

1 Extinguishing Security Interests

**Extinguishing Security Interests:
Secured Claims in Japanese Reorganization Law and
Some Policy Implications to the U.S. Law**

Abstract

This Article examines how secured claims are treated in Japanese business reorganization law, especially in the Civil Rehabilitation Act (*Minji saisei ho*), which was enacted in 1999 as the new general reorganization regime in Japan. Unlike the U.S. Bankruptcy Act, the Civil Rehabilitation Act does not have automatic stay on secured claims, nor does it allow any modification of secured claims by the rehabilitation plans. However, the Civil Rehabilitation Act has a unique procedure to restrict the rights of secured creditors, which is called “the procedure of extinguishing security interests (*tanpo-ken shometsu seikyu tetsuzuki*).” This procedure permits a debtor to cancel security interests in any property she owns that is necessary for continuation of her business, just by paying the secured creditors the liquidation value of such property. I analyze how this procedure can reduce the transaction costs which would arise if the debtor had to bargain with the secured creditors in order to avoid foreclosure sales. I also compare this procedure with the way how secured creditors are treated in Chapter 11 of the U.S. Bankruptcy Act, and discuss some policy implications to the U.S. law.

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I. Introduction

Business reorganization law in the United States imposes substantial restrictions on the rights of secured creditors.¹ First of all, secured creditors are prohibited from enforcing their rights at the time when a debtor files for bankruptcy (“automatic stay”).² Second, each secured creditor’s claim is bifurcated into two parts: the part covered by the value of collateral and the part not covered by it. In principle, only the first part is treated as a secured claim in the bankruptcy proceeding (“bifurcation”).³ Third, terms of each secured claim can be modified notwithstanding the objection of its claimholder. In particular, if the debtor promises to make deferred payments, whose present value is at least equal to the value of the collateral, to each objecting secured creditor in a reorganization plan, and the plan satisfies other requirements of the statute, then the plan will be confirmed by the court and each claim will be modified accordingly (“cramdown”).⁴

We can hardly say, however, that those restrictions on secured claims are indispensable features of any business reorganization law. From a historical perspective, the Bankruptcy Act before the 1978 reform – the Chandler Act⁵ – had a procedure, namely Chapter XI,⁶ which did

* For simplicity, any US dollar to Japanese yen (¥) conversion is at the rate of US\$1/¥100.

¹ As for the business reorganization law in the United States, I focus on Chapter 11 of the Bankruptcy Act. *See* 11 U.S.C. §§1101- 1174 (2005).

² *See* 11 U.S.C. §362(a)(4).

³ *See* 11 U.S.C. §506(a).

⁴ *See* 11 U.S.C. §1129(b)(1)&(2)(A).

⁵ *See* Chandler Act, Pub. L. No. 75-696, 52 Stat. 840, *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978). For an introduction to Chandler Act, *see* David A. Skeel,

not permit secured claims to be modified. Many firms, including publicly held corporations, were reorganized under Chapter XI, rather than under Chapter X⁷ which allowed modification of secured claims.⁸ Furthermore, from a perspective of comparative laws, some countries have bankruptcy laws that generally do not alter secured claims,⁹ and others have adopted legal restrictions on secured claims only recently.¹⁰ Also, even in countries where there exist some restrictions on secured claims in bankruptcy – such as Japan –, the ways of restriction may be different from those in the United States.

This Article examines how secured creditors are treated in Japanese business reorganization law, especially in the Civil Rehabilitation Act (*Minji saisei ho*),¹¹ which was enacted in 1999 as the new general reorganization regime in Japan. In contrast to the U.S. Bankruptcy Act, the Civil Rehabilitation Act does not have automatic stay on secured claims. In principle, secured creditors can freely enforce their rights even after commencement of the proceeding.¹² Also, while unsecured claims can be modified by a rehabilitation plan that is accepted by the majority of unsecured creditors and confirmed by the court, secured claims cannot be modified by the plan. However, the Civil Rehabilitation Act has a unique procedure to restrict the rights of secured creditors, which is called “the procedure of extinguishing security

Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1368–76 (1998).

⁶ See Chandler Act ch.11, 52 Stat. 840, 905-16 (1938) (codified prior to repeal at 11 U.S.C. §§ 701-799 (1938)).

⁷ See Chandler Act ch.10, 52 Stat.840, 883-905 (1938) (codified prior to repeal at 11 U.S.C. §§501-676 (1938)).

⁸ See Skeel, *supra* note 5, at 1375.

⁹ One example is German law. See Klaus Kamlah, *The New German Insolvency Act: Insolvenzordnung*, 70 AM. BANKR. L.J. 417, 428-29 (1996).

¹⁰ For example, Canadian bankruptcy law did not restrict secured claims before 1985. See F. H. Buckley, *The American Stay*, 3 S. CAL. INTERDIS. L.J. 733 (1994); Lynn M. LoPucki & George Triantis, *A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies*, 35 HARV. INT’L L.J. 267, 277 (1994).

¹¹ Law No.225, Dec.22, 1999, last amended by Law No.87, July 26, 2005.

¹² In fact, the Civil Rehabilitation Act has a procedure to allow the court to order stay on enforcement of specific security interests in a specified time period (“temporary stay”). Nevertheless, requirements for the stay order are rigid and the stay period is usually short. I will explain temporary stay later in this Article. See section II.C.1, *infra*.

interests (*tanpo-ken shometsu seikyu tetsuzuki*).”

In essence, this procedure permits a debtor in the Civil Rehabilitation proceeding to cancel security interests in any property owned by the debtor which is necessary for continuation of her¹³ business, just by paying the creditors who have security interests in it the amount of cash equal to the *liquidation value* of such property. The debtor cannot pay this value by installments or securities. Only one time payment in cash is acceptable. When parties do not agree on the liquidation value of the property, it will be assessed by the court in the appraisal proceeding. For example, suppose a debtor owes a creditor \$150 and has pledged a property whose liquidation value is \$120 as collateral. In the Civil Rehabilitation proceeding, the debtor can apply to the court for permission of canceling the creditor’s security interest just by paying \$120, not \$150. The difference between the face amount of value of the secured claim and the value of the collateral, \$30, becomes an unsecured claim, and the creditor can participate in the Civil Rehabilitation proceeding with this claim.

This Article examines what kinds of social benefits and costs the procedure of extinguishing security interests might have. I also compare this procedure with the way how secured creditors are treated in Chapter 11 of the U.S. Bankruptcy Act, and discuss some policy implications to the U.S. law. Here is the outline of the argument which will be developed in this Article.

Generally speaking, we need not impose any restrictions on secured claims for successful reorganization if there are no obstacles (asymmetric information and/or transaction costs) for a debtor and secured creditors to bargain with one another. This is because, in such an ideal world, they agree to avoid foreclosure sales when and only when such sales would be inefficient. For example, suppose a debtor owes a creditor \$150 and has collateralized some real property

¹³ Throughout this Article, I use “she” to refer to a debtor and “he” to refer to a (secured or unsecured) creditor.

whose liquidation value is \$120. If the going concern value of the property is, say, \$130, then it is better to use the property for the debtor's business than to sell it by foreclosure. In this case, the debtor will promise the secured creditor to pay some price, p , which is between \$120 and \$130, and ask him not to foreclose on the collateral. Such a bargain will make both parties better-off; the debtor will obtain the value equal to $\$130 - p$, which is positive, and the secured creditor will obtain p , which exceeds what he would receive by the foreclosure sale (\$120). Therefore, as long as there is no obstacle in the bargaining process, inefficient foreclosure will be avoided by a voluntary agreement.

In the real world, however, a variety of obstacles may prevent the parties from negotiating smoothly. Secured creditor may "hold up" the bargaining process requiring as large a share of the going concern surplus (i.e., the difference between the going concern value of the collateral and its liquidation value) as possible, using their rights to foreclose as a "threat." Such a hold-up problem may well become more serious when a debtor must negotiate with multiple secured creditors in order to realize the going concern surplus (for example, when several creditors have security interests with different ranking of priorities in the same asset). Furthermore, the going concern value of the collateral is likely to be uncertain and, through the daily management of her own business, the debtor may well have acquired private information on it. Such asymmetric information may also hinder the parties from bargaining efficiently.

The procedure of extinguishing security interests may enhance efficiency in those circumstances. With this procedure, the debtor can end the costly negotiations by recapturing the collateral just by paying its liquidation value to the secured creditors. This "exit option" of the debtor can prevent each secured creditor from holding up the bargaining process in order to obtain a larger share of the going concern surplus. It can also prevent the bargain from delaying because of uncertainty on the going concern value of the collateral.

Of course, for the procedure of extinguishing security interests to function well, the court must be able to assess the liquidation value of the collateral in a fairly accurate and foreseeable way. If not, disputes over the liquidation value may have to be settled in a time-consuming appraisal proceeding, whose cost may be even higher than the negotiation cost which would arise if the procedure of extinguishing security interests did not exist. Still, it appears reasonable to assume that the court can estimate the liquidation value of the collateral fairly easily, -- or at least more easily than the court estimates the going concern value of the collateral. While estimating the latter value requires the court to predict future cash flows that the debtor's business will earn using the collateral, estimation of the former value only requires prediction of a price of an individual asset. Besides, in predicting such a price, the court can often refer to a market price of the same (or, at least, similar) kind of assets in the neighborhood.

