

## Restructuring & Insolvency Newsletter

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### Sponsor/Investment Process in Japanese Restructuring

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| III. Sponsor Selection in Legal Insolvency Procedures |   |

With nearly three years having passed since the declaration of the COVID-19 pandemic, and with the addition of external factors such as the prolonged conflict in Ukraine, the reduction of excessive debt has become a major issue, especially for companies whose financial conditions have deteriorated through cash management measures.

Under these circumstances, there has been an increase in the number of large-scale rehabilitation cases in Japan, such as the Marelli Holdings case, which was the first in this country to be transferred from Turnaround ADR to simplified rehabilitation proceedings, and the Nichi-Iko Pharmaceutical Co., Ltd. case, in which the debtor (a listed company) formulated a rehabilitation plan including debt restructuring and was approved for Turnaround ADR.

The main approach in the debt restructuring process is to select a sponsor for the debtor and obtain financial assistance from it. In an increasing number of restructuring cases of globally-operating companies such as Marelli, companies or funds outside Japan are becoming strong sponsor candidates, and even more foreign players are expected to be actively selected as sponsor candidates in the future.

This issue of the newsletter focuses on the sponsor selection process in out-of-court restructurings and legal insolvency procedures in Japan, based on recent actual cases.

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### I. Current Practice in Japanese Restructuring

#### 1. Outline

In Japan, there are two drastic financial restructuring methods with debt restructuring (e.g. debt waiver): "out-of-court restructuring" in which debtors and creditors agree on a restructuring plan without the court's involvement; and "legal insolvency" such as civil rehabilitation and corporate reorganization proceedings, in which a company undergoes rehabilitation under the court's supervision.

In current practice in Japan, out-of-court restructuring has become the primary restructuring method, as damage to business value can be deterred because, in principle, only financial creditors are involved and the proceedings are undisclosed (listed companies are required to disclose related information). On the other hand, legal insolvency has the disadvantage of significantly damaging business value compared to out-of-court restructuring, and thus it is positioned as a last resort.

#### 2. Out-of-court restructuring

Out-of-court restructuring refers to a procedure in which debt is reduced through debt waiver or other such method under the agreement of all target creditors through private consultation between them (mainly financial creditors) and debtors, and the "Turnaround ADR procedure" is a quasi-legal out-of-court restructuring targeting large to medium-sized companies.

#### 3. Legal insolvency

Unlike out-of-court restructuring, which requires the consent of all targeted creditors, in legal insolvency, with the consent of a certain number of creditors as stipulated by law, it is possible to effect the debt waiver based on a rehabilitation or reorganization plan even to the creditors who object, and the target creditors are not only financial creditors but all creditors (including trade creditors).

Legal insolvency is broadly classified into two types: civil rehabilitation proceedings (*minji-saisei*) and corporate reorganization proceedings (*kaisha-*

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*kosei*) (see section III.2 for an overview), with civil rehabilitation proceedings being the principle procedure, as it maintains continuity of management and facilitates prompt rehabilitation.

The following is a brief comparison of private and legal restructurings:

	Turnaround ADR (Out-of-Court Restructuring)	Legal Insolvency
Law	Act on Promotion of Use of Alternative Dispute Resolution, Industry Competitiveness Enhancement Act	Civil Rehabilitation Act, Corporate Reorganization Act
Objective	Elimination of excess debt	Elimination of excess debt
Targeted Creditors	In principle, only financial creditors	All creditors (including trade creditors) are covered *Significant damage to business value is expected
Debt Reduction Requirements	Consent of all targeted creditors is required	Can be reduced by majority vote of creditors
Debt Reduction Schemes	Debt forgiveness, DES, DDS, etc.	In principle, debt waiver
Restrictions on Security Interests	No restrictions (or may be restricted with the consent of all targeted creditors)	<u>Civil Rehabilitation Proceedings:</u> In principle, it is possible to exercise security interests, but there are restrictions under the stay order for exercising them and under the permission system for extinguishing them. <u>Corporate Reorganization Proceedings:</u> Exercise of security interests is prohibited and security interest holders are incorporated into the proceedings.

