Recent Trends in Japanese ADR for Restructuring Insolvent Businesses

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Abstract

In Japan, there has been increasing use of the Turnaround ADR (Jigyo Saisei ADR) process as a means for early rehabilitation of a financially troubled company. This paper shall first outline the Japanese government's measures for preventing bankruptcy through REVIC and SME revitalization support councils during the past twenty years. The paper will then discuss the development of and transition to the Turnaround ADR process as a private resolution process not involving the government. This paper will then examine certain issues that have been identified regarding the Turnaround ADR process. Finally, this paper shall discuss the practice in Japan for banks to have company management provide guarantees for loans to a company, the issues that arise from this for financially troubled companies, and the Management Guarantee Guidelines (Kei-eisha Hosho Gaido Rain) which were developed to address these issues in the Turnaround ADR process by reducing the obligations of management in such circumstances.

Keywords: Turnaround ADR, REVIC, SME, Civil Rehabilitation Act, Corporate Reorganization Act, Management Guarantee Guidelines

Manuscript received: July 29, 2019; review completed: Sep. 18, 2019; accepted: Sep. 20, 2019

This paper provides an overview of Turnaround ADR as a relatively recent tool for business restructuring in Japan. First, this paper will discuss the situation which served as a backdrop to the development of Turnaround ADR, where the increase in bad loans was seen, and where, after the objectives of the temporary SME Finance Facilitation Act enacted by the Japanese government had been completed, Japan saw the rise of zombie firms among businesses which were not able to return to financial health, even though they had been recipients of assistance under that initiative.

The next part of the paper will discuss the decline in filings for in-court restructuring proceedings upon the rise of out-of-court options for restructuring starting with the government-supported processes of: (1) REVIC which currently is no longer taking on new projects; and (2) SME Revitalization Support Councils which are now the focus of government-supported business restructuring. The features of these forms of government-supported restructurings and the criticisms that these government supports have attracted will be the focus of this part of the paper.

This paper will then move on to discuss the development Turnaround ADR as an option for private workouts and an increase in its popularity. The rise of Turnaround ADR as a private process has been a welcome development for the amicable and early restructuring of mid-sized and large publicly traded companies alike. As shall be discussed in this paper, the reasons behind these are that in comparison to other approaches to restructuring, seeking a private workout as a first resort involves less deterioration in the debtor's corporate value and is a simpler and faster route to restructuring. This paper shall explain needs from which Turnaround ADR arose and the development of this option for private workouts.

Following an explanation of the Turnaround ADR process, this paper shall then turn to some issues in the Turnaround ADR process that are worthy of attention.

I. Overview and Background of Recent Rise in Non-Performing Loans

After several years of out of the spotlight, the problem of non-performing loans has recently begun to regain attention in Japan. The Japanese media has reported that Japanese regional banks have made allowances for non-performing loans for the period between April 2018 and September 2018, marking the first time in five years that they have done do so.[1]1 According to a study conducted by the Financial Services Agency of Japan ("FSA"), the increase of non-performing loans has not been seen since the Lehman crisis of September 2008.

This recent trend follows changes in the Japanese government's policy with respect to small to medium-sized enterprises ("SMEs"), particularly with respect to the adoption and application of the Act Concerning Temporary Measures to Facilitate Financing for SMEs ("SME Finance Facilitation Act")[2] and certain policy changes made by the FSA in relation to its supervision of the banking industry. The SME Finance Facilitation Act, which was enacted in December of 2009 as temporary law with an original end date of March 31, 2011, remained in effect until the end of March 31, 2013 after being extended twice. Following the expiration of the law at that time, the government essentially prolonged the effects of the law by the FSA supervising over the banks as the industry regulator.

The SME Finance Facilitation Act required banks to endeavor to take various measures in order to support SMEs during the difficult economic situation following the Lehman crisis. These measures included providing where requested by SMEs in financial difficulty, new financing and changing loan terms, including reduction of interest rates, postponing repayment and extension of the payment term. The FSA also required each financial institution to submit a report on its record of granting such forbearance measures to such SMEs, which essentially forced banks to accommodate requests for forbearance by such borrowers. Through the application of the FSA's revised supervisory guidelines, banks were also encouraged (essentially forced) to refrain from downgrading the credit rating of loans to such enterprises, and to preserve the ratings as if they were performing loans on condition that a "drastic business improvement plan

1) Nikkei Shinbun, morning edition (Dec. 26, 2018).
2) Act No. 96 (2009).

would likely be implemented" within a specified period. The way this occurred under the regulatory framework under the supervision of the Japanese banking industry and the results are briefly summarized below.

The FSA requires Japanese banks to evaluate their loans and categorize into one of the following six categories based on the debtor's financial status: (1) normal; (2) requiring caution; (3) substandard; (4) potentially bankrupt; (5) effectively bankrupt; and (6) bankrupt. These categories would then be used by the banks to determine whether to provide financing to a borrower. For example, a borrower who is classified as "normal" would receive financing while a borrower who is classified as "requiring caution" would not. These classifications also form the basis for a bank's determinations on allowances for non-performing loans. For example, 3% of the debt would be allocated in respect of debt in the "normal" category, while 100% of the debt would be allocated in respect of debt in the "effectively bankrupt" category. Deterioration in a borrower's financial status would normally require a bank to downgrade the borrower's credit ratings to an appropriate category, for example, from "normal" to "requiring caution". However, a change in the FSA's supervisory guidelines for banks during this time forced banks to preserve credit ratings in such cases on the condition that a "drastic business improvement plan would likely be implemented." The SEMs in financial trouble would expect to recover their vitality under this plan with the help of "business improvement support" executed by the banks. After the SME Finance Facilitation Act expired, the requirement for banks to report their record of granting forbearance measures to SMEs remained in effect as did the supervisory policy for banks to treat the non-performing loans of SMEs as performing loans.[3] As a result, banks were continued to be forced to grant forbearance measures to SMEs while refraining from downgrading credit ratings for loans to SMEs even if they were non-performing.

