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Bankruptcy Procedures and Industrial Reconstruction by Administrative Organs

— Asian economic crises and recent reform of economic laws
and regulations in Japan —

*Tatsuo Ikeda**

I. Introduction

1. Asian economic crises and recovery

Like a roller coaster, Asia went through violent changes in its economic plunge and recovery. Through these experiences, Asian countries have been struggling to drastically reform their economic structures. As part of their efforts, many are implementing a series of reforms to laws and regulations that effect the economy. There is no denying that behind the economic crisis lies the globalization of the market economy, including the money markets.

2. Globalization of market economy

The unavoidable globalization of the market economy is forcing these countries to reform their conventional economic structure, which has been protected by legal restrictions. In these reforms, it is essential to set up policies aimed at improving the competitiveness of businesses in the countries as they participate in more unrestricted markets. Such reforms naturally involve reconstruction of the legal system. Legal reforms have two aspects. One is consolidation of the legal infrastructure in line with participation in the WTO. The other is the revision of laws and regulations to ensure industrial competitiveness.

3. Improving industrial competitiveness

The reconstruction of the legal base targeting at WTO participation is a minimum standard. In contrast, legal reforms for enhancing industrial competitiveness are intended to intensify international competition, which is expected to follow participation in the WTO. Such reforms involve political decisions made sometimes from a strategic perspective based on the cultural and

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industrial characteristics of the country. The key to success in enhancing competitiveness is to construct a legal system that optimizes utilization of the management resources of the country. Industrial reform may include the fostering of small and medium-sized businesses and, if more attention is to be paid to the global market, the formation of a legal framework to promote mergers across national boundaries. Based on the experience in Japan, this article will center on the latter subject – construction of a legal base, in particular, the recent reform of, and the background to, laws and regulations that affect the economy.

II. Recent reforms to laws and regulations that affect the economy

1. “Corporate governance” and legal reforms

Amid a series of corporate scandals, worldwide attention has been directed in recent years to the transparency of corporate management, giving rise to discussions on legal reforms. In the past, discussions focused on who owns a company under the subject of corporate governance. In reality, however, the ownership issue proved to be irrelevant, because, as far as listed firms with excellent management are concerned, priority is given to stockholders with most attention paid to the securities market. In recent years, discussions on corporate governance centered on how to build a legal system to priorly or posteriorly check illegal acts by top corporate executives. These discussions include introduction and reinforcement of the shareholders’ representative action system and the non-interested third auditor system (1993, Commercial Code, Paragraph 1 of Article 18) and consolidation of criminal penalties.

Different countries seem to interpret corporate governance differently, except that their arguments share the guarantee of transparency and the full disclosure of corporate information. Corporate management has an obligation to provide accounts to shareholders. It has to provide accounts to creditors in the bankruptcy proceedings. The concept of company employees as stakeholders may change in line with the behavior of the economy in the future.

2. Industry Reconstruction Law (enforced on October 1, 1999)

(1) Purpose of the law

The Special Measures Law for Industry Revitalization and Reconstruction and the related Special Taxation Measures Law were approved by the Upper House and enacted on August 6, 1999. These laws are intended to facilitate corporate

restructuring in order to enhance the competitiveness of industries. These laws integrate a package of economic measures to smoothly shift management resources from low-productivity to high-productivity sectors, thus radically improving productivity and enhancing industrial vitality as soon as possible. These laws stipulate: in consideration of the decreasing growth rate of Japan's productivity as the result of changes in the economic environment at home and abroad, these laws aim specifically to implement measures to facilitate corporate restructuring while maintaining stable employment through the efficient utilization of management resources in Japan, thus improving productivity: these laws are also intended to revitalize domestic industries as soon as possible by encouraging research and other activities that would help reinforce the management resources for businesses. These two laws mark the establishment of a framework that will bolster and support corporate reconstruction. The measures provided by these laws include special treatment in terms of taxation and financing. These laws reflect a growing recognition among government officials of the need for corporate restructuring based on selection and concentration, through which the current systems are destroyed in a creative manner, as the key to economic rehabilitation. This implies reconsolidating Japan's advantages while complementing its disadvantages through corporate affiliations.