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### II. Sponsor Selection in Out-of-Court Restructuring

In the selection of a sponsor in an out-of-court restructuring, the financial creditors, who are the target creditors, require fairness, transparency, and neutrality in the selection process.

When there is a strong demand for ensuring transparency in that process and a competitive environment is necessary, or when it is anticipated that many potential sponsors will submit letters of intent and a comparative study of support conditions will be required, then bidding procedures will need to be implemented.

In addition, existing shareholders may become sponsor candidates in the restructuring of a company whose financial situation has deteriorated due to external factors such as the COVID-19 pandemic.

However, since existing shareholders are naturally more familiar with the actual situation of the target company than external candidates, in such cases, financial creditors and other sponsor candidates are more strongly urged to ensure transparency and fairness (e.g., elimination of information asymmetry) in the selection process.

The following are possible responses to this issue:

#### (i) Formulate and clarify rules for selection

A special internal team or committee (excluding parties related to existing shareholders) may be formed to manage the sponsor selection process without the influence of the existing shareholders, thus ensuring its independence.

In order to eliminate information asymmetry, there should be thorough information management throughout the process (e.g., preventing certain information from reaching the existing shareholders' side).

#### (ii) Decision-making for sponsor selection

The special team or committee described in response (i) may be given decision-making authority to ensure neutrality and impartiality in the sponsor

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selection process.

In the rehabilitation of listed companies, there are often general shareholders who have little involvement in the management of the company compared to the management shareholders. For such general shareholders who are less responsible for the deterioration of the company's management, there are cases where they remain as shareholders after the debt is reduced or they are paid a certain amount of compensation in the squeeze-out process, depending on the sponsor's intentions.

For example, in some cases where the company remains listed after an out-of-court restructuring, it fulfills a certain level of shareholder responsibility by diluting existing shares through a third-party allocation of new shares, while the general shareholders remain as they are. On the other hand, in the case of Nichi-Iko Pharmaceutical Co., Ltd., which delisted its shares after the out-of-court restructuring was completed, the company is scheduled to be a wholly owned subsidiary (delisted) through a reverse stock split after a third-party allotment of new shares by the sponsor.

### III. Sponsor Selection in Legal Insolvency Procedures

#### 1. Summary

For a company that files for legal insolvency, it is important to quickly obtain credit enhancement and establish a roadmap for restructuring. If the company can obtain sponsor support through M&A, it will be able to prevent damage to its business value through credit enhancement by the sponsor.

In the sponsor selection process, the key points are "how to maximize the contribution from the sponsor and the repayment to creditors," timing, and probability of fund contribution. The bidding procedure is preferable from the viewpoint of maximizing the contribution and fairness of the procedure.

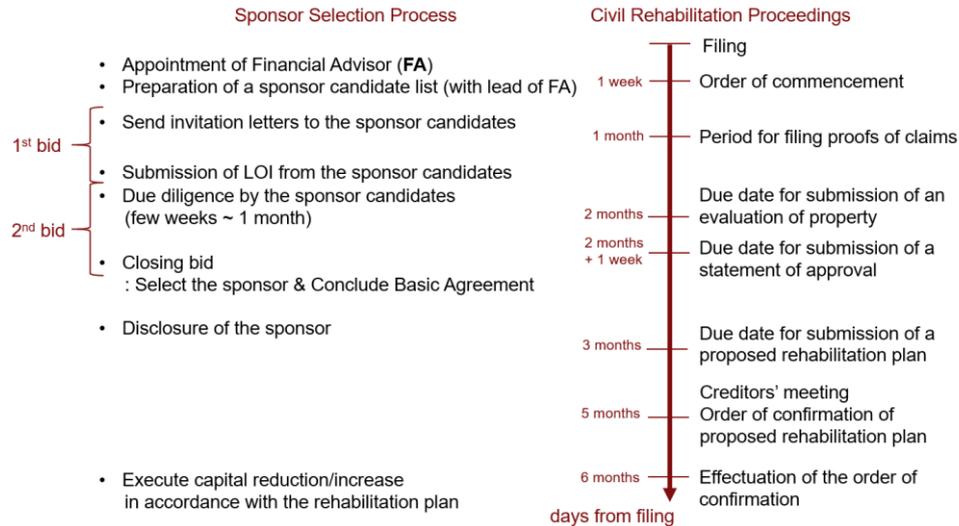
On the other hand, if the bidding process takes a certain period of time, during which the value of the business may be damaged, or if it is not suitable for small- and medium-sized companies, it may be acceptable to determine a sponsor without a bidding process. However, in such cases, voluntary meetings for creditors must be held and notices sent to them to obtain their