We may better appreciate the procedure of extinguishing security interests by comparing it with the treatment of secured claims in Chapter 11 -- especially with the procedure so-called "cramdown." Cramdown can also be viewed as an "exit option" of the debtor to recapture the collateral by paying the value of the collateral to the objecting secured creditor. There exists an important difference between these two procedures, however: While extinguishing security interests requires the debtor to make one-time payment of the value of the collateral, cramdown permits the debtor to make "deferred cash payments" whose present value is, in the court's estimation, equal to the collateral.¹⁴

A possible advantage of cramdown is that the debtor can exercise her exit option even when she is too liquidity-constrained to prepare the amount of cash equal to the value of the collateral. This apparent benefit is carried with costs, however; that is, cramdown imposes a much heavier burden on the court than the procedure of extinguishing security interests. In order

¹⁴ See 11 U.S.C. §1129(b)(2)(A)(i)(II) .

to determine whether the requirements of cramdown are satisfied, the court has to estimate not only the value of the collateral but also the value of deferred cash payments promised in the plan. To estimate the latter value, the court must first examine feasibility of the plan (if the plan is not feasible, then the debtor cannot pay the promised deferred payments), and then determine a proper interest rate by which to discount the deferred payments, considering a variety of risks involved in the reorganized business. These tasks are close to estimating the going concern value of the debtor's business as a whole, which is arguably much more difficult than estimating the liquidation value of an individual asset (or assets) used as collateral.

In the procedure of extinguishing security interests, the task of the court is restricted to estimating the liquidation value of the collateral, and it is up to the debtor to prepare this value by, say, obtaining a loan in the financial market. Judging from evidences showing many Chapter 11 debtors fail in reorganization after time-consuming proceedings,¹⁵ there seems a good reason for the Civil Rehabilitation Act to require the debtor to make one-time payment, though this requirement sometimes makes it difficult for some liquidity-constrained debtors to prepare necessary amount of cash.

Although allowing a debtor to extinguish security interests by paying the liquidation value of the collateral can be beneficial for the purpose of efficient reorganization, it can also involve costs. In particular, I examine how this procedure may induce a debtor to overly borrow and make an investment in too risky businesses at the expense of existing creditors at the time before the debtor files for the Civil Rehabilitation cases.

Considering this and other difficulties, we cannot be sure that the procedure of extinguishing security interests always enhances efficiency. Still, it is worth noting that about 1,000 firms each year, including dozens of publicly held corporations, file for the Civil

¹⁵ I compare performance of Chapter 11 with that of the Civil Rehabilitation Act in section II.B, *infra*.

Rehabilitation proceedings, and a considerable percentage of these firms succeed in reorganization in relatively short periods.¹⁶ These evidences suggest that such a simple procedure as the Civil Rehabilitation Act – no automatic stay on secured claims, no cramdown, and rather limited intervention of the court – can work fairly effectively. Based on this observation, the final part of this Article discusses some policy implications to the U.S. law. In particular, I will argue Congress should consider preparing a regime similar to the Civil Rehabilitation Act, and allowing each firm to choose this regime as a bankruptcy system which will apply to it when it later encounters financial distress, instead of the present Chapter 11 regime.

This Article proceeds as follows. Part II introduces Japanese reorganization laws and their treatments of secured claims, putting a special emphasis on the Civil Rehabilitation Act. Part III analyzes the procedure of extinguishing security interests and examines its possible social benefits. Part IV compares the treatment of secured creditors in the Civil Rehabilitation Act with that in Chapter 11 of the U.S. Bankruptcy Act, and analyzes relative advantages of these two procedures. Part V examines potential costs of extinguishing security interests. Part VI discusses policy implications to the U.S. law and concludes the analysis.

II. Secured Claims in Japanese Reorganization Laws: With a Special Emphasis on Extinguishing Security Interests in the Civil Rehabilitation Act

This Part describes how secured creditors are treated in Japanese business reorganization law, especially in the Civil Rehabilitation Act. In fact, Japan has different reorganization procedures provided by different statutes. I focus on the Civil Rehabilitation Act both because it

¹⁶ For performance of the Civil Rehabilitation Act, *see* section II.B, *infra*.

is by far the most widely used and because it has a novel procedure of restricting secured claims. Still, some brief introduction to Japanese reorganization laws will be useful.¹⁷

The Civil Rehabilitation Act (*minji saisei ho*)¹⁸ was enacted in 1999 and took effect in April 2000, as a new general reorganization law in Japan. Before its enactment, Japanese reorganization law mainly consisted of two statutes: the Corporate Reorganization Act (*kaisha kosei ho*)¹⁹ and the Composition Act (*wagi ho*),²⁰ the latter of which was repealed by the Civil Rehabilitation Act, while the former is still in effect for reorganization of stock corporations.²¹ Section A briefly explains those two statutes and their treatments of secured claims. Then section B describes the basic structure of the Civil Rehabilitation Act. Finally, section C explains how the Civil Rehabilitation Act treats secured creditors. Japanese reorganization law is summarized in Table 1.

[INSERT TABLE 1 ABOUT HERE]

A. Japanese Reorganization Laws and Their Treatment of Secured Claims

1. Corporate Reorganization Act

The Corporate Reorganization Act²² provides a special reorganization scheme for stock corporations (*kabushiki gaisha*). Stock corporations in Japan had (and have) alternatives to be

¹⁷ This Article focuses on business reorganization law and does not discuss other legal insolvency systems (such as consumer-bankruptcy laws). For a summary of Japanese insolvency law, see Kent Anderson & Makoto Ito, *Insolvency Law for a New Century: Japan's Revised Framework for Economic Failures*, in *LAW IN JAPAN: A TURNING POINT* (Asian Law Center University of Washington School of Law, ed., 2002).

¹⁸ Law No.225, Dec. 22, 1999, last amended by Law No.87, July 26, 2005.

¹⁹ Law No.154, Dec. 13, 2002, last amended by Law No.87, July 26, 2005.

²⁰ Law No.72, Apr. 25, 1922, repealed by Civil Rehabilitation Act, Law No.225, Dec.22, 1999.

²¹ The other reorganization procedure, corporate arrangement (*kaisha seiri*), which is provided in the Commercial Act (*sho ho*), Law No.48, Mar.9, 1898, has been rarely used and is being abolished by the Corporation Act (*kaisha ho*), Law No. 86, July 26, 2005, which will take effect early in 2006. So I do not examine this procedure at all.

²² Law No. 172, June 7, 1952, thoroughly revised by Law No.154, Dec.13, 2002, last amended by Law No.87, July 26, 2005.

reorganized either under this Act, or under the Composition Act before 2000 (and the Civil Rehabilitation Act after 2000). The Corporate Reorganization Act was thoroughly revised in 2002,²³ but its basic structure remains the same.²⁴

Enacted in the period of occupation by the Supreme Commander of the Allied Powers after the World War II, the Corporate Reorganization Act adopted, and still retains, the basic structure of Chapter X of the U.S. Chandler Act.²⁵ In particular, secured creditors, as well as unsecured creditors and shareholders, are “captured” in the proceeding. They are prohibited from individually enforcing their rights after the commencement of the proceeding, and their claims can be modified by the reorganization plan.

The number of uses of the Corporate Reorganization Act has been small – at most dozens each year.²⁶ One important reason for this is that this Act does not employ a debtor-in-possession (DIP) procedure. Rather, courts must appoint administrators (*kosei kanzai-nin*) operating the debtor’s business, and managers of the debtor corporation almost always have to leave their positions. This rule obviously discourages debtor corporations from petitioning in the first place. Furthermore, when the debtor corporation is insolvent (i.e., when its total liabilities exceed its total assets), its shareholders do not have any voting rights to approve the reorganization plan. Based on this rule, the entire interests of shareholders are usually cancelled without any compensation. Such practice is consistent with the idea of

²³ Corporate Reorganization Act, Law No.154, Dec. 13, 2002.

²⁴ For an introduction to the Corporate Reorganization Act before 2002 revision, see Tasuku Matsuo, *Corporate Reorganization*, in 7 *DOING BUSINESS IN JAPAN*, pt. XIV, ch.8 (Zentaro Kitagawa ed., 1997). As for the 2002 revision, see Shinichiro Abe, *The Japanese Corporate Reorganization Law of 2002*, 22 *AM. BANK. INST. J.* 36 (Mar. 2003).

²⁵ Bankruptcy Act of 1898, Ch. 541, 30 Stat. 544, amended by Act of June 22, 1938 (Chandler Act), Ch. 575, 52 Stat. 840, repealed by Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

²⁶ For the recent ten years (1994-2003), there were 450 filings (45 per year) for the Corporate Reorganization cases. See SAIKO SAIBANSHO JIMU SOKYOKU [Administrative Office of Supreme Court of Japan], SHIHO TOKEI NENPO: MINJI-GYOSEI HEN [ANNUAL REPORT OF JUDICIAL STATISTICS: CIVIL AND ADMINISTRATIVE DIVISIONS], each year edition [hereinafter JUDICIAL STATISTICS].

“absolute priority,” but it has also arguably discouraged many debtors from petitioning – especially most closely held corporations whose managers are large shareholders at the same time.

As a result, firms using the Corporate Reorganization proceedings have generally been restricted to large, often publicly-held corporations. As a matter of practice, most small and mid-sized firms had to rely on the Composition Act (as well as private workouts) to be reorganized, before enactment of the Civil Rehabilitation Act.

2. Composition Act

Until its abolishment in 2000, the Composition Act had been the general reorganization law in Japan.²⁷ It provided a procedure available to any types of business entities, such as stock corporations, limited liability companies, cooperatives, partnerships, and individuals. In contrast to the Corporate Reorganization Act, the Composition Act adopted a DIP procedure, providing debtors more incentives to petition. Secured creditors are not “captured” in the Composition proceeding, however. While unsecured creditors were prohibited from enforcing their claims, secured creditors could freely enforce their interests. Also, while the rights of unsecured creditors could be modified by a composition plan (*wagi*) which was accepted by a qualified majority of the unsecured creditors and confirmed by the court, the rights of secured creditors could not be modified without consent of each claimholder. Using the technical term of Japanese insolvency law, secured creditors were “separated” from the proceedings.²⁸

²⁷ For an introduction and empirical study of the Composition Act, see Theodore Eisenberg & Shoichi Tagashira, *Should We Abolish Chapter 11?: The Evidence from Japan*, 23 J. LEGAL STUD. 111 (1994).