(2) Practical application of the law

The Business Reconstruction Program under the Industry Reconstruction Law is utilized in a wide range of industries as shown in the below.** The program, for example, assisted capital tie-ups between Mitsubishi Motors Corp. and Volvo and between Fuji Heavy Industries and General Motors. Meanwhile, merger and acquisition (M&A) activities have been intensifying globally in recent years, reportedly recording an historic high for the first quarter of 2000. In Japan, mergers and acquisitions have been growing since 1994. These activities are likely to further intensify with the IT (Information Technology) revolution.

Over 40 companies** have used the Business Reconstruction Program. Their

** Authorized business plans based on the Business Reconstruction Program (relevant division of the International Commerce and Industry Ministry); for example,

① Sumitomo Metal Industries (Basic Industries Bureau, Iron and Steel Administration Division), ② Mitsubishi Motors (Machinery and Information Industries Bureau, Automobile Division), ③ Oji Packaging (Kanto Bureau of International Trade and Industry, Industry Planning Department, New Business Division; Consumer Good Industries Bureau, Paper Pulp and Printing Industry Division), ④ Kitamura (Machinery and Information Industries Bureau, Industrial Machinery Division, Electrical Machinery and Consumer Electronics Division; Basic Industries Bureau, Chemical Products Division),

efforts involve highly strategic measures as well as management restructuring. Tokyo Electron, for instance, stated that it would take advantage of the Industry Reconstruction Law to adopt stock options for subsidiary executives in response to foreign companies offering stock options to attract competent recruits. The law offers special treatment in registration tax in connection with debt-equity swap and the establishment of new companies under the Business Reconstruction Program after April 1, 2000.

3. Revision of the Small and Medium Enterprise Basic Law (1999)

(1) Revision of the basic concept

Originally aimed at correcting earnings gaps, the Small and Medium Enterprise Basic Law was established in 1963 to pursue economies of scale. The 1999 revision aims to encourage active business operations, such as startups and management innovation, to provide a safety net against economic crises, including financial turmoil. The government expects small- and medium-sized businesses provide vitality of the Japanese economy.

According to the prime minister's explanation at the plenary session of the House of Representatives on November 2, 1999, the government considers it essential to form a safety net for small-and medium-sized businesses; the revision of the Small and Medium Enterprise Basic Law now under Diet discussion aims to encourage small and medium-sized companies to take the initiative in Japan's economy, in addition to constructing a government policy for allowing these businesses to create industries and jobs; thus, the revision is far from cutting business and jobs for these workers; the extension of the definition of "small- and

⑤ NHK Spring (Machinery and Information Industries Bureau, Industrial Machinery Division), ⑥ Ube Industries (Consumer Goods Industries Bureau, Ceramics and Construction Materials Division), ⑦ Komatsu Zenoa (Machinery and Information Industries Bureau, Industrial Machinery Division), ⑧ Itec (Basic Industries Bureau, Textile Products Division), ⑨ Sakai Trading (Basic Industries Bureau, Textile Products Division), ⑩ Unitika Sparklight (Basic Industries Bureau, Textile Products Division), ⑪ Nagasaki Unitika (Basic Industries Bureau, Textile Products Division), ⑫ Tsujimoto Boseki (Basic Industries Bureau, Textile Products Division), ⑬ Mitsui Chemicals (Basic Industries Bureau, Chemical Products Division), ⑭ Big Suns (Machinery and Information Industries Bureau, Industrial Electronics Division), ⑮ Japan Spindle (Machinery and Information Industries Bureau, Industrial Machinery Division), ⑯ Nippon Itagami (Consumer Goods Industries Bureau, paper Pulp and Printing Industry Division), ⑰ Tokai Color (Basic Industries Bureau, Iron and Steel Production Division), ⑱ Ube-Nitto Kasei (Basic Industries Bureau, Chemical Products Division), ⑲ Shiseido and Shiseido Fine Toiletry (Basic Industries Bureau, Biochemical-Industry Division), ⑳ Fuji Heavy Industries (Machinery and Information Industries Bureau, Automobile Division)

medium-sized businesses” is based on the real situation of the country’s economy after the first revision of the definition in 1973 and therefore it is considered adequate and justifiable.