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understanding and ensure the appropriateness and fairness of the sponsor selection process.

### 2. Sponsor Selection Process by Bidding After the Petition is Filed

The standard schedule for selecting a sponsor through bidding procedures after filing a petition for legal insolvency is shown in the following chart:



This schedule is based on the assumption that a capital increase is conducted in civil rehabilitation proceedings. Although the chart assumes that the first and second round processes will be followed, the first-round bidding may be omitted in some cases by narrowing down the number of parties to be approached from the outset.

In legal insolvency, the repayment rate is naturally an important factor in the creditors' decision as to whether to approve a proposed plan submitted by the debtor.

Therefore, at the time of submission of the proposed plan, a final sponsorship agreement should, in principle, be in place, with the court's approval of that plan as a condition precedent. In addition, in order to fix the lower limit of the repayment rate in the proposed plan, the method of determining the succession consideration must be stipulated so that at least the lower limit of the repayment rate can be fixed.

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### 3. Prepackaged Civil Rehabilitation

#### A. Outline

Prepackaged civil rehabilitation refers to cases in which a sponsor is secured prior to the filing of a petition for legal insolvency. It should be noted that prepackaged civil rehabilitation in Japanese practice differs from "Prepackaged Chapter 11" in U.S. practice in that it only means selecting a sponsor prior to filing a petition, not proposing a rehabilitation plan, coordinating with creditors, or obtaining consent prior to filing the petition.

If the company can enter into legal insolvency after securing a sponsor, the damage to credit and business value that is caused can be minimized, and a smooth rehabilitation can easily be achieved.

When a company has time to search for a sponsor due to its cash flow being sufficient enough to do so, it often enters into legal insolvency after searching for a sponsor in advance to achieve smooth continuation of business after the petition is filed. There may be cases where the company has secured a sponsor in a prior out-of-court restructuring and drafted and presented a proposed business rehabilitation plan but fails to obtain consent from the target creditors for that plan and enters into legal insolvency with the sponsor as a prepackaged sponsor (sponsors selected before the petition is filed).

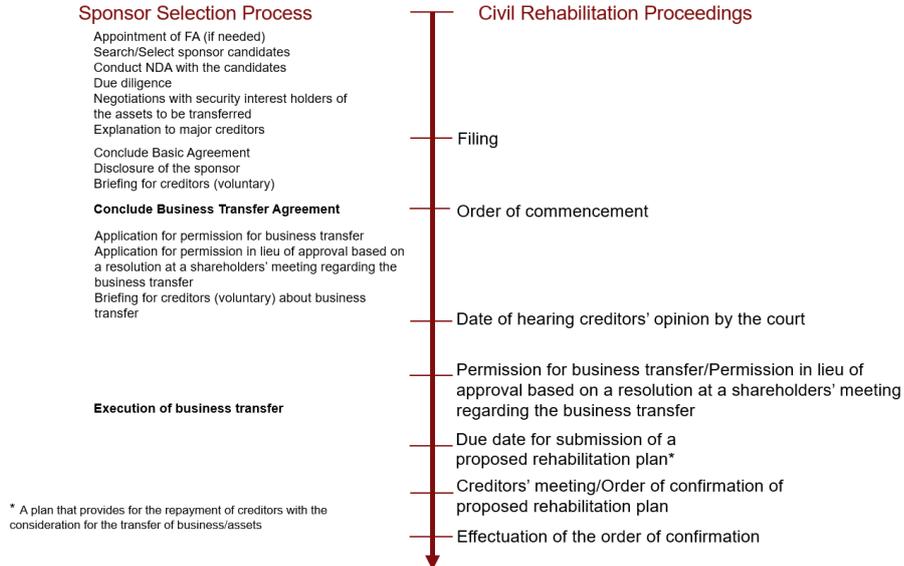
#### B. Scheme and Schedule

In the case of prepackaged civil rehabilitation, a basic agreement is concluded with the prepackaged sponsor before the petition is filed, and a final, legally binding sponsor agreement is concluded with the consent of the supervisors after the commencement decision is made.