²⁸ Security interests were called “separated rights (*betsujo-ken*)” in the Composition Act. See Composition Act § 43.

B. Introduction to the Civil Rehabilitation Act

In the late 1990s, Japanese government undertook a major revision of the entire system of insolvency law.²⁹ The revision was motivated to modernize the insolvency laws which had not been thoroughly reviewed for nearly a half century. Improvement of the insolvency system was also required to deal with the dramatic increase of bankruptcies during the protracted recession in the 1990s.³⁰ As the first step of a series of insolvency law reforms, the Civil Rehabilitation Act was enacted in 1999 and took effect in April 2000,³¹ replacing the 78-years-old Composition Act. This section describes the very basic structure of the Civil Rehabilitation Act,³² and also introduces some figures showing its initial performance.

As a successor of the Composition Act, the Civil Rehabilitation Act is a general reorganization regime available to all types of business entities.³³ It also adopts a DIP procedure: a rehabilitation debtor (in case of a corporate debtor, the debtor's manager) continues operating her own business during the proceeding,³⁴ though the court may appoint administrators (*kanzai nin*) replacing the debtor if the court considers such appointment necessary for rehabilitation of the debtor's business.³⁵ When the debtor continues managing her own business (as is usually the case), the court may, and usually does, appoint supervisors (*kantoku iin*) who monitor the debtor.³⁶

²⁹ For the background of Japan's insolvency law reforms, see Anderson & Ito, *supra* note 17; Takuya Miyama, *Minji saisei ho seitei no keii to ho no gaiyo* [Details of the Enactment of the Civil Rehabilitation Act and an Outline of the Act], 1171 JURISUTO 6, 6 (2000).

³⁰ Insolvency filings of both business and non-business sectors increased by over 1,000% during the ten years between 1991 and 2000. See Anderson & Ito, *supra* note 17, at 1.

³¹ Law No.225, Dec.22, 1999, last amended by Law No.87, July 26, 2005.

³² Because this Article focuses on secured claims, my introduction to the Civil Rehabilitation Act must be only a skeleton. Fortunately, a careful explanation and analysis of the Civil Rehabilitation Act is available in English. See Kent Anderson, *Small Businesses Reorganizations: An Examination of Japan's Civil Rehabilitation Act Considering U.S. Policy Implications and Foreign Creditors' Practical Interests*, 75 AM. BANKR. L.J. 355 (2001).

³³ See Civil Rehabilitation Act [CRA] §2.

³⁴ See CRA §38(1).

³⁵ See CRA §64.

³⁶ See CRA §54.

Like the Composition Act, the basic aim of the Civil Rehabilitation Act is to help the debtor to be reorganized by making accommodation with *unsecured* creditors. Thus, unsecured creditors are prohibited from individually enforcing their rights during the proceeding,³⁷ and their rights can be modified by a rehabilitation plan (*saisei keikaku*) that is accepted by a simple majority of unsecured creditors (both in amount of claims and in number)³⁸ and confirmed by the court.³⁹ The rights of secured creditors, on the other hand, are not affected in principle. In contrast to the Composition Act, however, the Civil Rehabilitation Act sometimes imposes special restrictions on secured claims, as will be explained in the next section.

After the rehabilitation plan is conclusively confirmed, the court must make a ruling of completion of the proceeding if neither administrators nor supervisors were appointed.⁴⁰ On the other hand, if supervisors were appointed (as was usually the case), the court must retain its jurisdiction and make the supervisors monitor the plan's execution. In the latter case, if it becomes clear after confirmation that there is no prospect for the plan being consummated, the court must make a ruling of discontinuance of the proceeding,⁴¹ and the case will usually be converted into liquidation. If, on the other hand, the debtor consummates the plan or three years have passed since the plan's confirmation, the court must make a ruling of completion of the proceeding.⁴²

So far the Civil Rehabilitation Act has been generally welcomed by the industrial world, as it provides a modernized and speedy reorganization procedure.⁴³ Petitions for the Civil

³⁷ See CRA §§39(1) & 85(1).

³⁸ See CRA §172-3(1).

³⁹ See CRA §§174-179.

⁴⁰ See CRA §188(1).

⁴¹ See CRA §194.

⁴² See CRA §188(2).

⁴³ See, e.g., Teikoku Databank, Ltd., *Minji saisei ho seko 4 nenkan no shinsei doko chosa* [Research on Filings during the 4 years since the Enforcement of the Civil Rehabilitation Act] 3 (2004), available at <http://www.tdb.co.jp/index.html> ("Civil Rehabilitation proceedings certainly go much faster than the other reorganization proceedings [such as the Composition and Corporate

Rehabilitation cases were 660 in the first nine months (Apr.1 – Dec.31, 2000), and 1,110 (in 2001), 1,093 (in 2002), 941 (in 2003) and 712 (in 2004) in the successive four calendar years.⁴⁴ Although these figures appear small compared with the counterparts of Chapter 11 of the U.S. Bankruptcy Act,⁴⁵ they show a dramatic increase from the figures in the era of the Composition Act.⁴⁶ Since typical Civil Rehabilitation cases involve much larger firms than typical Chapter 11 cases,⁴⁷ the importance of the Civil Rehabilitation Act for reorganization practices in Japan is greater than the numbers alone suggest. Besides, not only closely held companies but also publicly held corporations are reorganized under the Civil Rehabilitation Act. In fact, since the enactment of the Civil Rehabilitation Act, publicly held corporations have reorganized under this Act more often than under the Corporate Reorganization Act.⁴⁸ This is probably because the DIP procedure of the Civil Rehabilitation Act gives managers more chances to retain their jobs, so they have more incentives to petition.

Besides, many debtors obtain confirmation of the rehabilitation plans in relatively short periods. According to the survey of Teikoku Databank, Inc., of 2,871 debtor firms which had already succeeded or conclusively failed in obtaining confirmation of the rehabilitation plans by

Reorganization proceedings]”) (translated by the Author).

⁴⁴ See JUDICIAL STATISTICS, *supra* note 26, each year. This downward trend probably reflects the gradual recovery of the Japanese economy after 2000.

⁴⁵ From April 1, 2001 to March 31, 2002, there were 10,623 filings for the Chapter 11 business reorganization cases. See ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, FEDERAL JUDICIAL CASELOAD STATISTICS (2002).

⁴⁶ The average number of filings for the Composition proceedings each year was 249 in the last ten years (1990-99). See JUDICIAL STATISTICS, *supra* note 26, each year.

⁴⁷ The mean amount of debts of the 3,477 firms which filed for the Civil Rehabilitation proceedings from April 1, 2000, to March 31, 2004, was ¥6.5 billion (\$65 million). 1,890 (52.0%) of these firms had debts less than ¥1 billion (\$10 million), and 1,244 (34.2%) had debts less than ¥500 million (\$5 million). See Teikoku Databank, *supra* note 43, at 2. On the other hand, of 849 debtors that filed for the Chapter 11 proceedings in the 23 districts during the twelve months ending in June, 1993, 767 (90.3%) had debts less than \$5 million. See Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 AM. BANKR. L.J. 499, 528 (1999).

⁴⁸ From April 1, 2000, to March 31, 2004, 77 corporations whose stocks were traded in at least one of the stock exchanges in Japan filed for insolvency proceedings. Of those corporations, 54 (70.1%) filed for Civil Rehabilitation cases, while 18 (23.4%) filed for the Corporate Reorganization cases. The other 5 filed for liquidation. See Teikoku Databank, *supra* note 43, at 2.

the end of March 2004, 2,336 firms (81.4%) had obtained confirmation.⁴⁹ This confirmation rate is remarkably high compared with the counterpart of the U.S. Chapter 11 cases (27%, according to a recent survey⁵⁰). In addition, the *mean* interval from the petition to the confirmation of the rehabilitation plan is about 8 months (249.4 days),⁵¹ which also looks better than those of Chapter 11.⁵² Of course, what really matters is not how many plans are confirmed, but how many debtors consummate these plans and are successfully reorganized in the end. Although a consummation rate is not directly available, the annual reports of the Administrative Office of Supreme Court of Japan provide (a) the number of cases that ended by courts' rulings of discontinuance⁵³ or revocation⁵⁴ after getting confirmation of the plans,⁵⁵ and (b) the number of cases that ended by courts' rulings of completion of Civil Rehabilitation proceedings,⁵⁶ each year. For the period from April 1, 2000 to December 31, 2004, the total

⁴⁹ See Teikoku Databank, *supra* note 43, at 3. However, this figure includes 171 cases in which courts had already made a ruling of discontinuance after confirmation because they found there were no prospects of consummation of the plans. For discontinuance, see *supra* note 41 and the accompanying text. For confirmation rates, see also Ryuji Sonoo, *Minji saisei tetsuzuki to saisei keikaku no jitsujo to kadai* [*Real State and Issues of the Civil Rehabilitation Proceedings and Rehabilitation Plans*], 736 NBL 8, 24 (2002) (reporting that the confirmation rate in Tokyo District Court during the first two years since enforcement of the Act was 71.2%).

⁵⁰ See Gordon Bermant & Ed Flynn, *Bankruptcy by the Numbers: Outcomes of Chapter 11 Cases: U.S. Trustee Database Sheds New Light on Old Questions*, 17-1 AM. BANKR. INST. J. 8 (Feb.1998) (Study of 131,089 Chapter 11 filings between January 1, 1989 and December 31, 1995).

⁵¹ See Teikoku Databank, *supra* note 43, at 4. The median is not specifically reported there. Another study suggests that it is below 200 days. See Kazuhiro Kosuge & Keiko Tsutsumi, *Minji saisei jiken: ho seko go ni nenkan no jokyō o hurikaette* [*Civil Rehabilitation Cases: Reviewing the Two-Years Practices after the Enforcement of the Act*], 741 NBL 8 (2002) (54.9% of the cases in survey reached confirmation of the plans within 200 days after filing).