These distortive influences on the borrower classification were effectively maintained for ten years. During this period, since non-performing loans were not classified as such, the banks did not accumulate the allowances for non-performing loans as they normally would have done in the absence of the said influences. This, in turn, contributed to the bank's profits increase and a lack of disclosure of non-performing loans. This naturally led to the rise of zombie

3) Financial Services Agency, "Policy Regarding Inspection/Reporting Following the Expiry of the SME Finance Facilitation Act" (Nov. 2012).

firms showing no signs of improvement to their profit and loss statements, notwithstanding the rescheduling of debt through the forbearance measures (in fact there were many cases in which debt had to be rescheduled numerous times due to the failure of the rescheduling). Information recently published by the FSA indicates that there has been a 43% rise in businesses that remain unable to recover even after the expiry of five years or more following first being granted forbearance measures by a regional bank. Further, the FSA's statistics also indicate that among the intended beneficiaries of the SME Finance Facilitation Act, 53% were not given any "business improvement support" by the banks.[4]

The deteriorating situation led the FSA in March 2019 to end its policy of requiring banks to report to the FSA on forbearance measures granted to SMEs.[5] Banks were also no longer discouraged from downgrading the credit rating of borrowers with non-performing loans and therefore, following the end of the policy, loans which had been maintained in the "normal" category were downgraded to "requiring caution", "substandard", "potentially bankrupt", "effectively bankrupt" and "bankrupt" as they would have been normally categorized.

Absence of the distortive influence of the previous policies, the non-performing loans that have remained out of sight for years have suddenly resurfaced. It can be expected that this, in turn, will lead to a rise in insolvencies in the future.[6]

II. Recent Trend of Insolvencies

For the moment, it can be said that recent times have seen a decline in applications for insolvency proceedings in the Japanese courts.[7] In 1989, the number of bankruptcies (liquidation) filed with the Tokyo District Court was

4) Financial Services Agency, "Regarding issues for drastic business rehabilitation" (June 28, 2016).

5) Tokyo Shoko Research information, 8 (March 4, 2019).

6) For the period ended September 2018, non-performing loans arose for the first time in five years (the percentage of non-performing loans 1.74%) for regional banks. This was the first time for the change to increasing non-performing loans since September 2009 immediately following the Lehman crisis. Referencing Nikkei Shinbun, morning edition, 7 (Dec. 26, 2018).

7) Sonoo, Takashi, "The Direction of Court Supervised Restructuring and Private Restructuring Going Forward", 2050 Banking L. J., 6 (2016).

824, increasing dramatically to over 10,000 in 1999, reaching a peak of 26,561 in 2007, and then decreasing to 9,801 in 2017. A look at the statistics by the procedure is also interesting. The number of corporate bankruptcy filings went up to 3,525 in 2009 and decreased steadily to 1,736 in 2017. The number of civil rehabilitation proceedings (*Minji saisei tetuduki*), which is the main legal rehabilitation procedure in Japan, filed with the Tokyo District Court was 359 in 2001 and fell to 42 in 2017.

Although it may not be the only explanation for the decline in such proceedings, it can be said that there is a growing awareness in Japan regarding the effectiveness of taking early action when a business is failing to rehabilitate the business and avoid the necessity for a court-supervised process. In this connection, a series of procedures referred to as "standard out-of-court workouts" have been actively implemented by governmental institutions as well as private institutions in Japan as means for rehabilitating struggling businesses before it is too late.

III. Business Rehabilitation Through Governmental Institutions

There are two main governmental institutions that are involved in the rehabilitation of financially troubled companies: (1) the Regional Economy Vitalization Corporation of Japan ("REVIC"); and (2) the SME revitalization support councils.

A. REVIC

REVIC was established in 2013 as the successor entity of the Enterprise Turnaround Initiative Corporation of Japan ("ETIC"), which was established in 2009. REVIC is funded both by the Japanese government and by Japanese financial institutions. The main purpose of REVIC had been to support medium and/or small-sized companies that are financially troubled, with a focus on business rehabilitation. However, recently, it has begun to shift its focus to managing regional vitalization funds with regional banks, deploying rehabilitation specialists to the banks. REVIC should have completed its mandate to support financially troubled companies by March 2018. It, however, continues to do such work because of political considerations, but only to

complete existing projects that remained ongoing at that time without taking new rehabilitation projects for distressed companies.

B. SME Revitalization Support Councils

SME revitalization support councils, located in every prefecture of Japan, were formed to support business rehabilitation (e.g. providing support to draw up a business rehabilitation plan, negotiating with banks) under the supervision of the Small and Medium Enterprise Agency of Japan. From being formed in 2002 to the end of September 2017, the total number of cases they have counseled is 39,410, and the total number of cases for which they have provided support to draw up a business rehabilitation plan is 12,465. The number of such cases has increased rapidly year by year from 400 plans in 2012 to 1,511 plans in 2012, 2,537 plans in 2013, and 2,484 plans in 2015 then falling again to 1,319 plans in 2016, 1,047 plans in 2017. The rise from 2012 to 2015 was due to the government announced, so-called, the "Business Support Political Package for Small & Medium Enterprises", which was an initiative for SME revitalization support councils assisting as many companies as possible. 89% of all the plans only reschedule the terms of payment without involving fundamental solutions such as debt forgiveness. There are some cases that the terms of payment have been extended for 30 years or 50 years. This may have contributed to some financially troubled SMEs becoming zombie companies and the moral hazard between zombie companies and creditor banks.

C. Impact of the Governmental Agencies

The two quasi-governmental institutions discussed above have already survived for a long time - REVIC for ten years, including the years of its existence as its predecessor entity ETIC; and 15 years for the SME revitalization support councils. One of the main reasons why financially troubled companies seek such assistance is that their consultation is free of charge as the work of the SME revitalization support councils is funded by taxpayers.[8] Therefore, still, there are many financially troubled companies that ask these institutions to

8) The government contributed to the remuneration of the procedure implementer selected by the support council and also partially covered the costs of creditor due diligence process. See Ito, Hisato, et al., "The Reasons Why Civil Rehabilitation Proceeding Are Not Used – the Reasons Why Private Restructuring is Chosen", 152 Bus. Rehab. & Mgnt. of Cred. Cl., 40 (2016).

support their business. These institutions were established at a time when Japanese banks suffered under massive non-performing loans. However times have changed and the Japanese economy has already recovered from such depression. It can be said that the historical mission of these institutions has been completed. In recent discussions some argue that it is no longer necessary for such government agencies to be involved in business rehabilitation and that such activities would be better left to the private sector to handle.[9] However, this is an ongoing debate that involves the political issues surrounding the rescue of financially troubled SMEs, and therefore this may hinder the path toward a healthy "scrap and build" economy for Japan in which businesses are allowed to rise and fall.[10]

