Issues Surrounding Debtor-in-Possession Financing in Japan

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In Japan, debtor-in-possession (DIP) financing is attracting growing interest as a new way for businesses that have filed for bankruptcy to obtain the working capital they need in order to reorganize. One of the measures announced on 6 April (as part of the government's emergency economic package) to help the country's financial institutions reduce their non-performing assets and non-financial companies reduce their debts as quickly as possible was one on DIP financing. In this report we shall look at some of the issues that will have to be addressed if this approach is to gain wider acceptance in Japan.

1. The Growing Use of Bankruptcy Procedures under the Reorganization Law and the Advantages Expected from DIP Financing

DIP financing is used mainly by financial institutions such as banks and non-banks [1] to allow a company in distress that has petitioned to begin bankruptcy proceedings with a view to rehabilitation [2] to obtain the working capital it needs to remain in business, provided the bankruptcy court agrees. It is now an established approach to financing corporate rehabilitation in the United States. It enables the distressed company to obtain the working capital it needs to remain in business until a plan of reorganization is confirmed as well as to improve its liquidity position and to work towards rehabilitation.

In Japan, bankruptcy tends to be seen as marking a company's demise, and financial institutions are generally reluctant to lend to a company in distress. Therefore many companies that do decide to file for bankruptcy with a view to rehabilitation apparently seek support from another company (a sponsor) in order to maintain cash flow. In the case of a company filing for bankruptcy under the Corporate Rehabilitation Law, this sponsor (usually its parent, an affiliate, rival or

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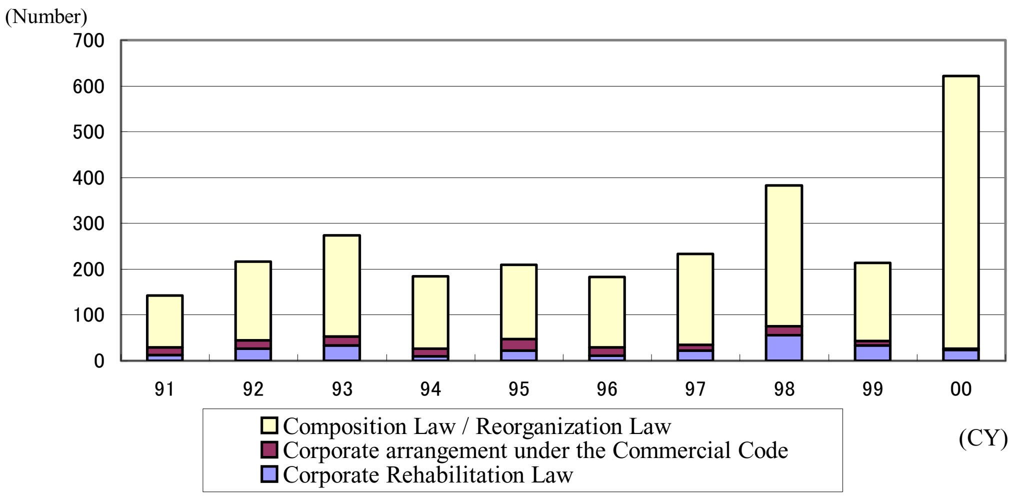
1 Non-financial corporations also sometimes provide DIP financing.

2 This corresponds to three different legal procedures in Japan: the Corporate Rehabilitation Law, the Reorganization Law and corporate arrangement under the Commercial Code. (The third of these became inoperative when the second came into effect.)

major business partner) will be appointed receiver (the equivalent of "trustee" in the United States) and assume responsibility for managing the company. Although in some cases the company's main bank may act as a short-term source of working capital by agreeing to discount bills, in most cases the sponsor will oblige by granting a loan, discounting bills or agreeing to underwrite a third-party offering. In the case of a company (usually a small one) filing for bankruptcy under the Composition Law (before this was replaced by the Reorganization Law), no receiver would be appointed and the existing management team would remain in place. This tended to make it more difficult to find a sponsor than when filing under the Corporate Rehabilitation Law. In addition, the Composition Law's provisions on loans were vague, and companies' attempts at rehabilitation sometimes failed because they found themselves unable to raise capital.