⁵² See Bermant & Flynn, *supra* note 50 (reporting that the *median* interval from the petition to confirmation was 432 days [14.4 months] for the cases filed during 1997).

⁵³ For discontinuance of the Civil Rehabilitation proceedings after confirmation of the plans, see *supra* note 41 and the accompanying text.

⁵⁴ The court may make a ruling of revocation of the rehabilitation plan if it finds that the debtor obtained confirmation of the plan by an unjust method or otherwise acted fraudulently. See CRA §189. Revocation of the plan is extremely rare.

⁵⁵ In short, figure (a) shows the number of cases that failed in reorganization after getting confirmation of the plans.

⁵⁶ Courts must make a ruling of completion of the proceedings when three years have passed since confirmation of the plans. See *supra* notes 40 & 42.

figures of (a) and (b) are 281 and 897, respectively.⁵⁷ The ratio of $(b)/(a+b)$, 76.1%, is admittedly not the same as the consummation rate,⁵⁸ but it implies that the consummation rate of Civil Rehabilitation cases is relatively high -- probably higher than that of Chapter 11 cases.⁵⁹

C. Secured Creditors in the Civil Rehabilitation Act

Now that I have explained the basic structure of the Civil Rehabilitation Act, I turn to its treatment of secured claims. The general rule of the Civil Rehabilitation Act is that secured creditors are “separated” from the proceedings⁶⁰— they can generally enforce their rights during the proceedings, and their claims cannot be modified by the rehabilitation plan. Unlike the Composition Act, however, the Civil Rehabilitation Act has two special procedures to restrict the rights of secured creditors: (1) temporary stay and (2) the procedure of extinguishing security interests. I explain these procedures in order.

⁵⁷ See JUDICIAL STATISTICS, *supra* note 26, each year.

⁵⁸ On one hand, the ratio shown in the text (76.1%) is, by itself, only an estimate of the probability for a confirmed plan to survive until completion of the proceeding, rather than the probability for the plans to be consummated. Because courts must make a ruling of completion if three years have passed since confirmation of plans, *see supra* note 42 and the accompanying text, it is possible for a plan to fail even after the court declares completion of the proceeding. Thus, inferring the consummation rate by this ratio may well lead to overestimation. On the other hand, for many Civil Rehabilitation cases, the time for a ruling of completion had not yet come by the end of 2004 (because three years had not passed since confirmation of the plans), while many unreasonable plans had already ended in discontinuance by that time. In this respect, this ratio (76.1%) is likely to underestimate the probability for a confirmed plan to survive until completion of the proceeding. The latter effect of underestimation may set off, or even overwhelm, the former effect of overestimation.

⁵⁹ For consummation rates of Chapter 11 cases, *see* Nancy Rhein Baldiga, *Is this Plan Feasible? An Empirical Legal Analysis of Plan Feasibility*, 101 COM. L.J. 115, 127 (1996) (reporting that, of 43 plans in survey, 15 [37.2%] were consummated and 8 [18.6%] were likely to be consummated); Susan Jensen-Conklin, *Do Confirmed Chapter 11 Plans Consummate? The Results of A Study and Analysis of the Law*, 97 COM. L.J. 297, 323-24 (1992) (of 45 cases, 21 [46.7%] were definitely consummated and 5 [11.1%] were probably consummated).

⁶⁰ Like in the Composition Act, *see supra* note 28, security interests are called “separated rights (*betsujo-ken*)” in the Civil Rehabilitation Act. *See* CRA §53.

1. Temporary Stay on Secured Claims

In contrast to the U.S. Bankruptcy Act,⁶¹ the Civil Rehabilitation Act does not impose automatic stay on secured claims. However, it does have a procedure to allow the court to order stay on the enforcement of a specific security interest for a “reasonable” period (“temporary stay”).⁶² Because this procedure is an exception to the general rule that the secured claims are “separated” from the proceeding, the requirements for the stay order are rigid: courts may order temporary stay only if (1) it is in the general interests of creditors, and (2) there is no likelihood of causing unreasonable loss to the secured creditor.⁶³ Unlike automatic stay, temporary stay must be ordered with respect to a particular security interest, and with a specification of the stay period. The stay order automatically loses its effect when the stay period has expired, though the court may modify its order to extend the period.⁶⁴ The objective of temporary stay is explained to give a debtor a time to negotiate with secured creditors in order to obtain their consents to stop the foreclosure sales, or, in case such negotiations break down, a time to petition for extinguishing security interests, which is described in the next section.⁶⁵

So far temporary stay has rarely been ordered,⁶⁶ and the period of stay has been relatively short (typically several months).⁶⁷ Consequently, practitioners seem to think that the effects of

⁶¹ See 11 U.S.C. §362(a)(4) (automatic stay on secured claims).

⁶² See CRA §31. This procedure is technically called “*tanpo-ken no jikkoo tetsuzuki no chushi meirei*,” whose direct translation would be “discontinuance order of the procedure of enforcement of security interests.” I paraphrase the term in order to collate it with “automatic stay” in the U.S. Bankruptcy Act and to emphasize that stay is not permanent but only for a period specified by the court. For further explanation of temporary stay, see Anderson, *supra* note 32, at 382.

⁶³ See CRA §31(1).

⁶⁴ See CRA §31(3).

⁶⁵ See RYOICHI HANAMURA, MINJI SASEI HO YOSETSU [INTRODUCTION TO THE CIVIL REHABILITATION ACT] 111-12 (2000).

⁶⁶ Of the 1225 cases filed in the 13 main district courts during the first two years after the enforcement of the Act, courts ordered temporary stay in 26 cases (2.1%). See Kosuge & Tsutsumi, *supra* note 51, at 13. Of the 613 cases filed in Tokyo District Court during the same period, the stay orders were made in 14 cases (2.2%). See Sonoo, *supra* note 49, at 20-21.

⁶⁷ See Sonoo, *supra* note 49, at 20-21 (explaining practices in Tokyo District Court, where the period of temporary stay is usually three months); HANAMURA, *supra* note 65, at 112 (maintaining that the period of stay should be generally “at most several months.”)

temporary stay on practices of Civil Rehabilitation are limited.⁶⁸ Attitude of the courts may be changed in the future, however. If the courts come to easily find the requirements for stay to be satisfied, and routinely extend the stay periods, then temporary stay will possibly come to work very similarly to automatic stay in the U.S. Bankruptcy Act. Because only a few years have passed since the Civil Rehabilitation Act took effect, and there have been few publicized cases on temporary stay,⁶⁹ how important effects this procedure will eventually have remains to be seen.

Although temporary stay may become an important device to restrict the rights of secured creditors, so far its effect seemingly has been limited to giving debtors relatively short time to negotiate with secured creditors. Accordingly, this Article focuses on the more novel and (in my opinion) theoretically more interesting restriction on the rights of secured creditors: the procedure of extinguishing security interests.

2. Extinguishing Security Interests

After commencement of the proceeding, a debtor can apply to the court for permission to extinguish security interests which exist in the debtor's property.⁷⁰ To obtain the permission, the debtor must specify the property the security interests in which she wants to cancel, and such

⁶⁸ For example, one lending officer of Tokai Bank, Inc. observes that “[temporary stay] will not have such a serious effect on practices.” TOSHIKI TAKAHASHI, *MINJI SAISEI JITSUMU NO TEBIKI [A GUIDE TO PRACTICES OF CIVIL REHABILITATION]* 90 (2002) (translated by the Author).

⁶⁹ I find only two publicized cases concerning temporary stay, in both of which petitions of stay order are denied. *See* Anonym v. Anonym, 1067 HANREI TAIMUZU 274 (Kyoto Dist. Ct., May 28, 2001) (petition for temporary stay is denied for the reason that the collateral is not necessary for the debtor's business and the temporary stay is not in the best interest of the creditors); Kinki Sangyo Credit Ass'n. v. Wada Shoten Corp., 1220 KIN`YU SHOJI HANREI 35 (Osaka App. Ct., Dec. 10, 2004) (petition for stay is dismissed because the debtor provides no evidence that there is a prospect for the debtor to make accommodation with the secured creditor, so the stay order would be only waste of time).

⁷⁰ *See* CRA §§148-153. For further explanation and analysis of this procedure, *see* Anderson, *supra* note 32, at 382-84.

property must be “indispensable for continuation of the debtor’s business.”⁷¹ The debtor must submit to the court the amount of cash equal to what she believes to be the value of the property.

⁷² Note that the debtor cannot pay this value by installments or securities. Only one-time payment in cash is acceptable. Such requirement presents a notable contrast to the “cramdown” procedure in American law, where a Chapter 11 debtor is allowed to make deferred payments to objecting secured creditors.⁷³ I will discuss on this difference later in this Article.⁷⁴

Secured creditors can, of course, object to the debtor’s valuation, and demand appraisal by the court.⁷⁵ In this case, the court appoints an appraiser (*hyoka-nin*), and stipulates the value of the collateral based on the appraiser’s opinion.⁷⁶ Then the debtor submits the appraised price, which will be distributed to the secured creditor(s). If there are multiple creditors who have security interests in the property, the cash will be distributed according to their ranking of priorities determined by the law outside bankruptcy. If the price is more than satisfy the claim of each secured creditor, the rest of the cash should be returned to the debtor. If, on the other hand, the price is less than satisfy the claim of each secured creditor, then the difference between the face value of the secured claim and the cash distributed to the secured creditor will become an unsecured claim, and the (former) secured creditor can make a claim of it in the Civil Rehabilitation proceeding, provided that the secured loan was made with recourse.⁷⁷

How should the appraiser, and eventually the court, assess the value of the collateral? The

⁷¹ See CRA §148(1).

⁷² See CRA §§148(2)(ii)&152(1).

⁷³ See 11 U.S.C. §1129(b)(2)(A)(i)(II).

⁷⁴ See section IV.B, *infra*.

⁷⁵ See CRA §149.

⁷⁶ See CRA §150.