In connection with this revision, Diet revises the Small and Medium Enterprise Guidance Law. The revision represents a shift of the government policy from “government-guided” activities of small- and medium-sized businesses to those based on government “assistance” in order to encourage these firms to reinforce self-help efforts.

4. Industrial Technology Reinforcement Law (2000)

The Diet passed on the Industrial Technology Reinforcement Law. This law aims at developing Japan’s creative technological capabilities and its ability to apply technologies practically. For this purpose, the law prescribes basic guidelines for the reinforcement of technological development as well as measures for providing financial and personnel support and for implementing environmental improvements so that the industry, academia and government can play their respective roles in a smooth, efficient manner. In short, this law intends to encourage all concerned parties to combine their efforts in the belief that industrial technology is the basis for Japan’s economic development in the future.

5. Civil Restoration Law (enforced on April 1, 2000)

(1) Formation of a re-challenge system

The Civil Restoration Law completely replaces the Reconciliation Law (enacted in 1922 and enforced in 1923), which was modeled on an Austrian law. This law aims to revitalize small- and medium-sized businesses.

The Civil Restoration Law focuses on helping these firms to restructure their businesses at an early stage. That is, procedures are initiated once there is the possibility that a firm is in danger of becoming insolvent. Under the former Reconciliation Law, procedures led mostly to bankruptcy, making the law extremely difficult to apply. The new law enables restructuring in a much shorter time, while allowing the management to continue business operations (debtor in possession). At the same time, the law introduces a simplified restoration system, which permits simpler procedures. In summary, this law (1) reduces the ratio of voting rights of creditors necessary to decide on a restructuring plan, (2) establishes a procedure for capital reduction, which paves the way for a debt equity swap system, and (3) introduces a simplified procedure to facilitate the restructuring of small-and medium-sized businesses.

Under the Civil Restoration Law, the debtor is to present a reconstruction plan. The debtor may not have sufficient capabilities. In this case, the court appoints a receiver. That is, a restructuring plan is submitted either by the debtor or the receiver. Creditors are also permitted to prepare a reconstruction plan. The plan submitted is reviewed at the meeting of creditors. The plan is approved by the court when no inconsistencies are found. During the plan compilation process, opinions of the labor union must be heard (Article 168). The liquidation value must be guaranteed for the creditors under this law. That is, at least the minimum collection rate that would be guaranteed in a bankruptcy proceeding must be guaranteed to the creditors.

The Civil Restoration Law permits collateral removal (Articles 158 and later). When property indispensable for continuing business operations are collateralized, the security may be removed if the debtor pays the market value of the property to the court. To prevent collateralized property from being subject to auction, the debtor is permitted to apply for the suspension of auction (Article 31). However, the right of exclusion is guaranteed for any creditor, that is, this right is effective regardless of whether civil reconstruction procedures are in progress (Article 53). One special feature of this law is the introduction of a claims adjustment system in connection with investigation of the responsibility of the management (Article 143 and later). Not only the debtor but also creditors are allowed to file for the application of this law.

(2) Practical use of the law

A total of 64 firms reportedly used the Civil Restoration Law within one month of its enforcement. This law is favorably accepted because the reconstruction period is shorter than under the Corporate Reorganization Law. In addition, this law does not require the resignation of the existing management. Although the reconstruction-oriented bankruptcy proceeding under this law is mainly intended for small- and medium-sized firms, some hard-hit larger businesses have used it. This law is also used in combination with the Industry Reconstruction Law. For example, Asahi Kogyo, an electric furnace maker, filed for the application of the Industry Reconstruction Law after it purchased business rights from Toyo Steel, which had filed for the application of the Civil Restoration Law. Toyo Steel reportedly closed its plants to implement de facto liquidation. It is to be noted that the efficient utilization of management resources will be accelerated by the combined application of the Civil Restoration Law and the Industry Reconstruction Law.