IV. Development/History of Private ADR for Business Rehabilitation

Separate from the options offered by the governmental institutions discussed above, the business rehabilitation ADR procedures by private institutions are also gaining attention recently. In particular, although applications had concentrated with REVIC in the past due to recommendations (effectively instructions) from the FSA to banks to use REVIC to deal with struggling debtors, the trend changed in favor of private ADR for business rehabilitation in March 2018 when REVIC stopped accepting new projects for the rehabilitation of SMEs. During the ten years from 2008 through 2017, there were 64 cases of applications to use the procedures, 217 in numbers of legal entities, 21 publicly traded companies submitted applications, and the number of formally processed cases is 53.[11] Taking the average, this is about five cases processed per year. In

9) Ito, Makoto. "Continuity and Lack of Continuity Between Court Supervised Restructuring and Private Restructuring", 163 Bus. Rehab. & Mgnt. of Cred. Cl., 26 (2019); Takagi, Shinjiro, "Concerns Regarding the Abuses Caused by Semi-Permanent Governmental Support for Enterprises in Financial Difficulty", Financial Affairs, 3 (Jul. 17, 2017); Nakajima Hiromasa, "Regarding the Signs of the Dangers Underlying Recent Governmental Insolvency ADR", 1499 Kinyuu shoji Hanrei 1 (2016).

10) Nakajima, Hiromasa. "Current Situation and Challenges of Insolvency ADR – Acknowledging the Trend From Court Supervised Restructuring to ADR", in Collection of Works to Celebrate the 70th Birthday of Yasuo Uneo Esq. "Legal Theory of Current Civil Procedures", 607 (2017).

11) Sudo, Hideaki. "Tracking 10 Years of Turnaround ADR", 163 Bus. Rehab. & Mgnt. of Cred. Cl., 38 (2019).

2018, eight cases were formally processed.[12]

In 2001, the "out-of-court workout guidelines" process, a process for debtors with financial institutions only as creditors, was established in Japan. This process, modeled on the INSOL 8 Principles of INSOL, the world's largest association of insolvency professionals, was the first formal out-of-court work out process adopted in Japan. This process undertakes the early rehabilitation of business for the purpose of obtaining a higher collection rate than the in-court procedures. This process also provides equal treatment that banks should not compete each other to collect money from the debtor first (first come all get). The process also had the merits with a high degree of credibility and a high possibility of allowing for the borrower's credit rating to be upgraded due to a reasonable business improvement plan with good prospects for realization adopted by the agreement of the creditors. Under the structure of this process, the business rehabilitation plan proposed by the debtor would only be adopted upon the unanimous consent of all the relevant financial creditors in the process.

The application for this process required the joint application of the financially troubled debtor with the debtor's main bank. The "main bank" for this purpose was the debtor's largest source of financing. Under the practices of banks at that time, it was believed that the main bank of the debtor was responsible for the debtor's financial circumstances. In a sense, it was viewed that the debtor's insolvency was a failure of that debtor's main bank. Therefore, non-main banks always complained that main bank should have supervised the debtor more closely and assisted its early revitalization. This accusation sometimes caused the main bank to take more responsibility than a pro-rata basis to get majority vote for the business rehabilitation plan.

Facing such objections, the main bank would then need to either: (1) purchase the claims of the objecting creditors; or (2) accept a rate of distribution lower than that of the other creditors so that the other creditors would enjoy a corresponding increase in their rate of distribution. In Japan, this is referred to as the "tendency of leaning to main (*mein yose*)". Accordingly, some main banks, unable to tolerate the lack of fairness, were hesitant toward such out-of-court work out procedures, and as a result, the number of out-of-court work out cases decreased significantly. In order to correct such abuses, Japan's turnaround ADR process was introduced.

12) Based on interviews with the JATP as a Turnaround ADR process provider.

V. Japan's Turnaround ADR Process

Japan's Turnaround ADR (*jigyou saisei ADR*) process was introduced through the framework created by amendments to the Act on Special Measures for Industrial Revitalization and Innovation of Industrial Activities[13] in 2007 and further through provisions in the Act on Strengthening Industrial Competitiveness ("Industrial Competitiveness Act")[14] of 2013. Unlike the process that existed before it, in the Turnaround ADR process, the debtor's main bank is placed in the same standing as a creditor along with the other banks and is treated equally among other creditors. During the last ten years, there have been 180 companies that have adopted business rehabilitation plans under the Turnaround ADR process, representing 83% of accepted applications.

The overall approach of the Turnaround ADR process is to assist a debtor in financial trouble to restructure the debts to its financial creditors, using a certified Turnaround ADR provider as a neutral third party. The aim is an early diversion to preserve the business before court proceedings become necessary. Because the Turnaround ADR process does not include the claims of trade creditors, these claims benefit from the protection of full repayment when a debtor is rehabilitated using this process. Accordingly, one of the merits of this process is that it avoids harm to the debtor's business by having only financial creditors grant compromises to their claims in order to rehabilitate the business. The past cases bear out the effectiveness of this approach, with many cases of business rehabilitation being accomplished solely through the rescheduling or forgiveness of the debtor's debts to its financial creditors.[15] It is also noteworthy that creditors obtain favorable tax treatment in respect of debt forgiveness granted to debtors under such business rehabilitation plans. There are cases of course in which the attempt at rehabilitation under Turnaround ADR fails and court supervising proceedings become necessary. The foregoing aspects of Turnaround ADR are reflected in its procedural framework as shall be discussed in Sections 5.1 and 5.2 as well as the issues that arise out of it as shall be discussed in Section 5.3.

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13) Act No. 131 (1999).

14) Act No. 98 (Dec. 11, 2013).

15) Shoji Homu, "All About Turnaround ADR", Japanese Association of Turnaround Professionals ed., 284 (2015).

A. Primary Participants in Turnaround ADR

1. Eligible Debtors

Any legal entity may qualify as a debtor for the Turnaround ADR process, as only natural persons are excluded from eligibility as debtor for these purposes. Accordingly, large enterprises such as JAL, medical corporations and educational institutions can all be eligible.