⁷⁷ What if the secured loan was made without recourse? Because the Civil Rehabilitation Act lacks any provision like section 1111(b)(1) of the U.S. Bankruptcy Act, *see infra* note 130, I believe that the secured creditor cannot make any claim for the deficiency. The assessed value of the collateral is all that he can get in this case. I should mention that single project financing (especially single real estate financing) is rare in Japan, and lending is typically made with recourse. *See Anderson, supra* note 32, at 384.

relevant section of the Supreme Court Rules of Civil Rehabilitation provides that the property shall be valued “assuming that the property were disposed of.”⁷⁸ The policy of this provision is explained by the Administrative Office of Supreme Court as follows:

In the Civil Rehabilitation proceeding, a secured creditor can, in principle, freely enforce his security interest (see Civil Rehabilitation Act §53), and the procedure of extinguishing security interests prevents the secured creditor from exercising this right. Therefore, from the point of view that we should assure the secured creditor the value of the collateral which he captures, when the collateral is evaluated in the appraisal proceeding, we should estimate the value which would be realized if the collateral were actually disposed of (i.e., if the secured creditor enforced his security interest).⁷⁹

According to this explanation, we can view the procedure of extinguishing security interests as a scheme enabling the debtor to recapture the collateral just by paying its *liquidation value*, namely, the value which would be realized “if the secured creditor enforced his security interest.”

Let me give two examples to help understand how this procedure works in practice.

Example 1: Suppose a debtor owes \$150 to a creditor and has pledged some real estate, which is worth \$120 and indispensable for continuation of her business, as collateral. Now suppose the debtor has petitioned for the Civil Rehabilitation proceeding and the secured debt is in default. Were it not for the procedure of extinguishing security interests, the debtor could not extinguish the interest of the secured creditor just by paying the value of the collateral (\$120). Rather, his lien would remain unless either he has received full amount of the face value of his secured claim (\$150) or the collateral is actually sold by foreclosure. This principle is called

⁷⁸ Civil Rehabilitation Rules §79(1), Supreme Court Rule No.3, Jan. 31, 2000.

⁷⁹ SAIKO SAIBANSHO JIMU SOKYOKU MINJIKYOKU [ADMINISTRATIVE OFFICE OF SUPREME COURT, CIVIL DIVISION], JOKAI MINJI SAISEI KISOKU [ANNOTATION OF CIVIL REHABILITATION RULES] 146 (2000) (translated by the Author).

“indivisibility of security interests (*tanpo-ken no hukabun sei*),” and has been considered as one of the most fundamental principles of the law of security interests in Japan.⁸⁰ Extinguishing security interests has modified this principle. In this procedure, the debtor can pay just \$120 to the secured creditor and cancel his security interest. The secured creditor will make a claim for the deficiency (\$30) as an unsecured creditor in the Civil Rehabilitation proceeding.

Example 2: Suppose that there are three creditors, C1, C2 and C3. Each of them has a claim of \$100, which is secured by the same asset owned by the debtor, but with different ranking of priorities; C1 has the first mortgage interest, C2 has the second and C3 has the third mortgage interest. The asset is now worth \$120. If there were not the procedure of extinguishing security interests and the debtor paid \$100 to C1, then C2’s second mortgage interest would be promoted to the first, and C3’s third interest would be promoted to the second. Thus, the debtor eventually would have to pay all the debts in order to extinguish these mortgage interests. In contrast, when the debtor uses the procedure of extinguishing security interests, she can pay \$100 to C1, \$20 to C2, and none to C3, and extinguish *all* the mortgage interests. C2 will make a claim of \$80, and C3 will make a claim of \$100, as unsecured creditors, in the Civil Rehabilitation proceeding.

III. Social Benefits of Extinguishing Security Interests

This Part examines what social benefits (if any) the procedure of extinguishing security interests might have. My basic argument is as follows: If there are no obstacles for debtors and creditors to negotiate with one another, then we have no need to restrict the rights of secured creditors. In such an ideal world, debtors can negotiate with secured creditors and persuade them to stop the foreclosure sales, as long as such sales would be inefficient (section A). In the real world, however, there can exist a variety of obstacles in the negotiation processes (section

⁸⁰ See TAKASHI UCHIDA, MINPO III [CIVIL CODE, VOL. III] 355 (1996).

B) The procedure of extinguishing security interests can serve social interests in this case. By giving the debtor an “option” to redeem the collateral just by paying its liquidation value, this procedure can reduce transaction costs and enhance efficiency (section C).

A. When There Are No Obstacles in the Bargaining Process

1. How Inefficient Foreclosure Could Be Avoided by Negotiation

I begin my analysis by a simple example. Suppose a debtor⁸¹ has borrowed from some creditor, and has pledged some asset she owns as collateral. Suppose also that, if the secured creditor seizes the collateral and sells it at auction, it will be sold at $\$L$.⁸² Thus, the liquidation value of the collateral is L . On the other hand, we can define the going concern value of the collateral, G , as the difference between the value of the debtor’s business that will realize if she can continue using the collateral for her business, and the value of her business that will realize if she cannot retain the collateral and must manage her business without using it.⁸³ For example, suppose that the debtor’s business will earn future cash flows whose present value is equal to \$1,000 if the debtor can use the collateral, and will earn future cash flows whose present value is \$300 if she cannot use it. Then G is $\$1,000 - 300 = \700 . Throughout this Article, I often use

⁸¹ The terminology of the “debtor” in my analysis requires some explanation. When the reorganization proceeding involves an individual debtor, the “debtor” in my analysis, of course, means the individual debtor herself. On the other hand, when the reorganization proceeding involves a corporate debtor, I assume that the manager of the corporation acts solely for the interests of its shareholders. In this case, the “debtor” is an abbreviation of “the group of shareholders of the corporate debtor, whose interests are represented by their loyal manager.” My assumption that the managers act loyally to their shareholders may be problematic especially for publicly held corporations, so obtaining any implication from this analysis should be done with a caution. On the other hand, such an assumption appears reasonable for most closely held corporations, where the management and the ownership are not separated.

⁸² For the purpose of defining L , I do not take into account the possibility that the debtor is the very person who values the collateral the most and becomes a winner of the auction. In other words, L is defined as the price at which the person, *other than the debtor*, who values the collateral the most will bid at auction.

⁸³ If the collateral is indispensable for continuation of the debtor’s business and her business will liquidate if it is seized and bought by a third party at auction, then “the value of the debtor’s business which will realize if she cannot retain the collateral” is equal to the summation of the liquidation values of all the assets the debtor owns, except for the collateral.

“*L*” and “*G*” for the abbreviations of “the liquidation value” and “the going concern value,” respectively. I focus on an under-secured loan case – that is, the face amount of the secured loan is now greater than both *L* and *G*.⁸⁴

Now suppose that the debtor is in default and petitions for the reorganization proceeding. Suppose also that the reorganization law (like the Composition Act in Japan or Chapter XI of the U.S. Chandler Act) imposes no restriction on the right of the secured creditor. The debtor cannot afford to pay full amount of her secured debt, so it may appear that she cannot prevent the secured creditor from foreclosing on the collateral. This is not the case, however, if there are no obstacles in the bargaining process between the debtor and the secured creditor.

In particular, suppose first that *G* is greater than *L*, so it is efficient for the debtor to continue using the collateral. Such an efficient result would easily occur if foreclosure did not involve any costs. In this case, when the secured creditor foreclosed on the collateral and sold it at auction, the debtor would be the highest bidder and could repurchase it.⁸⁵ In practice, however, foreclosure would involve quite a lot of costs. In addition to the time and costs spent

⁸⁴ Such a case is common in Japan these days, where the market of real estate has been sluggish since the collapse of the “bubble” economy in early 1990s.

⁸⁵ One might be suspicious whether the debtor can repurchase the collateral in the auction even if $G > L$ (that means the debtor values the collateral the most); for the debtor in a financial distress may be too liquidity-constrained to prepare enough amount of cash to make a successful bid. *See* Lucian Arye Bebchuk & Jesse M. Fried, *A New Approach to Valuing Secured Claims in Bankruptcy*, 114 HARV. L. REV. 2386, 2424-25 (2001) (considering the debtor’s liquidity-constraint as a main obstacle in the negotiation among the debtor and the secured creditors). Such difficulty would never happen if the financial market were perfect; for the debtor could borrow cash up to *G* by collateralizing the future cash flows that the debtor’s business would earn using the collateral. Because financial market is actually not perfect (for example, *G* may be difficult to observe for potential lenders), however, we cannot deny the possibility that the debtor finds it difficult to obtain enough amount of cash to repurchase the collateral. How often such cases occur is an empirical question.

Whether or not the problem of liquidity-constraint is serious, however, it is not the problem that the procedure of extinguishing security interests can (or tries to) solve. This is because this procedure demands the debtor to make *one-time* payment of the value of the collateral, *see* section II.C.2, *supra*. Thus, if the debtor is so liquidity-constrained that she cannot obtain cash enough to win the auction, then it is highly probable that she cannot use the procedure of extinguishing security interests, either. Extinguishing security interests must be understood as a scheme to deal with problems *other than* liquidity-constraint of the debtor, which will be discussed in this and the next section. Whether and how the law should try to solve the problem of liquidity-constraint is another question, to which I will turn in Part IV, *infra*.

in the seizure and auction process, the fact that the debtor's property is being foreclosed would put the debtor's business in a very uncertain position. In particular, if the property that is indispensable for continuation of the debtor's business is seized and bought by a third party at auction, then the debtor's business will be hopeless to continue. Such an uncertainty may well make it hard for the debtor to have business relationships with others (employees, suppliers and customers, and so on) while the auction is in progress. This may well be so even if the debtor is truly the person who values the property the most (i.e., $G > L$), for she may find it hard to make others believe this is the case. Thus, the value of the debtor's business (and also G) may substantially diminish during the auction process.