In April 2000, when the Reorganization Law came into effect, the Composition Law, which had always been considered problematic, was repealed.[3] The fact that the bankruptcy procedures under the Reorganization Law were simple and quick, and the conditions for filing for bankruptcy less stringent meant that during the first nine months after it came into effect (i.e., April-December 2000) 550 companies filed for bankruptcy under its procedures—significantly more than the 171 that filed under the Composition Law in 1999. As a result, in the whole of 2000 the number of companies filing for bankruptcy with a view to rehabilitation (622) was more than in any other of the past 10 years (Figure 1).

Figure 1 Rehabilitation-Type Bankruptcies



Note: The figures for 2000 include both the Composition Law (January-March) and the Reorganization Law (April-December).
Source: NRI, from Zenkoku Kigyo Tosan Shukei [Corporate Bankruptcy Statistics], Teikoku Databank.

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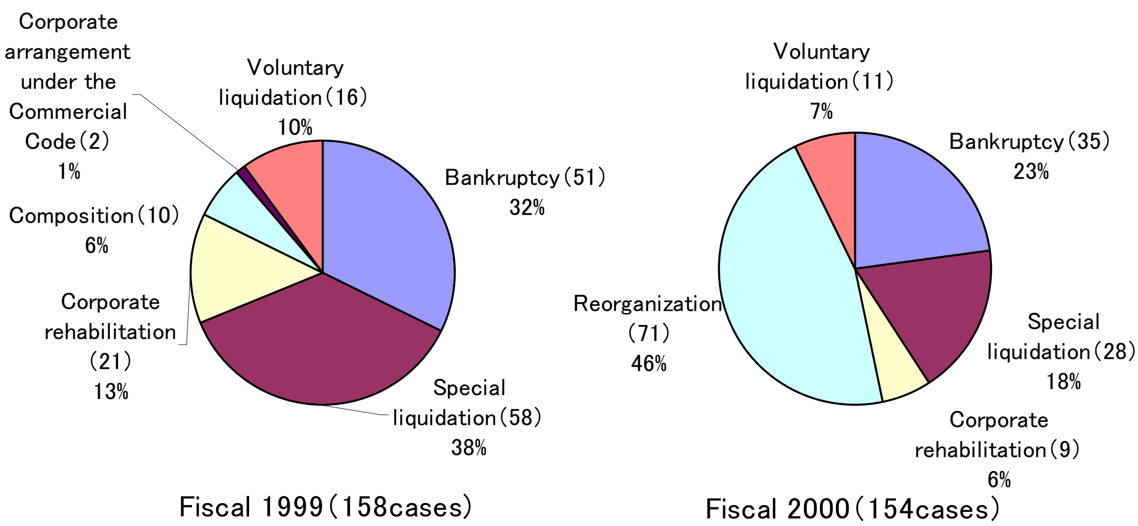
3 For further information about the Reorganization Law see Masanobu Iwatani, Reorganization of Insolvent Companies under the New Reorganization Law, Capital Research Journal, Spring 2000.

The number of major bankruptcies (involving debts of ¥10 billion or more) dealt with under the Reorganization Law has also increased since it was introduced. A comparison of the procedures used for dealing with major bankruptcies in fiscal 1999 and fiscal 2000 (Figure 2) shows that, whereas in fiscal 1999 liquidation procedures (i.e., bankruptcy, special liquidation or voluntary liquidation) accounted for 80% of the total in terms of the number of cases, in fiscal 2000 some 50% (71 cases) were dealt with under the Reorganization Law. Not only had the number of cases dealt with by liquidation procedures declined to nearly half of the total, but the number dealt with under the Corporate Rehabilitation Law had also declined to about half of the total. This suggests that companies that previously would either have had no alternative but to resort to liquidation or have chosen to file for bankruptcy under the complicated, slow and expensive procedures of the Corporate Rehabilitation Law have opted for the simple and convenient procedures of the Reorganization Law.

As the number of companies (including large ones) opting to file for bankruptcy under the Reorganization Law increases, the fact that (as under the Composition Law) a receiver is not normally appointed and the existing management team remains in place means that an increasing number of companies in distress may be unable to find a sponsor and have difficulty obtaining the working capital they need. The result is likely to be that an increasing number will turn to financial institutions for DIP financing. However, it is not enough for demand to increase. Potential lenders will have to have an incentive to provide such finance if it is to become more generally available. In this regard, US experience is instructive.