Schemes vary from case to case, but in both civil rehabilitation and corporate reorganization, since a quick off-plan business transfer is possible with court approval, a business transfer scheme is often adopted when there is a high need for prompt execution of support.

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The following is a sample schedule:



Under Chapter 11 in the U.S., it is common to select a sponsor candidate ("stalking horse") in advance when transferring a business or assets out of a proposed rehabilitation plan (so-called "363 sale"). However, since bids are made based on the conditions proposed by such sponsor candidate, there are many cases where the pre-selected candidate does not actually become the sponsor.

### C. Concerns

On the other hand, since one of the advantages of M&A in legal restructuring is that "a wide range of sponsors with favorable conditions can be sought after it becomes public knowledge that the petitioning company has entered into legal restructuring," the buyer side is sometimes concerned that a re-bid may be conducted after the company enters into legal restructuring proceedings.

In the Tohato Inc. case, Company A was the prepackaged sponsor, having offered a bid price of 13.5 billion yen and a loan for working capital before the petition was filed, but, at the creditors' meeting held after the petition, Company B (a creditor of Tohato, that had offered a higher bid price than Company A in the procedure for selecting a prepackaged sponsor) strongly requested a re-bid at the creditors' meeting, and thus a re-bid was conducted. Ultimately, Company A won with a bid of 18.3 billion yen, 4.8 billion yen more than the original price, and became the sponsor once again.

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In current practice, the necessity of prepackaged sponsors, the appropriateness of the selection procedure, the impact on the business of conducting re-bidding, the disparity in the prices offered by late sponsors (who make proposals in the re-bidding procedure after the petition is filed) and prepackaged sponsors, and the opinions of major creditors are taken into consideration. The necessity of re-bidding is determined on a case-by-case basis, considering the disparity in prices offered by those late sponsors and prepackaged sponsors, and the opinions of major creditors.

In addition, in prepackaged civil rehabilitation, the following contract clauses\* may be considered, taking into account the possibility of re-bidding; in such clauses, the stalking horse protection clause in Section 363 Sale of Chapter 11 in the U.S. is instructive:

- (i) Termination clause pertaining to re-bidding: allows the sponsor company to terminate the sponsorship agreement if it is forced to conduct a re-bid or the like.
- (ii) Last-look clause: allows a prepackaged sponsor to obtain a priority if it offers the same terms as a late sponsor.
- (iii) Breakup fee clause: a penalty clause for termination of the prepackaged sponsorship agreement.

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- Publication Yuhikaku Publishing Co., Ltd.
- Author Hajime Tanahashi, Akira Marumo, Chisako Takaya, Kenji Ito, Gaku Ishiwata, Atsushi Oishi, Akiko Sueoka, Katsumasa Suzuki, Yusuke Ishii, Airo Inoue, Hideki Utsunomiya, Koji Toshima, Yo Uraoka, Takayuki Kihira, Yoshihiro Kojima, Rintaro Shinohara, Hiromi Hayashi, Masakazu Masujima, Hiroko Yotsumoto, Hiroki Aoyama, Atsushi Okada, Aruto Kagami, Shuhei Kubota, Taichi Arai, Shuhei Uchida, Takeshi Okuyama, Shigeki Okatani,

\* The stalking horse agrees in advance to be the final buyer, if no candidates with better terms emerge. If any candidates with better terms than the stalking horse emerge and it fails to become the final buyer, then the debtor is required to pay it a certain break-up/topping-up fee.

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Author Masanori Sato
  
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