loan-Trading Association. Both the bilateral Agreement of Bank Transaction and the Syndicated Loan Agreement typically have fewer terms and conditions than those used in the US. Often, negative pledge is the only noteworthy covenant in these agreements. Some large and good-quality companies have been able to negotiate more liberal terms, while smaller companies are subject to more restrictions. It should be noted that Japanese banks have traditionally favored collateral over covenants as the more effective means to protect their interests.

In contrast to loan covenants, covenants in domestic unsecured bond indentures, on the other hand, have undergone dramatic changes since 1996. Through the end of 1995, Japanese domestic unsecured bond indentures were required by regulations to carry uniform financial covenants to protect bondholders. In January 1996, financial covenants were deregulated in accordance with the Ministry of Finance’s liberalization of the domestic bond market, and investors were left to judge the adequacy of each bond issue’s covenants on their own.

Subsequent to the reform, many issuers removed all financial covenants except the negative pledge and cross default clauses. As a result, Japanese domestic bond indentures now typically have far fewer covenants than those in the US, rendering bondholders few means for monitoring the performance of bond issuers and limited protections against potential default.

**V. Japanese Bankruptcy Regime – The Laws And The Reality**

A comprehensive legal study of the Japanese bankruptcy legislations is beyond the scope of this report. Rather, the focus is on key attributes of the Japanese insolvency regime and practices that Moody’s considers most relevant to creditor rights and debt recovery prospects.

**Orientation, Legal And Cultural Roots**

Japan’s legal system, including its bankruptcy laws, was originally based on German law as well as some French laws adopted in the modernization era after the Meiji Restoration. Japanese law thus generally falls under the Continental legal system, and is primarily influenced by German law.

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4. Standard covenants included 1) a negative pledge clause, 2) maintenance of net worth above a specified amount, 3) restrictions on cash dividends, and 4) avoidance of consecutive losses for specified time periods. Depending on the issuer’s debt rating, a negative pledge clause and one or more of the other covenants were required.
After World War II, a constitution based primarily on the US model was established, and a common law system was adopted under various laws. Consequently, while originally based on Continental law, current Japanese law is supplemented by Common Law, whose influence is evident in the Civil Code, the Commercial Code and the bankruptcy legal system in Japan.

Traditionally, the Japanese bankruptcy framework, under the influence of German Law, was oriented towards resolving corporate insolvency primarily through liquidation. Since the burst of the asset bubble in the early 1990s, as corporate failures multiplied in both frequency and scale, Japan’s antiquated bankruptcy system proved inadequate to cope with the sharp increase in corporate insolvencies.

Over the past several years, a series of new laws and initiatives have been introduced in Japan in an effort to reform and modernize its insolvency regime. The thrust of these efforts has been on introducing new features to the corporate rescue mechanism, modeled after Chapter 11 of the US Bankruptcy Code, to give distressed corporate borrowers “a second chance” - a core principle of the US bankruptcy framework. The other focus has been on promoting out-of-court workout processes as a more efficient and less costly alternative to the formal legal process.

The Formal And Informal Insolvency Mechanisms

Japan’s current insolvency regime consists of five separate legal proceedings. Liquidation-type bankruptcy proceedings are divided into two: Bankruptcy and Special Liquidation. Rehabilitation-type proceedings are divided into three: Company Reorganization, Corporate Arrangement, and Civil Rehabilitation proceeding. Exhibit 3 compares some of the key features of the five insolvency proceedings.

| Exhibit 3. Comparison Of The Five Insolvency Proceedings In Japan |
|----------------------|------------------|------------------|---------------------|------------------|
| Proceeding type      | Subject entities            | Cause for filing                      | Management of business in bankruptcy | Treatment of security interests | Role of court supervision in execution of plan |
| Insolvency Proceedings for Liquidation |
| Bankruptcy           | Natural persons, legal entities, unincorporated associations | Insolvency, carrying excessive liabilities | Trustee | Exercised outside of proceedings | Yes, until conclusion of the proceedings |
| Special Liquidation   | Joint stock companies (Kabushiki Kaisha or “KK”) under liquidation proceedings | Circumstances that significantly hinder liquidation | Special liquidator, institution for the company | Exercised outside of proceedings (provided that suspending foreclosure or requesting participation is possible) | Yes, until conclusion of the proceedings |