Figure 2 Major Bankruptcies (involving debts of at least ¥10 billion)



Notes: 1 The data for fiscal 2000 are based on those for April 2000 to February 2001. The figures in parentheses represent the number of bankruptcies.
2 Of the 71 bankruptcies for fiscal 2000, 23 involved the Sogo Group.

Source: NRI, from Zenkoku Kigyo Tosan Shukei [Corporate Bankruptcy Statistics], Teikoku Databank.

2. DIP Financing in the United States

1) The development of DIP financing

The current US Bankruptcy Code is based on the Bankruptcy Code of 1978 ("the Code"). This, in turn, contains major changes to its predecessor, the Bankruptcy Code of 1878, in that it tends to favor the company in distress rather than its creditors. One of the Code's new provisions was to make it easier for companies in distress filing for bankruptcy (under Chapter 11) to obtain working capital. It did this by creating incentives for financial institutions ("DIP lenders") to provide such capital.

However, when the Code was introduced, financial institutions remained reluctant to grant new lines of credit to companies in distress. Although institutions that had formed a close relationship with a company before it filed for bankruptcy were apparently sometimes willing to continue to put new money into it, lenders generally remained reluctant to view DIP financing in a positive light.

The first institution to see DIP financing as an opportunity was Chemical Bank (now J.P. Morgan Chase), which formed a department specifically for this purpose in 1984. Once Chemical successfully concluded a number of major DIP financing deals, other institutions began to follow.

In the 1990s Chemical and a number of other banks set about expanding their DIP financing operations in terms of both the number and size of deals. This was also when syndicated loans began to be used for this purpose, with lead managers obtaining credit ratings for such deals in order to encourage more institutions to participate.

As DIP financing increased, one of the issues that arose was how to treat new assets created as a result. Financial institutions were concerned that the regulators would regard DIP financing as a "highly leveraged transaction" (HLT) requiring stricter supervision and classify such assets as "unlikely to be recovered." Some of the leaders in the field therefore made a case for DIP financing to the regulators by explaining how such deals were structured and what risks were involved. The result was that in 1991 the regulators announced that DIP financing would not be regarded as a highly leveraged transaction.

As such stumbling blocks were gradually removed, the number of institutions offering DIP financing increased.

2) Two types

There are two types of DIP financing: offensive and defensive.

An example of the offensive type is when a financial institution offers to lend a distressed company the working capital it needs even though it has never had any dealings with the company before.

An example of the defensive type is when a financial institution that was already a creditor to the company when it filed for bankruptcy lends it more money in order to maintain its own influence and increase its chances of recovering its existing investment. Sometimes a company's main bank will do this on its own; sometimes a number of creditor banks will form a syndicate. Although this approach might appear similar to what happens in Japan when a bank grants an additional line of credit to a corporate customer in difficulty, it is different in that it is done as part of the transparent process of bankruptcy. Defensive DIP financing is much the commoner type.

3) The DIP financing process

(1) Access to lenders

In the United States, a company in distress considering remaining in business with the help of DIP financing after it files under Chapter 11 will normally start to negotiate with a prospective lender 1-3 months in advance in order to be sure of obtaining credit afterwards. A company will usually apply to the bankruptcy court for permission to do this at about the same time as it files under Chapter 11.

(2) Due diligence

When a potential lender is approached in this way, the first thing it will do is try to find out exactly why the company in distress has had to file for bankruptcy. It will then conduct a detailed analysis of the company, using both publicly available information (such as the 10-Q and 10-K reports US companies are required to produce by the SEC) and information contained in private databases. This is to find out (1) what distinguishes the company from its rivals and what is happening in the industry concerned; (2) how competent the management is; (3) what the company's assets are worth; and (4) what its current financial position is and what its future cash flow is likely to be. In addition, a prospective lender will obtain a range of information from the company itself and carry out a qualitative analysis (e.g., by interviewing staff). The result of this due diligence is often that a prospective lender will decide not to provide DIP financing. And even if it does decide to go ahead, a lender will usually agree with a customer how the money is to be spent and attach detailed conditions and restrictions in advance. Furthermore, as well as providing DIP financing, a lender may well assist a distressed company with its rehabilitation and charge a fee for its services as a financial adviser.