(3) Criticism

In many cases, the Civil Restoration Law is favorably accepted because it permits current management to continue business operations, thus facilitating M & A. On the negative side, the banking industry anticipates that irresponsible use of the law may lead to a tighter credit crunch. In fact, banks seem to be more reluctant to extend new loans. If the Civil Restoration Law accelerates banks' reluctance to loan, it would delay economic recovery. At the same time, however, banks would hesitate to continue rejecting new loans as the Industry Reconstruction Law is more rigidly applied to banks.

6. Other developments

Other legal developments include the following:

- (1) The Antimonopoly Laws was revised to permit the establishment of sure holding companies (Article 1, Paragraph 1).

Example: Daiichi-Kangyo Bank, Fuji Bank and the Industrial Bank of Japan jointly will establish a bank holding company in the fall of 2000, with each holding an equal stake, to integrate their operations in the spring of 2002. Their combined assets amount to ¥120 trillion, making the new group, Mizuho Financial Group, one of the world's largest banks. The group will divide operations by function and client.

The Bank of Tokyo-Mitsubishi and Mitsubishi Trust and Banking Corp. will also form a holding company in the near future.

- (2) The Commercial Code was revised.

- 1) The ban on the stock option system was lifted (1997).
- 2) The Corporate Merger Law was revised (1997).
- 3) The procedures were simplified for the formation of pure holding companies through stock swaps and transfers (1999). In Europe and the U.S., the stock swap system is considered to be an effective means of M & A.
- 4) The Corporate Divestiture Law will be enacted (2000).
- 5) The Commercial Code will be revised to encourage ventures.

As an exception in the treatment of venture companies, provisions of the Commercial Code will be simplified.

- (3) Full revisions of the Civil Procedure Law were made (1996 and 1998).
- (4) The Arbitration Law will be revised (2001 or later)

III. Conclusion

An economy is a living creature. As it grows, we must provide proper clothes to match it. Sometimes, it is necessary for the government to establish policies to encourage industries and investments in anticipation of its development or in order to bolster its growth. Among other things, "creative destruction" is indispensable to cope with drastic changes in technology and markets, including the accelerated shift to an information society.

In the compilation process of the aforementioned Industry Reconstruction Law, the Industry Competitiveness Conference was set up, involving all ministers, including the prime minister, and top corporate executives. Aimed at strengthening competitiveness in the supply side of the economy, laws were established to facilitate economic and industrial reform. Reform in a rapidly globalizing market economy is inevitably accompanied by "pains." A "job turnover" caused by reform will constitute a great challenge in the future.

(Material)

Proposal for the reconstruction of Asian economies (outline)

March 13, 2000.

The Federation of Economic Organizations

1. Japan is required to reconsider the significant role it should play in the development of Asian economies and to promote structural reforms to build infrastructures for maintaining economic vitality. It is essential for Japanese businesses to enhance corporate transparency, fully implement corporate governance and facilitate information disclosure, while improving their management. They hope to share these experiences with other Asian countries.
2. Japan is to promote the liberalization of trade and investment in lines with the economic situation of other Asian countries. As part of these efforts, Japan will accelerate dialog with other Asian countries to start a new round of the WTO at an early date. In addition, the country is required to endeavor to realize the AFTA program, as well as encourage bilateral agreements.
3. Asian countries, including Japan, should continue efforts to stabilize their currencies and financial system. As part of these efforts, it is essential for Japan to further develop manpower in financial fields and reinforce assistance to other

Asian countries from both the public and private sectors in technology transfers. The Manila framework needs to be consolidated for short-term capital transactions. To internationalize the yen, Japan is expected to promote the use of the currency in every field of business through public and private consensus, in addition to encouraging governments and businesses of other Asian countries to utilize the yen.

4. Japanese firms may be able to help strengthen the international competitiveness of other Asian countries through expanding their operations to these countries. To do this, however, Japan is required to solve problems with private debts. It is important to shift more assistance to the construction of next-generation infrastructures. Such support must be offered in an effective manner to increase investment effectiveness in private projects. Further, regarding manpower development, Japan is required to intensify assistance through participation from the private sector.