2. Eligible Creditors

As a general rule, qualified creditors are financial institutions, with particularly large trade creditors permitted on an exceptional basis where necessary, although such an exception has not been applied to date. This is essentially a process in which trade creditors are not informed of the process. Modification of repayment terms, such as rescheduling or reduction of debt, is implemented with financial creditors.

3. Eligible Turnaround ADR Providers

As needed in any ADR process, Turnaround ADR requires a neutral third party institution to act as an arbiter between the debtor and creditors involved in the process. Only a private organization certified by both the Ministry of Economy, Trade, and Industry and Ministry of Justice is permitted to act in this role. To date, the only organization that has received this certification is the Japanese Association of Turnaround Professionals ("JATP"). As shall be discussed in further detail below, a panel of three process practitioners (*tetuduki jitsushi-sha*) are usually elected to oversee the process.[16] The panel is usually composed of one presiding lawyer, one accountant, and one consultant or another lawyer, each with a background in business rehabilitation.

16) Regulation for Enforcement of the Act on Strengthening Industrial Competitiveness Relating to the Ministry of Economy, Trade and Industry (Order of the Ministry of Economy, Trade and Industry No. 1, Article 22(3) (Jan. 17, 2014).

B. Overview of the Turnaround ADR Process

1. Pre-Application Consultation/Drafting the Rehabilitation Plan

Drafting the Rehabilitation Plan

It is an established practice for the debtor to complete a pre-application consultation with the proposed Turnaround ADR provider. The provider asks empierced turnaround professionals to examine if the requirements for formal application would be met. If not they would consult with the applicant to meet the requirements.[17] In order for the proposed Turnaround ADR provider to accept the debtor's application, the Turnaround ADR provider must evaluate the debtor's proposed rehabilitation plan. The process is executed by the respected three process practitioners. The pre-application consultation process is to give the proposed Turnaround ADR provider the opportunity to evaluate a draft of the debtor's rehabilitation plan. The primary aspects of the rehabilitation plan that the proposed Turnaround ADR provider examines are as follows.[18]

a. The creditors can expect a reasonable economic benefit from the rehabilitation plan. E.g., the amount of money that can be collected under the rehabilitation plan is more than the money that can be collected under bankruptcy proceedings;
b. That the applicant will have the capacity on its own to dispose of excess capacity and idle assets and restructure or withdraw from unprofitable businesses;
c. That the plan has reasonable prospects for being realized; and
d. That it can be reasonably expected that the unanimous consent of all of the creditors in the process can be obtained for the rehabilitation plan.

In order for the Turnaround ADR provider to make its evaluation on the above points, the debtor must provide various supporting financial information with its draft rehabilitation plan, such as: its balance sheet, profit, and loss statement, cash flow statement, as well as any documentation to substantiate its profit outlook. The draft rehabilitation plan must be supported by a third-party

17) Turnaround procedural rules pursuant to the specified certified alternative dispute resolution procedures, Articles 9-21.
18) *Id.*, *supra* note 16, Article 21(2).

evaluation.

There are also certain specific requirements that the rehabilitation plan must meet based on the Turnaround ADR framework.

One example is the three-year deadline for improvement in the following terms whereby the rehabilitation plan must state that the debtor shall achieve the following within three years commencing from the year immediately following the year in which the rehabilitation plan comes into effect[19]:

- the debtor's deficit (i.e. debts exceeding liabilities) situation shall be resolved;
- the debtor shall return to profitability.

Where the proposed plan involves waiver of debt, further scrutiny will be applied by the Turnaround ADR provider on the following points.[20] These points should be explained in the Turnaround ADR process practitioners' evaluation report, which should be submitted to the creditors for the purpose of evaluating the debtor's business plan at the Second Creditors Meeting (discussed further in the next section):

a. whether the third-party evaluation of the debtor's assets was conducted in accordance with adequate standards (referring to the asset evaluation standards of ADR formally referred to as, "Standards for Asset Evaluation under Article 29(1)(i) of the Regulation for Enforcement of the Act on Strengthening Industrial Competitiveness Relating to the Ministry of Economy, Trade and Industry");
b. whether the amount of the proposed waiver of debt under the draft rehabilitation plan has been determined appropriately and would not constitute excessive assistance to the debtor;
c. whether there has been a reduction in shareholder rights; and
d. whether the plan involves the resignation of the officers of the debtor (in practice, particularly in the case of SMEs, management does not resign and continues in their respective offices; however, in such cases, it is necessary that there are compelling grounds for not replacing management, such as the reason that no other appropriate person could be found).

19) *Id.*, Article 28(2).
20) *Id.*, Article 29.

Preliminary Comments and Advice

During the pre-application consultation process, in addition to examining the debtor's draft rehabilitation plan, the proposed Turnaround ADR provider, in practice, a panel of respected process practitioners, also provides comments and advice to the debtor on the plan.[21] In practice, from the early stage, the Turnaround ADR provider will engage in comprehensive discussions with the debtor on the detailed aspects of the plan. In some cases, the Turnaround ADR provider even seeks the views of the major financial creditors and advises the debtor to reflect such views in the plan.

2. Formal Application for Turnaround ADR and Commencement

If the proposed Turnaround ADR provider is satisfied upon its review of the relevant information during the pre-application process, the debtor may then submit its formal application. Once the Turnaround ADR provider accepts the application, on the same day, a temporary standstill notice and invitation to a creditors' meeting for an explanation on the proposed rehabilitation plan is dispatched to the financial creditors by the debtor in the joint names of the debtor and the Turnaround ADR provider.[22] The proposed creditors meeting will be the first creditors meeting of the process ("First Creditors Meeting").