Insolvency Proceedings for Rehabilitation

<table>
<thead>
<tr>
<th>Proceeding type</th>
<th>Subject entities</th>
<th>Cause for filing</th>
<th>Management of business in bankruptcy</th>
<th>Treatment of security interests</th>
<th>Role of court supervision in execution of plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Reorganization</td>
<td>Joint stock companies (typically large companies)</td>
<td>1. When the likelihood of bankruptcy arises 2. When continuation of business is at risk upon payment of all obligations due</td>
<td>Trustee</td>
<td>May receive repayment only in proceedings</td>
<td>Yes, until conclusion of the proceedings</td>
</tr>
<tr>
<td>Corporate Arrangement</td>
<td>Joint stock companies</td>
<td>Likely to become insolvent, carrying excessive liabilities</td>
<td>Debtor (authorized order, managing order possible)</td>
<td>Exercised outside of proceedings (provided that suspending foreclosure is possible)</td>
<td>Yes, until conclusion of the proceedings</td>
</tr>
<tr>
<td>Civil Rehabilitation</td>
<td>Natural persons, legal entities (primarily for small and medium-sized companies, but gaining popularity among large companies)</td>
<td>1. When the likelihood of bankruptcy arises 2. When continuation of business is likely significantly hindered upon payment of all obligations due</td>
<td>Debtor (authorized order, managing order possible)</td>
<td>Exercised outside of proceedings (provided that suspending foreclosure or extinguishment by payment amount delivery possible)</td>
<td>None (provided that when a trustee or an administrator is appointed, yes for a certain period)</td>
</tr>
</tbody>
</table>

Moody’s notes that, although Japan’s insolvency regime provides legal mechanisms for both liquidation and rehabilitation of distressed borrowers, they are complex and lack coherence to some extent. As a result, in most distressed situations, informal negotiations among the related parties known as “private arrangements” are more frequently used rather than these formal legal proceedings. This phenomenon has partly contributed to the low level of reported defaults and bankruptcies in Japan.

5. For a more detailed summary of the five bankruptcy systems, please refer to Appendix A.
Since the Civil Rehabilitation Law was passed in April 2000, the proceeding under this Law has gained increasing popularity among Japanese debtors. The Civil Rehabilitation Law has replaced the repealed Composition Law and cured some of its deficiencies. For example, the Civil Rehabilitation Law

• creates a system for the preservation of the debtor’s assets before the commencement of a rehabilitation proceeding,
• relaxes the requirements for commencing a proceeding,
• provides a simplified procedure to determine claims and formulate the rehabilitation plan, and
• establishes a mechanism for monitoring performance of the rehabilitation plan.

In addition to the improvement of the formal rehabilitation proceedings, a set of informal workout principles, known as Private Rearrangement Guidelines (shiteki seiri gaidorain), were established in September 2001 by representatives from the financial and industrial sectors with representatives of the government, such as the Ministry of Finance and Financial Services Agency, as observers. The purpose of the Guidelines was to create the Japanese version of the so-called “London Approach”, in order to promote out-of-court restructuring as a more efficient and speedier alternative to court-supervised proceedings.

### Summary Of Recent Key Reforms To The Japanese Insolvency System

#### Amendments To Legislation

- 1999/2000 – The Civil Rehabilitation Law was enacted to replace the rescinded Composition Law.
- 2002 – The Corporate Reorganization Law was also amended to improve its efficiency and certain aspects of the Civil Rehabilitation Law were adopted.
- 2003 – An evaluation of the Bankruptcy Law was conducted by the Legislative Council to identify ways to rationalize, speed up and modernize the proceedings.

#### Other Insolvency-Related Initiatives

- 2001 – The revised Servicer Law was enacted to facilitate asset securitization as well as the resolution of nonperforming loans.[1]
- 2002 – Resolution and Collection Corporation and Industrial Revitalization Corporation were established and funded by the Deposit Insurance Corporation to deal with nonperforming loans as well as to facilitate the rehabilitation of debtor companies.


