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Rescue Financing in Japanese Restructuring Proceedings

I. Rescue Financing Under Japanese Restructuring Proceedings
II. Priority of DIP/Pre-DIP Financing Under Japanese Law
III. Practical Issues and Future Legal Reforms Related to Collateral for DIP/Pre-DIP Financing

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With the passage of several years since the outbreak of COVID-19 and additional external factors such as the soaring prices of various goods and services and the sharp depreciation of the Japanese yen, companies' financial conditions have deteriorated, while others are considering filing for restructuring proceedings, which is why the reduction of excessive debt has become a major issue as of late.

In order for them to successfully restructure their businesses, it is essential for companies to raise funds and secure cash flow for the duration of their restructuring proceedings. Just as the U.S. Bankruptcy Code provides special protection for rescue financing under Chapter 11, Japanese law also provides certain special protection for rescue financing to companies during their restructuring proceedings.

This issue of the newsletter focuses on the legal systems and practices for such continually evolving rescue financing.

I. Rescue Financing Under Japanese Restructuring Proceedings

1. Outline

Japanese restructuring proceedings are classified into two categories depending on whether the court is involved: "in-court insolvency proceedings" and "out-of-court workouts." The latter is becoming more commonly used to restructure the debtor's financial debts without commencing the former, which usually damages the company's going concern value. Generally, such out-of-

court workouts involve only financial institutions, while claims held by trade creditors are paid in full, thus preventing the deterioration of the debtor's business value.[1]

In both types of proceedings, the debtor often faces a temporary shortage of working capital to maintain the value of its business during the restructuring. Thus, in many cases, the debtor obtains a new loan from a lender, such as a financial institution or potential sponsor, for securing its cash flow.

In Japan, such financing is referred to as "DIP financing" or "pre-DIP financing" depending on the classification between in-court insolvency proceedings and out-of-court workouts, while in the U.S. Bankruptcy Code such financing during Chapter 11 proceedings is referred to as only "DIP financing."

2. DIP Financing

DIP financing is the provision of new financing to debtors who have filed for in-court insolvency proceedings, and is often used primarily for the following purposes:

(i) To provide working capital necessary for the proceedings.

(ii) To avoid a deterioration in the company's creditworthiness due to its announcement[2] of commencing the proceedings (i.e., DIP financing is used as a means of providing credit enhancement).

3. Pre-DIP Financing

Pre-DIP financing refers to the provision of new financing to debtors who have initiated out-of-court workouts. Though such workouts have a high hurdle to overcome in that they require the unanimous consent of participating creditors to be successful,[3] by securing funds through pre-DIP financing, the possibility of achieving successful out-of-court workouts is significantly increased because it allows the debtor to take its time in selecting and negotiating with its sponsor, formulating a restructuring plan, and negotiating with its financial creditors until each party is satisfied.

[1] We have seen some successful out-of-court corporate workout cases where the debtors are large, global companies with subsidiaries worldwide, like the Marelli case. For more information on this case, please see our Restructuring & Insolvency Newsletter Vol.1.

[2] Under Japanese law, the company must announce in the official gazette that such proceedings have commenced.

[3] The Japanese government is now considering a new system whereby creditors' rights can be amended based on the principle of majority rule.

II. Priority of DIP/Pre-DIP Financing Under Japanese Law

1. Need to Protect Rescue Financing in Restructuring Proceedings

DIP and pre-DIP financing involve loans being made to financially distressed debtors, and thus the would-be loan providers would naturally undertake a higher risk of default than that of ordinary loans.

To put it another way, in in-court insolvency proceedings, it is difficult for the debtor to obtain DIP financing unless the financing is given priority over other general creditors' claims. When it comes to out-of-court workouts, the risk of default will materialize if a lender provides pre-DIP financing and then the debtor fails to obtain the unanimous consent of participating creditors for the restructuring plan, and thus the proceedings switch to in-court insolvency. In such cases, it is difficult for the debtor to obtain pre-DIP financing unless the financing claims are given priority over other general creditors' claims.

Under these circumstances, Japanese law gives priority to DIP and pre-DIP financing claims as follows in order to motivate lenders to provide such financing.

2. DIP Financing

As with in-court insolvency proceedings, the most important thing is whether certain claims are classified as "common benefit claims." Such claims are paid outside of a rehabilitation plan and prior to general creditors receiving their share. This means that common benefit claims are paid in full as long as the debtor's rehabilitation proceedings are successful.[4]

In civil rehabilitation proceedings, which is the most common form of in-court restructuring-type insolvency proceedings in Japan, DIP financing claims become common benefit claims and are given priority in the following cases:

(i) When DIP financing is provided between the filing of the petition and the order of commencement of the proceedings and is approved by the supervisor; or

(ii) When DIP financing is provided with the supervisor's consent after the

[4] If the rehabilitation proceedings fail and the debtor switches to bankruptcy, the risk of not being paid in full arises even for common benefit claims.

order of commencement of the proceedings is given.