(3) Terms of financing

When a lender decides the terms on which it is prepared to provide DIP financing, the following are particularly important: the rate of interest, the amount, the period and which of the various credit options under Section 364 of the Bankruptcy Code of 1978 it proposes to adopt.

First, the rate of interest. This will obviously depend on market conditions, the creditworthiness of the company, the size of the loan, and the collateral, but usually it will be about LIBOR + 150-350 basis points. Three different types of loan are commonly used: revolving credit[4], a term loan[5] or a letter of credit (L/C)[6]. Besides interest, the company will have to pay various fees, including an up-front fee, an advisory fee, an unused line fee, administrative expenses (e.g., for looking after the collateral) and the costs of issuing a letter of credit.

The normal period for DIP financing is 1-2 years, but cases with shorter periods (of 60-120 days) also occur. These terms may be altered at any time if the situation during the bankruptcy procedure changes.

The next thing that a lender has to decide is which of the various credit options under Section 364 ("Obtaining credit") of the Bankruptcy Code of 1978 it proposes to adopt. By increasing the likelihood that a company in distress will repay any loans it obtains, the Code gives potential lenders an incentive to provide DIP financing and makes it easier for the company in distress to be granted a line of credit. Section 364 specifies four different terms (in descending order of creditworthiness) on which a company in distress may be granted credit (Table 1).

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4 An arrangement whereby a borrower may draw down funds up to an agreed amount at any time during an agreed period.

5 A secured loan for a fixed period longer than a revolving credit.

6 An arrangement whereby a financial institution guarantees payments made by a distressed company to business partners in the normal course of its business.

Table 1 Terms for Obtaining Credit under Section 364 of the Bankruptcy Code of 1978

(1) Unless the court orders otherwise, a debtor in possession may obtain unsecured credit in the ordinary course of business. That debt shall be treated as a post-petition administrative expense[7] with priority over other debts and must be repaid as and when required. (Sec. 364 (a))

(2) The court, after notice and a hearing, may authorize the debtor in possession to obtain unsecured credit other than in the ordinary course of business, allowable as an administrative expense. (Sec. 364 (b))

(3) If the debtor in possession is unable to obtain unsecured credit allowable as an administrative expense under (1) and (2) above, the court, after notice and a hearing, may authorize the obtaining of credit with priority over any or all administrative expenses (so-called "super priority") (Sec. 364 (c) (1)). Similarly, the court, after notice and a hearing, may authorize the obtaining of credit secured by a lien on property of the estate that is not otherwise subject to a lien or secured by a junior lien on property of the estate that is subject to a lien. (Sec. 364 (c) (2) (3))

(4) If the debtor in possession is unable to obtain such credit otherwise, the court, after notice and a hearing, may authorize the obtaining of credit secured by a senior or equal lien on property of the estate that is subject to a lien. However, the debtor in possession must demonstrate that there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted. (Sec. 364 (d))

Source: NRI.

Of these four options, the one which is most frequently chosen is the third (the “super-priority” clause). If this option is chosen, a DIP lender can ensure that repayment of its loan has priority over all administrative expenses and is therefore reasonably certain. In addition, if the fourth option is chosen, a lender can have a loan secured by a senior lien on property that is already subject to a lien. In most cases, either the third or the fourth option is chosen—or both. The converse of this is that, if a lender is unable to obtain either of these options, it is unlikely to be willing to provide DIP financing.