3. Temporary Standstill Notice

The temporary standstill notice is defined as a period during which, pursuant to the consent of all the creditors eligible for the process, the creditors should refrain from collecting the debts of the debtor, and requesting additional collateral or seeking any bankruptcy proceedings against the debtor.[23] This does not qualify as grounds for suspension of payments, which is one of the requirements for filing for bankruptcy under bankruptcy laws. Further, it does not qualify as an event of default triggering acceleration rights under special provisions in banking agreements, which is one of the uniform agreements commonly used for almost all customers of Japanese banks.[24] This standstill

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21) *Id.*, *supra* note 17, Article 21(1).
22) *Id.*, *supra* note 16, Article 23.
23) *Id.*, Article 20.
24) *Id.*, *supra* note 15, p. 82.

should be effective until the end of the First Creditors Meeting which should be held in two weeks from the notice. Further, it is not believed that the temporary standstill would be considered an ISDA credit event (CE, Bankruptcy or Failure to Pay) either.[25] The temporary standstill notice is only on a voluntary basis requested jointly by the debtor and the Turnaround ADR provider in the notice and further has no binding effect until voted upon at the First Creditors Meeting. Therefore, this temporary standstill should be approved at the First Creditors Meetings retroactively from the above notice to the end of the First Creditors Meeting and extended by the end of the Third Creditors Meetings by all attendees. It is essentially nothing more than a gentlemen's agreement. However, to date, there have been no reported instances of violations of the temporary standstill in Turnaround ADR.[26]

4. First Creditors Meeting

The First Creditors Meeting must be held within two weeks of delivery of the temporary standstill notice.[27] This First Creditors Meeting agenda includes matters to be reported/explained to the creditors as well as matters to be voted upon by the creditors.

The matter to be reported/explained is the debtor's proposed rehabilitation plan.

The matters to be voted upon include those that can be approved by a majority of the creditors and those that must be unanimously approved by all creditors.

The matters that require approval by a majority of the creditors are as follows:[28]

a. Election of the chair of creditors meetings as a person who will convene the meetings;
b. Election of the process practitioners from the Turnaround ADR provider to serve on the panel of process practitioners, here the expected process practitioners who worked so far on behalf of the Turnaround ADR provider would be recommended to the creditors; and
c. Time, date and venue for the next creditors meeting ("Second Creditors Meeting").

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25) Ito, Makoto. "On Interim Report Regarding CDS in Turnaround ADR", 1902 Banking L. J., 76 (2012).
26) Based on interviews with the JATP as a Turnaround ADR process provider.
27) *Id.*, *supra* note 16, Article 20.
28) *Id.*, *supra* note 16, Article 22(2).

The matters that require unanimous approval of all the creditors are as follows:[29]

a. The temporary standstill notice, which, as mentioned above, includes from the temporary standstill notice to the end of the Third Creditors Meeting;
b. Time, date and venue for the creditors meeting after the Second Creditors Meeting ("Third Creditors Meeting"); and
c. If it is expected that pre-DIP financing will be provided, then, the matter of whether the creditors consent to the priority treatment of such financing.

5. Second Creditors Meeting

The purpose of the Second Creditors Meeting is to deliberate on the rehabilitation plan.[30] The main actions of the meeting are for the debtor to explain the proposed rehabilitation plan and for the Turnaround ADR process practitioners to present its report on its evaluation of the proposed rehabilitation plan.

In order to ensure that the plan will be approved by the creditors, in practice, the debtor will disclose the proposed rehabilitation plan to the relevant creditors soon after the First Creditors Meeting to obtain their views and consider any necessary changes to the plan in light of those views. The Turnaround ADR process practitioners would act as a mediator between the debtor and the creditors for such purposes and advise on changes with a view to making the proposed rehabilitation plan reasonable and acceptable to both sides. In practice, there are so many cases to have sequel meetings as the Second Creditors Meetings to submit the rehabilitation plan and the process practitioners' report. The reasons for extension are following: (1) the debtor cannot make the rehabilitation plan until it finds the buyer of the company; (2) it takes time to predict the future profit to meet the requirements for the rehabilitation plan; (3) it takes time to convince some of the objecting creditors; and (4) to modify the existing rehabilitation plan to the manner which would be approved by all the creditors etc.

Turnaround ADR process practitioner's report on the proposed rehabilitation plan contains the Turnaround ADR process practitioner's opinions on the proposed plan's compliance with laws, fairness, appropriateness and its reasonableness from an economic perspective.[31]

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29) *Id.*, *supra* note 16, Article 22(2)(4)-(5), Industrial Competitiveness Act, Article 58(1)(2).
30) *Id.*, *supra* note 16, Article 24.
31) *Id.*, *supra* note 16, Article 28.

6. Third Creditors Meeting

The third meeting of the creditors in the Turnaround ADR process ("Third Creditors Meeting") is for the creditors to vote on the proposed rehabilitation plan.[32] The approval of the rehabilitation plan requires the unanimous consent of all the creditors covered in the process.

7. Overall Timeframe

The average time to complete the process [from the First Creditors Meeting] to obtain the unanimous consent of creditors is normally just over four and half months based on the statistics of the Turnaround ADR Provider. Among the cases completed to date, the period from commencement to completion has been 27 months for longer cases and two months for shorter cases.

8. Extensions and Further Procedures

In the event that there are objecting creditors in the result of the vote, it is possible to extend the Turnaround ADR process to give the debtor a chance to try and obtain the consent of the objectors, but only if a majority of the creditors approve such extension.[33] Where such extension is approved, the next creditors' meeting is usually held around one month after the Third Creditors Meeting.

Where the debtor is unable to obtain the unanimous consent of all the relevant creditors, the debtor may try to resolve the issue with the objecting creditors through special conciliation (i.e., special conciliation under Act on Special Conciliation for Expediting Arrangement of Specified Debts, Act No. 158 of December 17, 1999, *Tokutei Chotei*) or the matter may proceed to one of the courts supervised proceedings, such as civil rehabilitation (*Minji Saisei*) or corporate reorganization(*Kaisha Kosei*). The special conciliation procedure provides an easy and simplified way for distressed debtors to negotiate its rehabilitation, e.g. extension of the existing term, and/or debt forgiveness, etc. under the court procedure. The court organizes the committee of mediation, the members of which consist of persons specialized in law, tax, finance, corporate finance, and evaluation, etc. The committee can examine the facts and the case and would mediate between the parties and propose a conciliation clause. If the

32) *Id.*, *supra* note 16, Article 26.
33) *Id.*, *supra* note 16, Article 25.

parties cannot cooperate with this clause proposed by the committee, the court can issue an order (Article 17 order, *17jou kettei*), the effect of which is as same as conciliation at the court unless either party objects within two (2) weeks after the order.

In practice, however, Article 17 order is not a form of recourse that is often pursued. Instead, if there are objecting creditors, the matter will most often move to an in-court proceeding. The rare case in which this Article 17 order has been seen to be useful was the situation where the objecting creditor under the Turnaround ADR is one of the local governments, or where approval of the local council's meeting would be needed to accept the proposed rehabilitation plan.