Business startups and closures in Japan

| Year | 1975 – 1978 | 1978 – 1981 | 1981 – 1984 | 1984 – 1987 | 1987 – 1990 | 1990 – 1993 | 1993 – 1996 |
|---------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Startup | 6.2% | 6.1% | 4.7% | 4.2% | 4.1% | 4.6% | 3.7% |
| Closure | 3.4% | 3.8% | 4.0% | 3.6% | 4.7% | 4.7% | 3.8% |

Overview of the Special Measures Law for Industry Revitalization and Reconstruction (1999)

I Promotion of business reconstruction

“Selection and centralization” “Improvement in productivity”

Speedy, smooth shift from low-productivity sectors to high-productivity sectors

1. What is *Business Reconstruction* ?

① **Alteration of the business structure = Reorganization of the business portfolio.**

② **Business innovation = Advancement into new business fields.**

2. Approval of a Business Reconstruction Plan by the ministry

3. Support and assistance

(1) **Special tax treatment**

(2) **Simplification of procedures required by the Commercial Code**

(3) **Fiscal and financial support and assistance**

(4) **Assistance in startup and new business development by small- and medium-sized firms**

4. Support and assistance for a Utilization Business Plan

II Assistance in startup and new business development by small- and medium-sized firms

1. What to receive support and assist?

① **Startup**

② **New Management Resources Utilization Plan by small- and medium-sized firms**

2. Approval by the governor of a New Management Resources Utilization Plan submitted by small- and medium-sized firms

3. Support and assistance
4. Support and assistance based on directory provisions

III Revitalization of technological development

1. Attribution to developing firms of results of consigned technological development (intellectual property) based on public funds
2. Favorable treatment of license, charges and examination fees on patents (reducing them by half) obtained by authorized TLOs

Overview of Civil Restoration Law

1. Purpose of legislation

A new bankruptcy proceeding basic law of reconstruction type is enacted to replace the Composition Law, aiming to restore the business or economy of an obligor, who is in a financial bind rationally and practically.

2. Overview of the Law

The Law provides small businesses with a legal framework in which reconstruction will be easier by newly establishing a bankruptcy proceeding of reconstruction type, which is not only fair and transparent to the parties concerned including obligees but also expeditious, practical and appropriate to the modern economic society.

A proceeding which provides small businesses or the like with a legal framework in which reconstruction will be easier

- ① Accessible to every corporation and individual
- ② Accepts a petition of bankruptcy before becoming bankrupt
- ③ In principle, current management shall operate the business.
- ④ Enhances preservation measures
- ⑤ Assures a disposal combined with the bankruptcy of the parent company or subsidiary company

A proceeding fair and transparent to the parties concerned including obligees

- ① Introduces the avoiding system, aiming to secure the liberation of obligees
- ② Prevents moral hazard by making an elucidation of the civil and/or criminal responsibilities of directors
- ③ Assures the execution of restoration plans under the supervision of a supervising commissioner
- ④ Enhances the commitment of obligees by introducing the obligees committee system
- ⑤ Protects the benefit of obligees by applying permission system to the transfer of business in proceedings
- ⑥ Assure the transparency of proceedings by improving the conditions for inspecting documents relating to a case.

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| Proceedings expeditious, practical and appropriate to the modern economic society |
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- ① Introduces the resolution in writing system by giving discretion to the obligees meeting
- ② Simplifies and rationalizes the investigation and/or determination procedures for credits
- ③ Establishes the security right extinguishment system for securing the use of operation assets
- ④ Makes an elucidation of preferential fulfillment of debts in relation to financing for supporting restration
- ⑤ Establishes the court permission system to replace the shareholder's meeting resolution system with respect to the business transfer and/or capital reduction
- ⑥ The special treatment proceeding is established in parallel for aiming at expeditious setup of a restration plan by partly omitting proceedings.
- ⑦ Introduces the system including immediate forcible execution and restration plan annulment
- ⑧ Provides the prescriptions capable of coping with an international bankruptcy case