### Insolvency Framework Improved But Effectiveness Uncertain

In Moody’s view, the various new initiatives to reform the Japanese insolvency regime have rightly focused on improving the efficiency of the system, for example by lowering the barriers to commencement of a proceeding, thus encouraging early and speedy actions to rescue troubled borrowers. The bankruptcy courts, particularly Division 8 (in charge of Company Reorganization cases) and Division 20 (in charge of Civil Rehabilitation cases) at the Tokyo District Court, are also focusing more on efficiency and have issued various guidelines in an effort to speed up the bankruptcy process. All these represent a major step forward from the previous framework, where lengthy and tedious processes under the repealed Composition Law and other proceedings often resulted in procedural delays that destroyed enterprise value and diminished prospects for a successful rehabilitation.

While these legal changes are important, it is equally or perhaps even more important to create the right economic incentives to encourage proactive behaviors to deal with troubled debtors. Yet, changes in corporate practices and behaviors only take place slowly. Corporate executives of distressed companies, often not accountable to an independent board and shareholders, continue to have few incentives to take early decisive actions. By the time a restructuring becomes unavoidable, little value can be salvaged. Even creditors are often reluctant to impose strict but necessary restructuring measures, either due to relationship constraints, or due to their own weakened financial condition, rendering large loan write-offs difficult.

Structuring a successful reorganization of a distressed corporate debtor is also a highly complicated task, in which all the related parties and, in particular, the bank creditors must demonstrate a high degree of competence and sound judgment. The lack of a strong credit culture at Japanese banks, the passive nature of the Japanese institutional bond investors, coupled with the social and financial constraints placed on them, make it difficult for the creditors to make an independent and objective assessment of the borrower’s reorganization plan and rehabilitation prospect.
As a result, when reorganization does take place, either through court-supervised formal proceedings or out-of-court informal negotiations, the focus has often been on restructuring the debtor’s balance sheet rather than the underlying corporate, operational, and managerial practices of the business. Consequently, debt rescheduling and forgiveness, debt-for-equity swaps or other measures of financial rescue merely serve to prolong the debtor’s survival, but often fail to improve its long-term financial health. Particularly when it comes to large-sized companies, emphasis has been placed on preserving troubled borrowers, regardless of their economic viability, in order to preserve jobs and minimize disruption to social priorities.

In Moody’s view, despite recent efforts to reform and improve the Japanese insolvency system, its effectiveness, in the sense of restoring enterprise value and enhancing the efficiency of economic resource allocation, still leaves a lot to be desired. Indeed, the reform of the Japanese insolvency system cannot be accomplished without resolving some related structural issues in its financial, political and corporate governance systems, as an insolvency regime is never a stand-alone process but part of a broad economic, legal, governmental and social system.

**Are Creditors In A Good Position To Influence The Bankruptcy Process In Japan?**

This question raises two principal and inter-related issues:

- To what extent do creditors have the power to commence and control insolvency proceedings?
- To what extent are creditors able to negotiate protection for themselves in the event of a debtor’s insolvency and exercise rights granted to them despite the commencement of insolvency proceedings against the debtor?

In Moody’s view, a creditor in Japan (particularly a secured creditor) is generally in a good position to influence the insolvency process although the degree of influence varies with the specific bankruptcy proceedings. Under the Bankruptcy Law, a secured creditor can enforce its collateral security through foreclosure or auction sale of the debtor’s property without resorting to bankruptcy proceedings. In reality, however, creditors often negotiate with debtors for settlement and rarely resort to outright foreclosure for debt recovery. An unsecured creditor must resort to a court to enforce his right. Under Corporate Reorganization proceedings, however, even a secured creditor may not be able to exercise his rights during the proceedings, and claims are paid in accordance with a reorganization plan, which requires approval of creditors by certain legally-specified majority, depending on the type of creditors.