C. Certain Issues with Turnaround ADR

1. Applications for Rehabilitation by Enterprise Groups

Where the company in need of rehabilitation has various subsidiaries throughout the world, this raises cross-border issues. This is a topic that has been gaining attention among various international or multinational bodies, including the United Nations Commission on International Trade Law ("UNCITRAL"). The UNCITRAL Legislative Guide on Insolvency Law, part three, Treatment of enterprise groups in insolvency, adopted in 2010[34] refers to these issues and advocates the use of crossborder insolvency agreements as does the UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation adopted earlier in 2009.[35] The EU has also put into place further measures for improved coordination in crossborder insolvencies involving company groups by updating its insolvency regulation with the recast Insolvency Regulation[36] entered into force in 2015.

In Japan, applications for Turnaround ADR on an enterprise group basis is quite common and familiar to Japanese practice as indicated by the statistic

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34) United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law, Part three: Treatment of enterprise groups in insolvency (2012), available at https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/leg-guide-insol-part3-ebook-e.pdf.

35) United Nations Commission on International Trade Law (UNCITRAL) Practice Guide on Cross-Border Insolvency Cooperation (2010), available at http://www.uncitral.org/pdf/english/texts/insolven/Practice_Guide_Ebook_eng.pdf.

36) Regulation (EU) No. 2015/848.

discussed above, with the 64 applications over the course of ten years involving 217 entities.

Although enterprise group insolvencies in Japan involving only Japanese entities do not necessarily give rise to cross-border issues (but see the discussion further below on creditors located outside of Japan) this is an area that still involves a number of unique issues in Japanese practice. First, the enterprise group must select the entity to apply for the Turnaround ADR process and the scope of the group's entities to be covered under the application by the selected entity. In this regard, at the first application stage, the debtor side makes this selection; however, in the end by the time of submitting the rehabilitation plan, the views of the creditors are also taken into consideration. The issues to be considered here are whether there is a necessity for financial assistance, whether the financial creditors (i.e. the banks) have provided credit on a group basis, whether the entities in the group which will not be included in the process have received credit separately, or whether it is expected that they will select some group companies to go to court-supervised proceedings or another process.

The next issue to be considered is whether a par rate provision applies.[37] A par rate provision is a provision in the debtor's business rehabilitation plan which provides for equal distribution to all the creditors of the multiple debtors within the enterprise group. Normally in the case of multiple debtors, equal distribution to the creditors of all the debtors would be inconceivable. Given that the assets and liabilities would differ by a debtor, it would normally be expected that the distributions to the creditors of each debtor entity would be different based on the situation of each debtor. However, where the par rate provision is applied, such differences would be disregarded, and the same rate of distribution would be applied to all the creditors of the different debtors and accordingly, there is the problem that this would not be acceptable to the creditors. For example, among the entities in an enterprise group, if the distribution rate is set at 5% applying a par rate provision, where a 10% rate of distribution normally would have applied to creditor A and a 1% rate of distribution normally would have applied to creditor B, it could be considered that creditor A would be unjustly disadvantaged and creditor B would be unjustly advantaged. Of course, the "best interests rule" is also applied under the Turnaround ADR process[38] meaning that

37) *See* Nakai, Yasuyuki. "For the Further Expansion of Turnaround ADR", 1140 NBL, 68 (2019).

38) Regulation for Enforcement of the Act on Strengthening Industrial Competitiveness Relating to the Ministry of Economy, Trade and Industry, Article 28 paragraph 4 (Order of the Ministry of Economy, Trade and Industry No. 1) (2014).

the process is guided by the principle that the expected return to each of the creditors under the proposed business rehabilitation should be more than the amount that they would receive if the debtor was liquidated in bankruptcy. The issue is whether the distribution rate can be considered appropriate solely by satisfying the best interests rule. In this connection, the prevalent view is favorable towards par rate provisions. The reasoning behind the view that an equal rate of distribution should be used for the creditors of all entities within the enterprise group is that financial institutions determine how much credit to grant an entity in an enterprise group based on the consolidated financial statements of the enterprise group. This view focuses on the fact that banks do not merely examine the entity among the group which serves as the hub for financing/loans (if on a non-consolidated basis, it can be expected that this entity's distribution rate would be the highest) but rather make their decision to provide financing based on the enterprise value of the group as a whole.

2. Issues Concerning Different Classes of Creditors

The Turnaround ADR process involves a number of issues concerning the relevant creditors. A primary issue concerns creditors holding registered security interests.[39] In Japan, registration of the mortgage is required in order for the creditor to perfect its security interest over the mortgaged property against third parties. It is common practice for banks to take a mortgage on the property of the debtor when providing financing. The banks, however, would try to reduce administrative costs, especially the registration cost of perfection. The banks reduce the cost of perfection by applying provisional registration instead of formal registration. The difference between the provisional one and the formal one is that effect of former is limited to keep its priority once the former transformed to the latter one.

On this point, this practice is respected at least among banks in the Turnaround ADR process, and accordingly, it is common for provisional registration to be treated the same as formal registration in this process. This is permitted since the creditors covered in the process are only financial institutions. However, where the unanimous consent of all cannot be obtained in the Turnaround ADR process, and the relevant debtor's insolvency must be resolved through an in-court proceeding, the provisionally registered creditors will not be treated as

39) *Id*., *supra* note 14, p. 125.

perfected, and as such, those creditors will not be considered secured creditors in the in-court proceedings.

As a similar issue, in the case of term deposits, a bank would normally freeze the account in order for the deposits to be considered as a security. However, the relevant deposit-taking bank would have a high expectation that it could set off against non-term deposits and therefore, these would be treated as protected claims, essentially secured rights. It is a measure to give regard to the practice of financial institutions.

Secondly, it is possible to have a Turnaround ADR process involving creditors who have the protection of their entire amounts secured and/or small creditors. In this regard, theoretically, there is no clear written rule for excluding such creditors. However, in practice, there are cases where in order not to impair other financial creditors who participate in the process, on obtaining the consent of the creditors, over secured creditors are not called upon to participate in the process. While the claims should be paid in accordance with their terms they may be asked to support the process by reducing the existing amount of interest or interest rate in the future.