If a lender does have a loan secured by a senior lien on property that is already subject to a lien, the company in distress must provide "adequate protection" of the interest of the holder of that lien. What this means is that a bankruptcy court will only

[7] This is similar to the notion of "common interest claims" under the Corporate Rehabilitation Law in Japan. These are claims for expenses incurred in furthering the interests of all creditors (including lawyers' fees incurred in the course of the rehabilitation process and employees' wages) which have priority over any claims on the company originating from pre-petition causes and must be repaid as and when required regardless of the rehabilitation process (Corporate Rehabilitation Law, Article 209).

approve DIP financing if it is sure, for example, that an additional lien has been granted or that the value of the property on which the lien is secured is adequate. However, even if such adequate protection is largely lacking, the holder of an existing lien is unlikely to object to a senior lien being secured on the same property if he believes that the value of the business is more likely to increase if it obtains DIP financing and succeeds in reorganizing than if it is liquidated and the property on which the lien is secured sold. Such cases are common in defensive types of DIP financing where the financing is provided by the holder of an existing lien. When the court does approve an application for DIP financing, the terms are published.

(4) DIP financing as the beginning of an ongoing business relationship

Once DIP financing has been repaid, the lender may decide to end the relationship there and then. In some cases, however, lenders try to maintain the relationship, using DIP financing as a foothold in the door to further business.

If, for example, a lender believes that a company that was once in distress is now capable of standing on its own feet, it may decide to offer it a new line of credit on its own or by opening an information book on the company and inviting other financial institutions to participate in a syndicated loan. As the reason for syndicating a loan is to spread the risk, it is common for the institution that acted as DIP lender also to act as lead manager. If the reorganization is successful, the DIP lender can become the company's main bank, thereby opening the door to other business.

4) Reasons for the growth in DIP financing

(1) Relatively low risk and relatively high return

Because Section 364 of the Bankruptcy Code of 1978 enables a DIP lender to be granted a high priority or, in some cases, to be granted a lien, DIP financing is not particularly risky.

At the same time, rates of interest on such loans tend to be higher than average, so the incentives for a financial institution are quite considerable. Nevertheless, competition among lenders is increasing, and this has tended to exert downward pressure on rates.

(2) Regulatory status

In 1991 (see above) the Federal Reserve (FRB), the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) revised their definition of "highly leveraged transaction" and announced that DIP financing that had been approved by a court would not be considered a highly leveraged transaction.

The notion of a highly leveraged transaction as a high-risk transaction has been adopted and defined by all three federal financial regulatory agencies (the FRB, the FDIC and the OCC) to enable them to carry out their supervisory role.[8] As financial institutions know that, if they have large amounts of HLT assets on their books, the regulators may step up their supervision while analysts and investors will also watch them more carefully, they will normally have strict limits for such assets.

Although DIP financing was originally generally regarded as a highly leveraged transaction, the persistent lobbying by some of the main DIP lenders ensured that the regulators did not designate it as such.

Similarly, although not stipulated in any regulation or examination manual, new assets created as a result of DIP financing would appear to be classified as "pass."

Therefore as the regulatory status of DIP financing has become clearer and the regulators have recognized the relatively low risk of such transactions, financial institutions have found it easier to take a positive attitude towards such financing.

(3) Court approval for DIP financing

Under the Bankruptcy Code of 1898, the bankruptcy court judge was responsible not only for the legal aspects of a case but also for the administrative aspects (e.g., supervising the receiver and the reorganization of the company in distress). Under the Bankruptcy Code of 1978, however, a new agency (the United States Trustee) within the US Department of Justice was created to look after the administrative aspects of bankruptcy cases. This has left the judge in such cases to concentrate on the legal aspects, and his involvement in the bankruptcy procedure has become more passive. The result has apparently been that, if the company in distress, the DIP lender and the creditors' committee can reach an agreement among themselves, the court will usually grant an application for DIP financing. The company will apply to the bankruptcy court for approval of the financing either at the same time as or immediately after it files under Chapter 11, and the court's decision is announced about 15 days later.

8 A transaction is regarded as a highly leveraged transaction if the purpose of the loan is to finance a buyout or acquisition or to recapitalize a company and the transaction (1) increases the borrower's debt ratio to more than 75%, (2) increases the borrower's debt by at least 100% and its debt ratio to more than 50% or (3) is regarded by the syndication agent or the regulator as a highly leveraged transaction. Once a loan to a company has been designated a highly leveraged transaction, all transactions with the company are regarded as such.