| Exhibit 4. Position Of Creditors In A Distressed Scenario By Jurisdiction |
|-----------------------------|----------------|----------------|------------------|----------------|----------------|
| Country | Do creditors have the ability to initiate proceedings? | Does a formal stay period apply? | Does management remain in position? | Is super priority financing available? | Do creditors have the ability to influence the rescue plan? |
| Japan | Yes | No, but an injunction can be filed | Yes, under Civil Rehabilitation | No | All creditors vote but main bank plays dominant role |
| UK | Yes | Yes | No | No | All creditors vote [1] |
| France | Yes | Yes | Yes | No | Court decision |
| Germany | Yes | Yes | Yes, but only for creditors providing goods and services | No | All creditors vote but must receive court approval (i.e. cram down possible) |
| US | Yes | Yes | Yes | Yes | All creditors vote but cram down possible |

[1] If the administrator believes that the realizable value is less than the senior creditor’s secured claim, there is no requirement to call a meeting. The proposals will be deemed to have been approved unless a meeting is requisitioned by one or more of the creditors holding at least 10% of the votes.

Although the Japanese bankruptcy laws do not provide for an "automatic stay" such as exists in the US and UK regimes, a petition for a comprehensive injunction can be filed to preserve the assets of the debtor from creditor seizure during the interval between the filing of a petition for the Corporate Reorganization and Civil Rehabilitation proceedings and the court order for the commencement of the proceedings. The comprehensive injunction does not, however, prevent a creditor from continuing with a lawsuit that was filed before the commencement of the case, nor does it prevent a creditor from commencing a post-petition legal action against the debtor.

Treatment of incumbent management of the debtor company is a contentious issue in any corporate bankruptcy regime. Unlike proceedings under the Corporate Reorganization Law, the Civil Rehabilitation Law allows incumbent management to stay on to manage the company during the proceedings.

**Priority Of Claims**

One of the main principles that is common to the various insolvency proceedings in Japan is the "equality rule" under which all creditors are, in principle, treated equally. Although the laws grant priority to certain claims such as tax liabilities and employees’ claims based on public interest considerations, they do not provide for subordination of claims based on the status of the creditor in relation to the company.
The equality rule is applied most thoroughly under the Bankruptcy Law. All creditors having claims of equal priority are entitled to distribution from the bankruptcy estate based solely on the proportion of the amount of their claims. Therefore, it is not permissible in bankruptcy proceedings to subordinate certain claims having equal priority.

In the case of Special Liquidation, Corporate Reorganization or Civil Rehabilitation, the laws allow exceptions to the equality rule as long as the different treatment of creditors does not disturb the equitableness of the plan.

As in most other jurisdictions, with the notable exception of the UK, creditor claims in Japan (both secured and unsecured) rank behind administrative expenses, taxes, and other priority claims. Japanese bankruptcy laws also give preferential treatment to unpaid salary, bonus, severance pay and other forms of employee compensation. Some large and/or more creditworthy borrowers in such industries as telecommunication, steel or railway are allowed by law to offer creditors a preferential right over their whole assets. This preferential right was introduced after World War II in order to channel scarce funds to these priority sectors, but exercise of such rights has never taken place.

Reshuffling The Pecking Order

Importantly however, in practice, although secured bank loans in theory have legal priority over other unsecured debts, it is not unusual for secured bank loans in Japan to suffer greater losses than other debt classes due to Japanese banks’ financial support of troubled borrowers through means of debt forgiveness and/or debt-for-equity swaps.

Under the main bank system in Japan, main banks have traditionally been required to sacrifice themselves in order to support borrowers as well as other creditors, including other bank lenders and unsecured bondholders. Before the corporate bond market was liberalized in 1993, large Japanese banks, which often acted as corporate borrowers’ both main banks and bond trustees, routinely bought back defaulted bonds from bondholders in order to maintain public confidence in the bond market. Although these buy-back practices have moderated in recent years, the main banks’ moral obligation and tendency to support troubled borrowers and other creditors remain deep-rooted. In practice, some bank loans are treated as quasi-equity despite their higher legal priority.

Main Bank System Under Stress But Expected To Persist

The decade-long economic recession in Japan has put considerable stress on the traditional convoy system of main bank support as the substantial deterioration in Japanese banks’ financial condition has weakened their capacity to provide support. The rapid growth of the syndicated corporate loan market may also help redefine the traditional creditor-borrower relationship in Japan over time.