Accordingly, as long as $G > L$, the debtor has a strong incentive to negotiate with the secured creditor and try to obtain his consent to stop the foreclosure sale. And she can always do so if there exist no obstacles in the bargaining process or, more particularly, if there is no information asymmetry between the debtor and the secured creditor and if they can negotiate with each other without any costs. In such an ideal world, as long as G is greater than L , the debtor can always promise the secured creditor to pay L plus some share of the going concern surplus.⁸⁶ The secured creditor has an incentive to accept this offer, because it will give him more than what he would get if he enforced his security interest (i.e., L). The debtor also has an incentive to make this offer, for by doing so she can retain the collateral without spending any costs in the foreclosure sale. Thus, we expect the parties to get to an agreement.⁸⁷

⁸⁶ More specifically, the debtor will promise to pay $L + a(G-L)$, where $0 \leq a < 1$. How much share of the going concern surplus the debtor offers to the secured creditor in exchange for his promise to stop foreclosure will depend on the relative bargaining powers of the debtor and the secured creditor, which are determined by such factors as time preference of each party.

⁸⁷ This is a simple application of Coase Theorem – that is, if there are no “transaction costs,” an efficient result will always occur regardless of the choice of legal rules. See Ronald H. Coase, *The Problem of Social Cost*, 3 J.LAW & ECON. 1 (1960). A non-cooperative bargaining model, in which two parties negotiate with each other under perfect information, also predicts that the parties will come to an agreement instantaneously. See MARTIN J. OSBORNE & ARIEL RUBINSTEIN, *BARGAINING AND MARKETS*, Chap.3 (1990). Douglas Baird and Randal Picker used the bargaining model to

Next suppose that G is less than L . In this case, the debtor cannot afford to make a payment that will satisfy the secured creditor, so the collateral will be seized and bought by a third party at auction. This result is also desirable, for the debtor is not the person who values the collateral the most, so she should no longer retain it.

In sum, as long as there is no obstacle in the bargaining process, foreclosure will be avoided by a voluntary negotiation between the debtor and the secured creditor if and only if such foreclosure is inefficient (i.e., if and only if $G < L$). We do not need the procedure of extinguishing security interests in this case, nor do we need any other scheme to restrict the rights of secured creditors.

2. Practices in the Composition Act

Although the above analysis relies on the ideal assumption of “zero transaction costs,” it still has something to do with the reality. As was explained in section II.A.2, above, the Composition Act, which had provided a general reorganization scheme for Japanese firms until 2000, did not impose any restriction on the rights of secured creditors. That did not necessarily mean, however, that a Composition debtor could not avoid foreclosure unless she paid every secured creditor the full amount of the face value of every secured debt. In fact, the debtor often made an agreement with each secured creditor to avoid the foreclosure sale. In such an agreement, the debtor promised to pay the secured creditor full or part of her secured debt, often by installments, and the secured creditor in turn promised to refrain from enforcing his right, as long as the debtor kept paying as promised. Such an agreement was often called “security agreement (*tanpo-ken kyotei*),” “payment agreement (*bensai kyotei*),” or “separated-right

analyze the bargaining process between a debtor (more precisely, a corporate debtor’s owner-manager) and a secured creditor whose claim is secured by the whole assets of the debtor. See Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311 (1991).

agreement (*betsujo-ken kyotei*).”⁸⁸ Inefficient foreclosure sales, and inefficient liquidation of the debtors’ businesses caused by them, could be avoided through such agreements, at least in some circumstances.

B. When There Are Obstacles in the Bargaining Process

1. Parties May Not Negotiate Efficiently

So far I have explained that, if there are no obstacles in the bargaining process, the debtor can always bargain with the secured creditors to avoid inefficient foreclosure sales. In reality, however, a variety of obstacles may prevent the parties from bargaining smoothly.

We can think of several reasons for the parties to have difficulty in reaching an efficient agreement. One possible reason is that the debtor and the secured creditor(s) disagree on the value of the collateral. Intuitively, it seems more likely that the parties have different estimation on the going concern value (G) of the collateral than on its liquidation value (L). Of course, estimating L is also speculative, but, after all, it only requires the parties to predict the price of an individual asset, not the value of the debtor’s whole business. In contrast, estimation of G requires the parties to predict the future cash flows that the debtor’s business will earn with (and without) using the collateral,⁸⁹ and to calculate the present value of those cash flows. Thus, estimating G actually requires estimating the value of the debtor’s business itself, and evaluation of a financially distressed firm is arguably much harder than evaluation of an individual asset.⁹⁰

⁸⁸ Although the Composition Act prohibited a debtor from paying to any unsecured creditors outside the Composition proceeding, it allowed the debtor to pay (or promise to pay) secured creditors in order to redeem the collateral. For practice of security agreements in the era of the Composition Act, see TOZAI TOSAN JITSUMU KENKYU KAI [STUDY GROUP ON THE INSOLVENCY PRACTICES IN TOKYO AND OSAKA], WAGI [COMPOSITION] 283-90 (1988).

⁸⁹ Note that G is defined as the difference between the value which the debtor’s business will earn with using the collateral and the value which the debtor’s business will earn without using it. See *supra* note 83 and the accompanying text.

⁹⁰ For difficulty of evaluating financially distressed firms, see Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85,

Furthermore, through daily management of her own business, the debtor may well acquire a variety of information on the value of her own business (and also G), which is difficult for creditors to obtain. Such asymmetry of information may well make it difficult for the parties to reach an agreement.

For example, suppose that the debtor and the secured creditor basically agree on the value of L , but they have different evaluation on G , and the debtor has relatively more accurate information on it. In this case, the debtor will negotiate with the secured creditor in order to redeem the collateral if G is greater than L . But in this negotiation, the debtor may well pretend that G is as close to L as possible. This is because the fact that G is much greater than L means that the debtor can afford to make a payment (p) much higher than L to the secured creditor for compensation of stopping the foreclosure sale, so she may really be demanded high p by the secured creditor. Having such a strategy of the debtor in mind, the secured creditor may try to “screen out” the debtor with high G from debtors with low G . More particularly, he may demand some very high price at the beginning of the negotiation, and gradually lower the demand prices as the negotiation goes on. The debtor with higher G has greater stake to lose when the negotiation is prolonged, so she tends to compromise with a higher price in an earlier period of the negotiation. On the other hand, the debtor with lower G does not easily compromise, and makes an agreement in a later period of the negotiation at a lower price. This means that, as the true value of G is closer to L , bargaining tends to delay longer.⁹¹

Another possible reason to make a negotiation process costly is that the debtor may have to negotiate with multiple secured creditors to realize G . For example, several creditors have security interests in the same asset, or different creditors have security interests in different

89 (1995).

⁹¹ Strategic bargaining as described in the text can be formerly analyzed with a non-cooperative bargaining model under asymmetric information. For a review of literatures in this field, see John Kennan & Robert Wilson, *Bargaining with Private Information*, 31 J. ECON. LITERATURE 45 (1993).

assets that work together and produce a synergy. In these cases, G will be destroyed if even one of those creditors enforces his security interest. Such a situation appears fairly common, indeed. Empirical studies, both in Japan and in the United States, suggest that even small firms often obtain secured loans from a quite few creditors.⁹²

Arguably, the more secured creditors a debtor has to negotiate with, the more likely it becomes that bargaining is prolonged. This is because each secured creditor has an incentive to “hold up” the bargaining process in the hope of getting a larger share of G . Each creditor will demand as high a price as possible in exchange for refraining from the foreclosure, using his power to enforce his security interest as a “threat.”⁹³

2. Empirical Evidences Suggesting Negotiation Could Be Costly

So far I have pointed out several obstacles that may prevent the parties from bargaining smoothly. An important question is: How serious are these problems in practice? Concerning this question, two kinds of evidences in Japan may be suggestive. One is about comparison between the performance of the Composition Act and that of the Civil Rehabilitation Act.

⁹² According to the survey of Japan Small Business Research Institute conducted in 2002, over 40% of the firms with 20 or less employees have transactions with three or more financial institutions. Also, over 30 % of the firms with 101 – 300 employees have transactions with six or more financial institutions. See JAPAN SMALL BUSINESS RESEARCH INSTITUTE, WHITE PAPER ON SMALL AND MEDIUM ENTERPRISES IN JAPAN 2003: THE ROAD TO REGENERATION AND CREATION OF AN ENTREPRENEURIAL SOCIETY 145, Fig. 2-3-12 (2003), available at http://www.chusho.meti.go.jp/hakusyo/h15/download/2003haku_eng.pdf. Of course, not all of the claims of these financial institutions are secured. But the same study also reports that more than 80% of the loans to those small firms by their main banks are secured. *Id.* at 142, Fig.2-3-5. Judging from these figures, even small firms in Japan have a quite few secured creditors. Small firms in the United States also obtain secured loans from multiple creditors, according to the survey by Ronald Mann. See Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 657 (1997).

⁹³ Recent literatures analyzing bargaining among multiple parties with a non-cooperative game-theoretic model predict that bargaining may delay even under perfect information. See Hungbin Cai, *Delay in Multilateral Bargaining under Complete Information*, 93 J.ECON. THEORY 260 (2000); Hungbin Cai, *Inefficient Markov Perfect Equilibria in Multilateral Bargaining*, 22 ECON. THEORY 583 (2003). This result presents an interesting contrast with a two-party bargaining model, which predicts that bargaining will reach an agreement instantaneously. See OSBORNE & RUBINSTEIN, *supra* note 87.

Generally speaking, the Composition proceedings, which lacked any restriction on secured claims, had less petitions⁹⁴ and lower confirmation rates,⁹⁵ and took longer time from petitions to confirmation of the plans, than the Civil Rehabilitation proceedings.⁹⁶ Another is a questionnaire survey to those who had experienced in serving as Composition administrators.⁹⁷ More than 75 percent of the respondents answered that they thought some restrictions on the rights of secured creditors were needed in the Composition proceedings.⁹⁸ These evidences, though far from determinative,⁹⁹ are consistent with the hypothesis that debtors sometimes have difficulties in being reorganized if they have to negotiate with secured creditors with no legal

⁹⁴ Petitions for the Composition proceedings were, on average, about 250 each year, *see supra* note 46, while petitions for the Civil Rehabilitation proceedings were 700 - 1,000 each year, *see supra* note 44 and the accompanying text.