Thirdly there is the issue of creditors located outside of Japan.[40] With respect to examples of foreign financial creditors, there are banks that provide financing directly to the local subsidiary of the parent company located in Japan. Also recently, there are many examples of the non-performing loans held by Japanese banks being sold on the secondary market outside of Japan to banks located outside of Japan. Needless to say, such foreign creditors also qualify as creditors covered under the Turnaround ADR process. However, it has been said that there are significant issues for such creditors to participate in the process. Firstly, time and cost is necessary in order for the relevant creditors to gain an understanding of Japan's Turnaround ADR process. Further, where such foreign banks or funds have a policy of seeking maximum collection for the short term gains instead of seeking mid to long term gains through the continuation of the debtor's business, it may be difficult to gain their consent for the debtor's business rehabilitation plan. This point exposes the weakness of the requirement under the Turnaround ADR process for unanimous consent. The debate is currently ongoing as to whether this can be changed so that a business rehabilitation plan under the Turnaround ADR process can be adopted by a majority in order to address this issue.[41]

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40) *Id., supra* note 14, p. 67.

3. Protections for claims of trade creditors

As discussed above, as a general rule, the creditors covered in the Turnaround ADR process are only financial creditors and the claims of trade creditors are not covered. Essentially, the claims of trade creditors are fully paid without the trade creditors even becoming aware of the process. This is out of an understanding that including the claims of trade creditors in the Turnaround ADR process would be an obstacle to rehabilitation by harming the debtor's business and reducing enterprise value. The idea is that by fully paying its debts to its trade creditors, this allows the debtor to continue its business in the normal course thereby facilitating business rehabilitation, which would, in turn, maximize collection for the financial creditors. This idea, however, raises the question of whether the same principle should then to be applied for the continued protection of trade creditor claims in the case where the unanimous consent of the creditors could not be obtained in the Turnaround ADR process and the debtor commenced court-supervised rehabilitation procedures (for example civil rehabilitation). In this regard, the Industrial Competitiveness Act which is now the law that provides the primary legal framework for the Turnaround ADR process adopted amendments in 2018[42] which include provisions to address concerns regarding the claims of trade creditors in the process.[43] These provisions essentially provide that if in the Turnaround ADR process, the designated certified ADR provider (i.e. currently JATP) confirmed that "the creditor's claims are small" and "the continuance of the relevant business would be markedly impaired unless the claims are repaid at an early stage", and the debtor thereafter applied for in-court rehabilitation proceedings (i.e. civil rehabilitation proceedings or corporate reorganization proceedings), the court should make its determinations on the following matters taking such confirmation into consideration:

a. whether to prohibit the repayment of the relevant claims pursuant to the standstill order;
b. whether to permit the repayment of the relevant claims as an exception as

41) Japan Institute of Business Law, "Report on the Study for Further Facilitation of ADR Procedures Relating to Business Rehabilitation", 9 (2015) discusses a model based on determination by a majority. Please see at https://www.shojihomu.or.jp/documents/10448/1149026/jigyousaisei201503.pdf/b0c51a9f-62cc-4a03-b5bc-6eb28571a27f.

42) Amendment to 2018 Act No. 33 (May 30, 2018).

43) Industrial Competitiveness Act, Articles 60-65.

claims of a small amount; and

c. whether giving priority treatment to the repayment of the relevant claims would impair the fairness of the rehabilitation plan.

Although the provisions do not bind the courts to specifically give special treatment to the claims of trade creditors, they do call for the "confirmation" from the Turnaround ADR process to be respected. Through these provisions, even if the debtor fails in the Turnaround ADR process and proceeds to in-court rehabilitation proceedings, there are increased chances for the claims of trade creditors to be protected. It is hoped that by making it easier to transition from the Turnaround ADR process to in-court proceedings, there will be increased use of the Turnaround ADR process as a means for early business rehabilitation.[44]

4. Debate on Means for Transitioning from Turnaround ADR to Court Supervised Procedures

As mentioned in connection with the treatment of trade creditors claims above, and pre DIP financing as shall be discussed in further detail below, there are some issues that arise in an ADR Turnaround process which have implications in the court-supervised process where the ADR Turnaround process fails. However, there seems to be a debate between the lawyers and banks on a framework for allowing a debtor's case to be transitioned from Turnaround ADR to a court-supervised proceeding. The lawyers for the debtors would like there to be a link between the Turnaround ADR and the court procedures such as under the Civil Rehabilitation Act and Corporate Reorganization Act. They would like to smoothen the transition if the proposed rehabilitation plan cannot obtain unanimous consent from the creditors in the Turnaround ADR process and the case moves to the court procedure. The lawyers would prefer that the proposed rehabilitation plan under the Turnaround ADR process would survive and get designated majority approval by creditors. The designated percentage of the approval is not as high as that of Turnaround ADR (unanimous consent). Therefore they tend to think that the proposed rehabilitation plan, once rejected under the Turnaround ADR process can be accepted easily at the creditors' meeting and approved by the court easily. However the Japanese banks have different views. The banks have the view that

44) Tominaga, Hiroaki. "Industrial Competitiveness Act Amendments and Operation − Provisions Concerning the Claims of Trade Creditors −" 163 Bus. Rehab. & Mgnt. of Cred. Cl., 46 (2019).

the procedure under the Turnaround ADR process and the court procedure both under the Civil Rehabilitation Act and Corporate Reorganization Act should be separately seated from each other and should have no connections. If the standstill notice under the Turnaround ADR is given to the bank, the department which had communicated with the debtor thus far should be in charge of this procedure. As discussed above this notice does not constitute a condition for filing for insolvency nor trigger events of default under ISDA. Usually this department is located inside the branch of the bank that is located where the debtor is located and has a long relationship with the debtor. Therefore the department considers this procedure very seriously and would like to deeply involved in and to cooperate with the debtor for the purpose of hoping that the debtor would rehabilitate itself and become a normal client again. However if the debtor files for a formal insolvency procedure to a court, the attitude of the bank changes dramatically. The department in charge of the case moves from the branch which had close relationship with the debtor to the management department of the bank's headquarters having no relationship with the debtor and being dedicated to handling non-performing loans and court procedures. The personnel of this headquarters level department only manages the debts and is usually not so cooperative with the debtor compared to the local branch. The change in the responsible department and therefore also change in the personnel in charge of the matter at the bank would prevent debtors from avoiding steps for early revitalization and becoming "zombie company." Therefore banks need the court procedure as a kind of last resort, very furious method for the debtor once it takes this procedure.