Nevertheless, changes are taking place only slowly and Moody’s expects the main bank system to persist for the indefinite future, particularly if the budding economic recovery takes hold and eases off the pressure to take difficult actions. In Moody’s view, at least over the medium term, if a strong, long-standing relationship exists between a bank and a borrower, the bank may well continue to act as a supporter rather than an arms-length creditor in an insolvency situation. This calls for a continued analysis of the priority of claims and recovery prospects beyond the pure legal perspective.

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6. Even for unsecured bank loans, a bank can, as stipulated in the “The Agreement of Bank Transaction”, demand collateral from a borrower at any time the bank considers necessary.
A Sense Of Security - What Is Collateral Worth And Can It Be Enforced?

By and large, Japan has an effective system for the granting and taking of security interests in borrowing/lending transactions. In Japan, there are various types of security available for movables and immovables. Mortgages are widely used for real estate such as building and land. Pledge is more commonly used for movables and claims. Security by way of transfer is also widely used, and liens can be created by operation of law.

In practice, real property is still the most popular collateral used to secure debt in Japan. Japan has a well-established registration system for real properties. The holders of ownership rights, use rights, attachments and certain other liens and security interests must record their rights and interests in real property on the relevant real property register in order to assert their rights and interests against any future infringement. Under Japanese laws, there are several types of security interests that may be created in real property. Among such security interests, the mortgage (teitoh-ken) is the most popular type. The mortgage that is used to secure a specific debt is called the normal mortgage (futsu-teitoh-ken). The mortgage that is used to secure debts that may arise between a debtor and a mortgagee, up to a specific maximum amount in the aggregate, is called the revolving mortgage (ne-teitoh-ken), which is often used to secure trade debt or a bank’s credit-line facility.

Enforcement Of Security Interests

The specific security interest enforcement process depends on the type of security. From a legal standpoint, the enforcement mechanism is well-established. A secured creditor’s power to foreclose on a security interest is common to almost all types of collateral.

The foreclosure of a mortgage is, in principle, conducted by a public auction in accordance with the Civil Execution Law. A public auction process is initiated by the mortgagee filing a petition for commencement of the public auction with a court having jurisdiction over the relevant real property. The court administers the entire process of the public auction including the distribution of the sales proceeds. Depending on the market conditions, the location of the real property, the complexity of the rights of and interests in the real property, the number of cases pending at the relevant court, and many other factors, it usually takes about one year to complete the entire public auction process.

However, despite the various legal remedies available to secured creditors, in practice it is customary for Japanese banks to take a much more conciliatory approach towards defaulted debtors, particularly for large-sized companies or those that have a long-standing relationship with the lenders. As noted above, debt rescheduling, reorganization, and other forms of private arrangements are the norms. Foreclosure and auctions, when utilized, are often against small companies.

Compulsory Extinguishment Of Security Interests May Impair Creditor Rights

While the security rights of creditors are generally well-protected under Japanese laws, these rights can be impaired by provisions that allow for the compulsory extinguishment of the security interest. Under the Civil Rehabilitation Law, with respect to security interests on properties that are considered essential to the continuance of its business operations, a debtor can, with the permission of the court, seek to extinguish a security interest by making a monetary payment to the secured debtor equivalent to the fair value of the subject property. Any secured creditor who objects to such payment can argue at the court based on the assessment of the appraiser. However, the security interest will be extinguished if the debtor pays the amount determined by the court. In this way, a debtor can compulsorily extinguish the security interest on its own initiative. Although it is infrequently used in practice, it could severely compromise creditors’ rights and reduce the recovery value of their claims. Conversely, it can be especially advantageous to debtors when the value of the asset has declined.

Recovery Value Often Low

In Japan, the typical court-ruled recovery rate is usually lower than that in the US. This is because relationship banks, as noted above, often support a borrower until the last minute. But their support tends to be limited to what the bank can bear at any particular time, which often falls short of a support level necessary to restore the borrower’s financial health. A second or even a third round bail-out package to the same borrower is often required. By the time the borrower’s condition has deteriorated to a point beyond rescue, the value of its assets may have already been greatly diminished, and thus often offers little recovery for creditors.