⁹⁵ According to the survey of the Research Group on Empirical Study of Composition Proceedings (headed by Yoshimitsu Aoyama, Professor of Tokyo University), of the 347 Composition cases filed in the eight major district courts in Japan in 1982 and 1987, 189 cases (54.5%) were confirmed, while 134 were withdrawn, 14 denied and 9 discontinued. *See* Shintaro Hayashi, *Wagi tetsuzuki no shinko* [*Progress of Composition Proceedings*], in WAGI HO NO JISSHO TEKI KENKYU [EMPIRICAL STUDIES OF THE COMPOSITION ACT] 61, 61-62 (Yoshimitsu Aoyama ed., 1988). *See also* Eisenberg & Tagashira, *supra* note 27, for summary and analysis of this survey in English. Such a confirmation rate was considerably lower than that of Civil Rehabilitation cases, *see supra* note 49 and the accompanying text.

⁹⁶ According to the empirical study on Composition cases cited in 95, *supra*, the average period of time between petition and plan confirmation was 214 days for 1982 cases and 271 days for 1987 cases. *See* Hayashi, *supra* note 95, at 64. These periods were not necessarily longer than that of Civil Rehabilitation cases (249.4 days), *see supra* note 51 and the accompanying text, but they showed a trend of delaying. Indeed, such a trend appears to have continued during 1980s and 90s, and bankruptcy-law practitioners agree that typical Civil Rehabilitation cases go substantially faster than Composition cases. *See* comment by Takashi Sonoo, a Judge of Tokyo District Court in: Makoto Ito, et.al., *Zadankai: Tokyo chisai ni okeru minji saisei tetsuzuki no jitsujo* [*Panel Discussion: Real States of Practices of Civil Rehabilitation Proceedings in Tokyo District Court*], 746 NBL 8, 15-16 (2002) (saying that Composition cases generally took one year).

⁹⁷ Composition administrators were appointed by courts and supervised the debtors' management. Many of them were lawyers practicing in business reorganizations.

⁹⁸ Toyohisa Isobe & Manabu Wagatsuma, *Wagi kanzai-nin ni taisuru ankeeto chosa no kekka* [*Results of the Questionnaire Survey to Composition Administrators*], in WAGI HO NO JISSHO TEKI KENKYU [EMPIRICAL STUDIES OF THE COMPOSITION ACT] 259, 294 (Yoshimitsu Aoyama ed., 1988).

⁹⁹ The Composition Act had long been criticized by many practitioners and scholars for many reasons, and the Civil Rehabilitation Act was enacted in order to correct these problems. *See* Anderson, *supra* note 32, at 362-63. Thus, it is not clear to what extent the better performance of the Civil Rehabilitation Act is attributed to the adoption of the procedure of extinguishing security interests. As for the questionnaire to Composition administrators, we can hardly deny the possibility that these people were sympathetic to debtors and hoped the debtors' businesses to be reorganized, whether or not such reorganization would be socially desirable.

restrictions on enforcement of secured claims. In the next section, I analyze how the procedure of extinguishing security interests in the Civil Rehabilitation Act may mitigate such difficulties.

C. Social Benefits of Extinguishing Security Interests

This section analyzes how the procedure of extinguishing security interests may enhance efficiency. The argument is basically that, by giving the debtor an option to “exit” out of the negotiation with the secured creditors just by paying the liquidation value of the collateral, this procedure can reduce the transaction costs which might otherwise arise in the negotiation between the debtor and the secured creditors. Careful analysis is needed, however, to see when and how this procedure can work in this way.¹⁰⁰

1. When and How Extinguishing Security Interests Enhances Efficiency

I conjecture that extinguishing security interests is the most beneficial when the following conditions are satisfied. First, the liquidation value of the collateral (L) is fairly certain: the debtor and the secured creditor basically agree not only on how much L is, but also on how the court would evaluate L in the appraisal proceeding.¹⁰¹ Second, the debtor has relatively accurate information on the going concern value of the collateral (G). Third, the debtor does not suffer from serious liquidity-constraint: she is able to prepare the amount of cash equal to L , even though she cannot pay full of her secured debt, which can be greater than both G and L .¹⁰²

If all the above conditions are satisfied, extinguishing security interests functions nicely.

For example, suppose that both the debtor and the secured creditor agree on L and can verify

¹⁰⁰ The analysis in this section focuses on *allocation* efficiency; that is, how the collateral is allocated for more efficient use with lower costs at the time of reorganization. Extinguishing security interests may also affect *investment* efficiency, however, which I will analyze in Part V, *infra*.

¹⁰¹ As I explained earlier, when the parties do not agree on L , it is assessed by the court based on the opinion of the court-appointed appraiser. *See supra* note 75-76 and the accompanying text.

¹⁰² I examine the reasonableness of the first two conditions later in this section. The third condition will be discussed in section IV.B, *infra*.

this value to the court, but only the debtor knows G . In this case, if the debtor values G more than L , then she will exercise her option to pay L to the secured creditor and extinguish his security interest, saving transaction costs which might arise if she had to negotiate with him under information asymmetry on G . If, on the other hand, the debtor values G less than L , then she will not exercise her option because she has no incentive to pay more than the value of the collateral for her business. In the latter case, the secured creditor will enforce his security interest and realize L . We will obtain efficient results in both cases.

Extinguishing security interests is likely to be more beneficial when the debtor has to negotiate with multiple secured creditors. For example, suppose different creditors have security interests with different ranking of priorities in the same asset. In this case, bargaining may be costly even when there is no uncertainty over either L or G , for each secured creditor may hold up the bargaining process requiring the larger share of G .¹⁰³ We can avoid such costly negotiation by giving the debtor an option to exit out of the negotiation just by paying those creditors L in total, which will be distributed according to their ranking of priorities.

For the procedure of extinguishing security interests to perform well, however, the court must be able to evaluate L in a fairly *accurate* and *foreseeable* way. If, for example, the court erroneously estimates L as \$40 though the true value of L is \$50, then the debtor who values G more than \$40 but less than \$50 will exercise her exitoption and inefficiently continue using the collateral. Besides, extinguishing security interests may work poorly if it is difficult for the parties to foresee how the court will evaluate L in the appraisal proceeding. This can happen even when the parties agree on the value of L itself. The debtor and the secured creditor naturally discussed on the value of the collateral at the time when they originally negotiated on conditions of the secured loan, so it is not surprising that they have a fairly common idea on L .

¹⁰³ See *supra* notes 92-93 and the accompanying text.

But they may still disagree on how the third party, the court, will evaluate L . Such uncertainty may make it difficult for the parties to reach an agreement, and disputes over L may have to be settled in litigation (more particularly, in the appraisal proceeding). Then the litigation costs might be higher – perhaps much higher – than the negotiation costs which would arise if the procedure of extinguishing security interests did not exist and the debtor had to negotiate with the secured creditor to avoid the foreclosure sale, like in the era of the Composition Act.¹⁰⁴

Whether and to what extent the court can estimate L in an accurate and foreseeable manner is an empirical question, which is beyond the purpose of this Article. But intuitively, it appears reasonable to assume that the parties and the court can agree on the value of L fairly easily – at least more easily than they agree on G . As I pointed out in the last section,¹⁰⁵ L is only the value of an individual asset, which is arguably easier to estimate than the value of a financially distressed firm itself, which is necessary to estimate G . Besides, in order to evaluate L , the parties and the court can often refer to a market price of the same (or, at least, similar) kinds of assets in the neighborhood.¹⁰⁶

¹⁰⁴ Bargaining under the Composition Act was likely to be costly for such reasons as uncertainty over G or multiplicity of secured creditors. *See* section III.B.1, *supra*. Still, there was no uncertainty over how the court would decide a case if the negotiation broke down and the dispute was brought to the court; that is, parties were certain that the court would permit the secured creditor to foreclose on the collateral whenever the debtor was in default. This aspect of certainty might sometimes make the negotiation costs under non-existence of the procedure of extinguishing security interests even cheaper than the negotiation costs under existence of it.

¹⁰⁵ *See supra* note 90 and the accompanying text.

¹⁰⁶ Concerning the difficulty of evaluation discussed in the text, readers may suggest one alternative solution: Why not an auction? Rather than relying on the court estimating the liquidation value of the encumbered asset, the Civil Rehabilitation Act (or any other bankruptcy regimes) could simply allow secured creditors to enforce their rights and sell the asset in the auction process and, at the same time, allow the debtor to participate in the auction. The debtor can offer the highest price and recapture the asset if, and only if, she is the person who can use the asset most efficiently (that is, if $G > L$). Such an auction regime may have its own fault, however, as was explained in section III.A.1, *supra*. One difficulty is that an auction will put the debtor's business in a very uncertain position. If the asset indispensable for the debtor's business is seized and bought by a third party in

The second important condition for the procedure of extinguishing security interests to function efficiently is that the debtor has fairly accurate information on G . If not, then this procedure may be inefficiently used: the debtor may exercise her option to extinguish security interests even when $G < L$, or fail to exercise it even when $G > L$. Still, the assumption that the debtor has good information on G – at least compared with the secured creditors and the court – also appears fairly reasonable. Through the daily management of her own business, the debtor naturally has acquired various information on the value of her business (and also G), which is difficult for others to obtain.

2. Extinguishing Security Interests As a Liability Rule

We may better appreciate the procedure of extinguishing security interests when we view

the auction process, then the debtor's business will be hopeless to continue. Such an uncertainty may well make it hard for the debtor to have business relationships with others while the auction is going on. This may well be so even if the debtor is truly the person who values the asset the most, for she will find it hard to make others believe this is the case. Thus, the value of the debtor's business may substantially diminish during the auction process.