5. Pre DIP finance

As discussed above, the Turnaround ADR is a process in which the debtor is rehabilitated while claims of trade creditors continue to be fully paid. Accordingly, sometimes the debtor needs financing from banks in order to continue to operate its business. In order to encourage banks to provide such needed financing, it makes sense to treat financing provided under such circumstances as having priority in the nature of common benefit claims. As such, there are cases in which pre DIP finance is given priority in the Turnaround ADR process with the unanimous consent of the relevant creditors. However, in the event that the ADR Turnaround process failed and the debtor had to proceed to a court-supervised process, such financing would be considered "claims

preceding the commencement of the insolvency proceedings" and would, therefore, be treated as insolvency claims (bankruptcy claims, rehabilitation claims, corporate reorganization claims[45]) and could be subject to the distribution process under the relevant procedure. Accordingly, in order not to discourage banks from providing loans for pre DIP financing, it is possible under the Turnaround ADR framework to ask the relevant court to consider giving the pre DIP financing priority where during the prior Turnaround ADR process the creditors gave their unanimous consent to give priority to such financing, and this was confirmed by the Turnaround ADR provider. This request is not binding on the court; however, has the impact of having the court to consider giving priority to pre DIP financing in considering the equitableness of the treatment of all creditors.[46] The unanimous consent of the creditors for this pre DIP finance can be obtained at one of the creditors' meetings in the Turnaround ADR process mentioned above. In fact, it is not uncommon for the creditors to vote unanimously in favor of this given the necessity of pre DIP financing. As at the beginning of July 2019, 72 cases for Turnaround ADR have been formally accepted by the JATP and in 19 cases among these, pre DIP financing was confirmed. This represents 26% of the cases.

6. Costs

Another issue that has been pointed out regarding ADR procedures is the cost. A weakness of private ADR in comparison to the court process is the cost of applying for in-court proceedings and the free of charge proceedings of the semi-governmental institutions of the above. Cost is an unavoidable part of private proceedings that do not rely on support from the government. In the past, when business rehabilitation relying on government institutions was promoted, there was the impression that ADR was costly. Recently, however, as the discouraging impact on the rise of private firms in this area caused by the government's involvement in business rehabilitation becomes more noticeable, some have begun to point out that the use of government funds to engage in business rehabilitation for over ten years has given rise to abuses of the system such as a rescheduling plan that gives a debtor to pay back the debt over the

45) Bankruptcy Act (Act No. 105), Article 2 (5) (Jun. 7, 1995); Civil Rehabilitation Act (Act No. 225), Article 84 (1) (Dec. 22, 1999); Corporate Reorganization Act (Act No. 154), Article 2(8) (Dec. 13, 2002).

46) Industrial Competitiveness Act, Article 58-60; *Id*., *supra* note 16, Article 33.

course of 50 years. Further, the JATP is currently studying a simplified procedure with reduced costs for uncomplicated cases. In Japan, it can be said that there is now an increasing call for a Turnaround ADR process in which a broader scope of creditors from large enterprises to mid to small-sized enterprises can participate.

D. Management Guarantee Guidelines (*Kei-eisha Hosho Gaido Rain*)

One of the innovations to induce debtors' management to file for Turnaround ADR is to reduce the obligations of management members as a guarantor to pay back the debtors' loan. It is standard practice for Japanese banks to ask the management of the debtor, especially CEO, to be a guarantor of the debtor company when giving loans to a company. If the debtor filed for an insolvency procedure either under Bankruptcy Act, Civil Rehabilitation Act, or Corporate Reorganization Act, the CEO as a guarantor would be liable for paying back the huge amount of debtors' loan. This is one of the main reasons in Japan when debtors are accused to have waited too long to file for insolvency procedures which would have facilitated rehabilitation if the company had filed at an early stage. While we recommend early revitalization, management of the distressed companies is very reluctant to file for insolvency procedures at an early stage because they do not like to owe this obligation. The Management Guarantee Guidelines ("Guidelines") help the management to reduce its obligation. The Guidelines became effective from 2014, which was supported by the Japan Chamber of Commerce, National Bankers Association, and the Japanese Government. Under these Guidelines, the management of the debtor files for this procedure to the Turnaround ADR provider together with the filing under Turnaround ADR. When the temporary standstill notice would be issued to the creditors, the notice would include that adjustment of the obligations of the company's guarantors (i.e. members of management such as the CEO who have guaranteed the company's debts) should be resolved along with the Turnaround ADR process. At the First Creditors Meeting, the guarantor's attorney report the assets and obligations of the relevant guarantor (usually the CEO), and outline of the payment plan by the guarantor. The outline of the payment plan should be examined on its economical reasonableness together with the debtor's rehabilitation plan. The payment plan includes, for example, reduction of the amount of guarantee, or extension of the payment term. The payment plan is also

submitted and examined at the Second Creditors Meeting and needs a unanimous vote to approve the payment plan at the Third Creditors meeting.[47]

VI. Conclusion

As outlined in the foregoing, Turnaround ADR has become a mainstay for private workouts in Japan. For example, in the JAL (Japan Air Line) bankruptcy case, the largest Japanese bankruptcy case in recent history, although the matter was ultimately moved to corporate reorganization proceedings, Turnaround ADR was initially pursued as a means to explore early restructuring through a private workout. In this way, Turnaround ADR has become an indispensable tool for the restructuring of mid to large-sized companies. On the other hand, it is also true that there remain some issues with Turnaround ADR. In particular, especially as businesses become increasingly global, the requirement to achieve unanimous consent of the creditors covered under the process will become increasingly untenable. To gain the acceptance of all creditors where the creditors are based in various countries, having differing fundamental goals and differing interests in the outcome is an almost impossible prospect. Going forward, the solution for Turnaround ADR in this respect will be to establish a system for consent by a majority and to bind the objecting creditors to the result.

47) *See* https://www.chusho.meti.go.jp/kinyu/keieihosyou/index.htm; Kobayashi, Nobuaki, "Overview of Management Guarantee Guidelines, First and Second Parts" NBL 1018 and 1019 (2014).

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