7. Moody’s is in the process of studying the default and recovery rates of corporate bond issuers in Japan and other Asia-Pacific countries, and plans to publish a special comment to discuss the issues in more detail.
Bibliography


International Monetary Fund, (2003), "Japan: Financial System Stability Assessment and Supplementary Information", IMF Country Report


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World Bank, "Insolvency Overview - Japan"
Appendix A. Summary Description of Insolvency Proceedings In Japan

1. Bankruptcy

Bankruptcy, a fundamental insolvency proceeding in Japan, was introduced and established in 1922 based on the German and Austrian laws, with the purpose of dissolving the debtor and liquidating its assets. Bankruptcy proceedings in Japan are similar to those in Germany.

The ground for filing a bankruptcy proceeding exists (a) when the debtor is continuously unable to make payments due to its lack of paying ability, or (b) when the total liability of the debtor exceeds its assets. Upon the verification of the ground for bankruptcy, the court adjudicates the debtor as bankrupt and appoints a trustee. Once the debtor is adjudicated as bankrupt, the assets of the debtor will constitute the bankruptcy estate and the trustee will be entitled to manage and dispose such estate.

As soon as the trustee is appointed, the trustee will (a) take charge of the debtor’s assets, (b) estimate the value of the debtor’s assets, (c) prepare an inventory of property and a balance sheet, and (d) report, among other things, to the creditors’ meeting the reason for the debtor’s bankruptcy status, the current situation of the bankruptcy estate and the prospect of the bankruptcy proceeding. At the same time, the trustee, under the supervision of the bankruptcy court, will liquidate the debtor’s assets into cash and prepare for the distribution to creditors. Creditors anticipating a distribution are required to file their claims with evidence thereof with the court. The trustee will examine and determine whether to admit or object to each claim within a specified time period designated by the court. Creditors are also entitled to raise objections to the claims of other creditors. After the bankruptcy estate is liquidated into cash and the creditors’ claims are confirmed and no challenges have been made thereto, the trustee will distribute the proceeds in the following order:

1. Estate Claims, including taxes and expenses incurred in the proceedings
2. Right of Exclusion (betsujoken) (secured claims)
3. Senior Bankruptcy Claims (general liens (sakidori tokken), etc.)
4. Bankruptcy Claims (unsecured claims)

2. Special Liquidation

The Special Liquidation procedure is a court-supervised proceeding applicable only to stock companies undergoing normal liquidation proceeding pursuant to a resolution for dissolution of the company by the shareholders meeting or other causes provided in the Commercial Code. The Special Liquidation proceeding will commence (a) if there is a situation which seriously impedes the normal liquidation proceeding, or (b) if the liabilities of the company exceed or may exceed its assets.

Upon the court’s verification of the ground for Special Liquidation, the court will adjudicate the commencement of a Special Liquidation proceeding and appoint a “special liquidator”, who will most likely be the liquidator of the normal liquidation proceeding. Under the supervision of the court, the special liquidator shall liquidate the debtor’s assets and may (a) pay the creditors (if the company is not insolvent); (b) make independent settlements with all or any creditors for certain exoneration to eliminate the debtors insolvency and pay the creditors thereafter; or (c) prepare a settlement plan reducing the creditors’ claims on a substantially equal basis (which is more flexible than on a pro rata basis) in order to eliminate the debtors’ insolvency status, submit such plan to the creditors’ meeting, obtain their approval and pay the creditors thereafter.

Procedure (c) is the most common feature of the special liquidation proceeding while procedure (b) is less common and procedure (a) is applied in very rare occasions. However, the settlement plan is effective only if creditors approve the plan by at least a 75% majority of the amount of claims and majority of the number of creditors and if the court approves the plan thereafter.

The special liquidation procedure is governed not only by the Commercial Code but also by the Non-litigation Procedural Law.

8. For detailed information, please refer to “Insolvency Overview – Japan”, World Bank.
3. Corporate Reorganization

Corporate Reorganization is a rehabilitation-type insolvency proceeding, which was established in 1952 under the guidance of the US after World War II. Its purpose was to preserve and reorganize companies while continuing to adjust for the interests of creditors, shareholders and other parties related to distressed joint stock corporations (“KK”). This is more often used for rehabilitation proceedings of relatively large-scale companies and in most cases, the existing management team leaves the company.