3. Issues Surrounding Debtor-in-Possession Financing in Japan

Ever since the asset boom of the late 1980s turned to bust and Japanese companies found themselves saddled with more debt than they could cope with, there has been an active debate involving both the public and private sectors about what financial approaches should be used to help companies adjust their balance sheets and restructure their operations, and what institutional arrangements are needed to enable them to do this. One of these approaches is DIP financing, and measures to enable it to be used more easily (along with similar measures for the Legislation for Corporate Separations and the Law on Special Measures for Industrial Revitalization) were included in the government's latest emergency economic package. The key role played by the government in promoting its use has been one of the distinctive features of the growth of DIP finance in Japan. One specific development has been that the Development Bank of Japan (a public-sector financial institution) has set up a “Corporate Reorganization Loan System” and begun to provide DIP financing to companies in distress that have filed for bankruptcy, provided they are economically or socially useful and involved in a business with the potential for growth.

DIP financing is therefore gradually gaining acceptance in Japan, but a number of issues will have to be addressed before it can gain full acceptance. These include the following:

1) Incentives for lenders

Under the existing system in Japan, when a company in distress which has filed for bankruptcy with a view to rehabilitation applies for a loan for use as working capital, it must obtain court approval regardless of whether this is done under the Corporate Rehabilitation Law or the Reorganization Law. Such claims are normally treated as "common interest claims," which have priority over any claims ("general claims") originating from pre-petition causes and must be repaid as and when required regardless of the rehabilitation process. There is therefore a certain guarantee that loans will be repaid. However, there are no legal incentives (such as those in Section 364 of the Bankruptcy Code of 1978) to lend to a company in distress.

In this connection, the government's latest emergency economic package indicates the need to improve the Corporate Rehabilitation Law and the Reorganization Law in order to make it easier for companies to reorganize: "…the Reorganization Law will also be examined to see whether DIP financing needs to be given a higher priority, and any revision necessary will be completed by fiscal 2003 ."

If it seems that simply treating DIP financing as a common interest claim is not enough to ensure its growth, consideration will have to be given to offering additional incentives for lenders. In that case, however, adequate consideration will have to be given to the interests of any pre-petition creditors, and the criteria according to which courts decide whether to approve applications for DIP financing will have to be redefined.

2) Need for more precise classification of DIP financing

In Japan, it is not clear which of the four loan categories in the examination manual that financial institutions are required to use when carrying out their self-assessment DIP financing should be assigned to, and this is likely to cause problems. If it is Category III ("recovery doubtful") or Category IV ("irrecoverable"), this will act as a considerable disincentive to potential DIP lenders. This point was taken up in the government's emergency economic package, which mentioned "the need for the examination manual to be more specific," and, as a result, the Financial Services Agency published a draft revision of the manual on 26 April. According to the draft, "it needs to be considered whether common interest claims on a debtor who has applied to reorganize under the provisions of either the Corporate Rehabilitation Law or the Reorganization Law should normally be classified (on the basis of how likely they are to be recovered) as either "pass" or Category II ("care required"). The revised version is due to become effective on 1 July, 2001, following a process of public comment.

3) Need for prompt initiation of bankruptcy process

In Japan, companies in distress generally only file for bankruptcy just before they become insolvent or otherwise not at all. This means that, when a company does file for bankruptcy, its assets are already likely to have been seriously degraded and it may be too late. There are a number of possible reasons for this, but the social stigma of bankruptcy in Japan and the reluctance of companies to incur shame are two major factors. One of the aims of the Reorganization Law was to relax the requirements for petitioners in order to encourage companies to file sooner rather than later so that they can make an early start on their rehabilitation, but this appears to have had little effect so far.

One of the reasons financial institutions in the United States regard DIP financing as a relatively low-risk type of lending—apart from the fact that the law provides adequate protection of their claims—is that they carry out a thorough examination (of the cash flow, etc.) of the company in distress and only provide financing to companies they believe are able to reorganize. There is little point in providing DIP financing to a company once its assets have been severely depleted and it stands little chance of reorganizing—even if it has filed for bankruptcy. Long-established social values and patterns of behavior cannot be expected to change overnight, but it is to be hoped that, just as financial institutions need to make the necessary arrangements so that they can provide DIP financing, distressed companies themselves will file for bankruptcy in good time so that they will stand that much better a chance of reorganizing successfully.