This legal regime is similar to the conversion of unsecured borrowings into administrative claims under Section 364(a)(b) of the U.S. Bankruptcy Code. However, it differs from Japanese restructuring law with respect to the granting of priority rights to DIP financing as follows:

(i) Under the U.S. Bankruptcy Code, there is the super-priority system, which allows financing after a Chapter 11 filing to be given priority over all other administrative claims (Article 364(c)). However, there is no such system in Japan, where DIP financing does not have the highest priority among common benefit claims.

(ii) Under the U.S. Bankruptcy Code, there is also the priming lien system, which allows for the granting of priority over existing security interests in financing after the filing of a Chapter 11 petition (Article 364(d)). However, there is also no such system in Japan.

3. Pre-DIP Financing

A. Granting Priority in Out-of-Court Workouts

If a debtor moves from out-of-court workouts to in-court insolvency proceedings, in principle, pre-DIP financing claims are generally treated the same as other general claims (i.e., they are not given priority).

However, where pre-DIP financing is provided in out-of-court workouts, priority may be granted at the subsequent in-court insolvency proceedings if certain requirements are met. For example, under the turnaround alternative dispute resolution (ADR) process ("**Turnaround ADR proceedings**"), which is one of the most popular standardized forms of out-of-court workouts in recent years, especially for large companies, they must obtain confirmation from the supervisor that the pre-DIP financing meets the following requirements:[5]

(i) The borrowing is reasonably necessary for maintaining the debtor's cash flow up to the date on which the restructuring plan is expected to be approved;

[5] In order for pre-DIP financing claims to be granted priority in civil rehabilitation proceedings, the court must ultimately determine that the priority given itself is "not prejudicial to equity." Thus, it should be noted that the final determination of whether priority is granted is left to the court, which means that priority treatment is not guaranteed.

(ii) The borrowing is due and payable on or after the date on which the restructuring plan is expected to be approved; and

(iii) Consent has been obtained from all eligible creditors to treat the borrowing as having priority over the repayment of other claims held by creditors subject to the Turnaround ADR proceedings.

B. Methods of Conversion to Common Benefit Claims

The method described in sub-section A above only ensures that pre-DIP financing claims are paid preferentially pursuant to the debtor's civil rehabilitation plan after the debtor has switched to civil rehabilitation proceedings and the creditors have approved the rehabilitation plan. In other words, this method does not ensure that pre-DIP financing claims are paid in full outside of the rehabilitation plan during the civil rehabilitation proceedings.

However, some pre-DIP financing providers request that their claims be paid as common benefit claims even before the rehabilitation plan is approved by the creditors.

In order to fulfill these creditors' demands, if their claims are fully secured by collateral and there is no risk of harm to other general creditors' interests even though they are paid as common benefit claims from time to time, in principle, they can be effectively converted to such claims and be paid accordingly before the creditors approve the rehabilitation plan.[6]

III. Practical Issues and Future Legal Reforms Related to Collateral for DIP/Pre-DIP Financing

As mentioned in section II.3.B, in order to convert pre-DIP financing claims into common benefit claims, it is desirable for these claims to be fully secured by collateral. However, financially distressed companies seeking such financing often no longer have valuable assets to be provided to pre-DIP financing providers as collateral. Furthermore, there is no system in Japan that gives priority to security interests in DIP/pre-DIP financing claims, such as the priming lien under Section 364(d) of the U.S Bankruptcy Code. Therefore, in some cases, pre-DIP financing is not available because the debtor is unable to provide

[6] There are multiple legal approaches to converting to common benefit claims, but, regardless of which approach is used, it is desirable for the pre-DIP financing claims to be fully secured by collateral.

sufficient collateral.[7]

The Japanese government is currently deliberating on amending the collateral law system, including creation of a security system for the company's business as a whole (so-called "business security interests"). In this context, discussions are taking place on whether to establish a system whereby DIP financing claims have priority over business security interests, with reference to the U.S. priming lien, in order to promote DIP financing.[8] Since a system to promote DIP/pre-DIP financing may be established in the future, the discussions should be closely monitored.

NEWS

- Tomotaka Furukawa joins Mori Hamada & Matsumoto

  (Message from Mr. Tomotaka Furukawa)

  I am honored to be joining Mori Hamada & Matsumoto.

  Following my admission to the Japanese bar in 2020, I joined Inaba & Partners, where I mainly focused on the practice areas of real estate and infrastructure and energy.

  At Mori Hamada & Matsumoto, I look forward to leveraging my experience to date, and will strive to further hone my professional expertise to support the firm's clients.

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[7] Recently, the scheme of self-trust of accounts receivable (self-trust scheme) has attracted attention as a method of providing collateral for DIP/pre-DIP financing. The advantages are that (i) it can be used even for receivables with a covenant against assignment, and (ii) the countervailing requirements can be fulfilled by a method that does not involve public notice.

[8] Legislative changes in this direction can also be found in other countries. In Singapore, for example, a 2017 amendment to the Companies Act introduced a "super-priority" regime allowing certain "rescue financings" (i.e., financings that are necessary for the survival of a company or to achieve a more advantageous realization of the assets of an accompanying company) (Section 67 of the Insolvency, Restructuring and Dissolution Act 2018).