Features Of Corporate Reorganization Proceedings

- Even a secured party may not be able to exercise its rights during the proceedings, and claims will be paid in accordance with a reorganization plan.
- Shareholders participate in the proceedings and bear the company’s losses.
- When handling small monetary claims, labor claims, and small- and medium-scale company claims, etc., public policy considerations are taken into account.
- The court oversees the reorganization plan even at the implementation stage, in an attempt to firmly support such implementation.
- The role of trustees in corporate reorganization proceedings is different from that in bankruptcy proceedings, as it has the authority not only to manage and dispose of assets but also to manage the debtor’s business until the proceedings are concluded.

Changing The Order Of Claims By The Reorganization Plan

Under Corporate Reorganization, the reorganization plan is required to be prepared justly and fairly, treating claims in the following order:

1. Reorganization Secured Claims
2. Senior Reorganization Claims including general liens (sakidori tokken) and other preferential claims
3. Reorganization Claims other than Senior Reorganization Claims
4. Shareholder Claims of shares having priority in the distribution of residual assets
5. Shareholder Claims of shares other than those having priority in the distribution of residual assets

4. Corporate Arrangement

Corporate Arrangement is a rehabilitation-type insolvency proceeding and its purpose is to rehabilitate companies that are in financial difficulties. However, Corporate Arrangement merely provides rudimentary proceedings and many details are left to interpretation and practice. Thus, Corporate Arrangement provides a more flexible procedure than other rehabilitation-type proceedings. In addition, management will not necessarily lose control of the company, unlike the proceeding under the Corporate Reorganization Law.

To commence a Company Arrangement proceeding, an application can be filed pursuant to Article 381 of the Commercial Code. The court then issues a provisional order prohibiting the company from taking various actions, including payment of its debts. Requests are normally received to advise on the alternatives available to creditors to satisfy claims against the company.

5. Civil Rehabilitation

Civil Rehabilitation is a relatively new insolvency proceeding established in 1999 to replace the repealed Composition Law. Its purpose is to appropriately adjust the civil claims between debtors and creditors in order to rehabilitate debtors’ business. With the consent of the majority of its creditors, a rehabilitation plan is established and approved by the court. The proceeding is often used for rehabilitation of small and medium-sized companies as well as individual entrepreneurs.

Features Of Civil Rehabilitation Proceedings:

- In principle, existing management continues to handle the debtor’s business as a debtor-in-possession (DIP), but when necessary a petition for the appointment of a supervising administrator or trustee may be filed with the court.
- A secured party may exercise its rights outside the civil rehabilitation proceedings as a holder of a Right of Exclusion (betsujoken); provided, however, that when a property is deemed essential for the company’s business, the debtor may file a petition to extinguish security interests in such property by making a monetary payment equivalent to the value of such property to the court.
**Comparison To US Bankruptcy Law**
(The comparison is between Civil Rehabilitation proceedings and Corporate Reorganization proceedings in Japan and Chapter 11 proceedings in the US.)

<table>
<thead>
<tr>
<th>Country</th>
<th>Cause For Filing</th>
<th>Commencement Of Proceedings</th>
<th>Automatic Stay</th>
<th>Creditor Committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>Debtors can file without being insolvent</td>
<td>Effective immediately after filing.</td>
<td>All creditor (secured or unsecured) collection activities are automatically suspended upon filing</td>
<td>Must be established and play a leading role in the proceedings.</td>
</tr>
<tr>
<td>Japan</td>
<td>A cause for filing is necessary although this requirement has been relaxed.</td>
<td>Not effective until the court separately orders proceedings should commence.</td>
<td>When a court order to commence proceedings is issued, unsecured creditors' rights are suspended in Civil Rehabilitation proceedings, and the rights of both unsecured and secured creditors are suspended in Corporate Reorganization proceedings.</td>
<td>The establishment of a creditor's committee is optional, and creditors rarely take an active role in the proceedings.</td>
</tr>
</tbody>
</table>
Related Research

**Special Comment:**

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Bankruptcy & Ratings: A Leveraged Finance Approach for Europe Part II: France, June 2000, #57017
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