One might find another difficulty in the auction regime; that is, the debtor in the reorganization process may be so liquidity-constrained that she cannot pay the value of the asset, even though she can use the asset more efficiently than any others. Because the Civil Rehabilitation Act now demands the debtor to make one-time payment of the value of the asset to extinguish security interests in it, however, liquidity-constraint cannot be a reason to prefer the procedure of extinguishing security interests (as is now employed) over the auction regime. Of course, we can conceive a regime that allows the debtor to make deferred payments, whose present value equals the value of the asset, and to extinguish security interests. Such a regime might cause a serious problem of evaluation, however – that is, who values the present value of deferred payments, and how? I will discuss the trade-off of liquidity-constraint and evaluation in Part IV.

So far I have supposed that, in the auction process, the encumbered assets are directly at auction. This is the case in the real auction process under laws of security interests both in Japan and in the United States. In contrast, Lucian Bebchuk and Jesse Fried propose a novel auction regime which would, they argue, solve the problems of liquidity-constraint and evaluation simultaneously. I will discuss their proposal later in this Article. *See infra* note 154.

it from a perspective of *property rules* and *liability rules*.¹⁰⁷ As is widely known, property rules protect entitlements by deterring nonconsensual taking, while liability rules compensate entitlement holders if a nonconsensual taking occurs.¹⁰⁸ Upon default of the secured debt, the secured creditor has an entitlement to foreclose on the collateral and use its proceeds to satisfy his secured claim. Such an entitlement is protected by a property rule outside the Civil Rehabilitation proceeding: in order to stop the foreclosure, the debtor must negotiate with the secured creditor and obtain his consent (unless the debtor pays the full amount of the face value of her secured debt, which, I assume, is greater than the value of the collateral). In contrast, when the debtor enters the Civil Rehabilitation proceeding, she can “take” his security interest just by paying “damages” equal to the liquidation value of the collateral, which the secured creditor would receive if he enforced his entitlement.

According to the recent economic analysis on the property rules and liability rules, one important virtue of the liability rules is to allow the court to “harness” the private information which the non-entitlement holder naturally holds.¹⁰⁹ This is what extinguishing security interests aims to do. By leaving the debtor to choose whether or not to exercise her option, we can harness the private information that the debtor has on *G*.

3. Actual Use of Extinguishing Security Interests

So far the actual use of extinguishing security interests has been rare. Of the 1225 cases filed in the thirteen main district courts from Apr. 1, 2000 to Mar. 31, 2002, courts ordered

¹⁰⁷ See Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

¹⁰⁸ See Ian Ayres & Paul M. Goldbart, *Correlated Values in the Theory of Property and Liability Rules*, 32 J.LEGAL STUD.121, 121 (2003).

¹⁰⁹ See Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713, 725 (1996). See also Richard R. W. Brooks, *The Relative Burden of Determining Property Rules and Liability Rules: Broken Elevators in the Cathedral*, 97 NW. U. L. REV. 267 (2002) (suggesting that benefits of liability rules depend on the court’s ability to estimate damages accurately).

permission of extinguishing security interests only in 10 cases (0.82%).¹¹⁰ Like in the era of the Composition Act, debtors often rely on voluntary agreements (so-called “security agreements”) with secured creditors in order to avoid foreclosure,¹¹¹ rather than apply to the courts for permission of extinguishing security interests. We should not underestimate the value of this procedure by the number of actual uses alone, however. If L is not subject to severe uncertainty and parties can agree at what price the court is likely to assess L , then they will settle a dispute by a voluntary agreement, rather than spend costs in the appraisal proceeding. The real benefit of extinguishing security interests is to set up the baseline of the voluntary negotiation and reduce transaction costs. Thanks to the exit option of the debtor, the share of the secured creditor from the negotiation is fixed to L , so the parties only have to agree on the value of L . We no longer have to worry that bargaining may be delayed either because the parties do not agree on G or because the secured creditor holds up the bargaining process in order to obtain a higher share of G .¹¹²

IV. Comparison with Cramdown in Chapter 11

This Part compares the procedure of extinguishing security interests in the Civil Rehabilitation Act with the manner of treating security interests in Chapter 11 of the U.S. Bankruptcy Act, especially with the “cramdown” procedure.¹¹³ Section A introduces the structure of Chapter 11 to the extent necessary to make a meaningful comparison with the Civil

¹¹⁰ Kosuge & Tsutsumi, *supra* note 51, at 13.

¹¹¹ For security agreements made in the era of the Composition Act, *see supra* note 88 and the accompanying text. As for the practices of security agreements in the Civil Rehabilitation Act, *see* JIGYO SAISEI KENKYU KIKO [JAPANESE ASSOCIATION OF BUSINESS RECOVERY], SAISEI KEIKAKU JIREI SHU [CASES OF REHABILITATION PLANS] 20-23 (2002).

¹¹² Alternatively, however, the small number of uses of the procedure may suggest that many debtors are so severely liquidity-constrained that they cannot use it in the first place. I will discuss on the matter of liquidity-constraint in section IV.B, *infra*.

¹¹³ *See* 11 U.S.C. §1129(b).

Rehabilitation Act.¹¹⁴ Then section B analyzes relative advantages of these two rules.

A. Secured Creditors in Chapter 11: Cramdown in Particular

1. Overview of Chapter 11 and Cramdown

Readers who are familiar with American bankruptcy law may find similarity between the procedure of extinguishing security interests on one hand, and cramdown in Chapter 11, on the other. Generally speaking, extinguishing security interests allows a debtor to “bifurcate” her secured debts into two parts: (1) the part covered by the value of the collateral and (2) the part not covered by it. The debtor has an “option” to pay just the first part and make the second part of her debt unsecured.

Under the U.S. Bankruptcy Act, bifurcation of secured claims is not only allowed but also required, according to section 506(a).¹¹⁵ For example, if a debtor owes a creditor \$150 and has collateralized one asset whose value is \$120, then the creditor’s claim is treated as a secured claim only to the extent of the value of the collateral, \$120, and the rest of his claim (\$30) is treated as an unsecured claim in the bankruptcy proceeding—aside from so-called “section 1111(b) election.”¹¹⁶ Furthermore, a Chapter 11 debtor has an option to pay just the value of the collateral (\$120) and retain it for her own business notwithstanding the objection of the secured creditor, at least in some circumstances. Cramdown can work in this way, as is described

¹¹⁴ For a concise and analytical guide to the American bankruptcy law, see DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* (3rd ed. 2001).

¹¹⁵ An allowed claim of a creditor secured by a lien on property in which the estate has an interest ... is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property, ... and is an unsecured claim to the extent that the value of such creditor’s interest ... is less than the amount of such allowed claim.

11 U.S.C. §506(a). For bifurcation, see David Gray Carlson, *Bifurcation of Undersecured Claims in Bankruptcy*, 70 AM. BANKR. L.J.1 (1996).

¹¹⁶ Things may become somewhat complicated in Chapter 11 because a secured creditor can elect to have his entire claim treated as secured, according to section 1111(b) of the Bankruptcy Act. See 11 U.S.C. §1111(b). This option to elect, however, does not protect the interest of the secured creditor as strongly as it first appears. I discuss on this election in *infra* note 126.

below.¹¹⁷

During the Chapter 11 proceeding, the debtor may file a plan of reorganization,¹¹⁸ which divides the creditors into various classes and proposes a treatment for each class. If the plan is accepted by a qualified majority voting of each impaired class,¹¹⁹ and satisfies other requirements of section 1129(a),¹²⁰ then the court must confirm the plan and terms of each claim will be modified accordingly.¹²¹ In a typical case, however, each secured creditor consists of one class by himself.¹²² Thus, the debtor usually has to rely on section 1129(b), rather than 1129(a), to obtain confirmation of the plan over the objection of any secured creditor. Section 1129(b) provides that the court must confirm the plan despite the fact that some impaired classes are against the plan, provided that several conditions are satisfied. This procedure is commonly called “cramdown.”¹²³ For a plan to be crammed down on a dissenting class, it must meet all the requirements of section 1129(a) except for paragraph (8), which requires the plan to be accepted by each impaired class. Besides, the plan must not “unfairly discriminate,” and must

¹¹⁷ Douglas Baird and Randall Picker analyzed Chapter 11 with a model of non-cooperative bargaining between the debtor and the secured creditor. *See* Baird & Picker, *supra* note 87. One difference between their analysis and mine is that they characterized the “new value exception” as an exit option of the debtor, while my analysis below characterizes cramdown as the debtor’s option, though I admit that the new value exception will increase the debtor’s availability of her option. *See infra* note 132 and the accompanying text.

¹¹⁸ *See* 11 U.S.C. §1121(a).

¹¹⁹ A class of claims is deemed to accept the plan if the plan is accepted by at least two-thirds in amount and more than one-half in number of the claims of the class. *See* 11 U.S.C. §1126(c).

¹²⁰ *See* 11 U.S.C. §1129(a).

¹²¹ *See* 11 U.S.C. §1141.

¹²² To be classified into the same class, claims must be “substantially similar.” *See* 11 U.S.C. §1122(a). If creditors have liens on different assets, or, have liens on the same asset but with different ranking of priorities, their claims are generally deemed not substantially similar and must be classified into separate classes. *See* 7 COLLIER ON BANKRUPTCY ¶ 1122.03[4][c] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. Rev. 2004) (citing cases).

¹²³ For cramdown in general, *see* 7 COLLIER ON BANKRUPTCY, *supra* note 122, ¶¶ 1129.04-06; Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979). For cramdown on secured creditors, *see* Charles D. Booth, *The Cramdown on Secured Creditors: An Impetus Toward Settlement*, 60 AM. BANKR. L.J. 69 (1986); Jack Friedman, *What Courts Do to Secured Creditors in Chapter 11 Cram Down*, 14 CARDOZO L. REV. 1496 (1993).

be “fair and equitable,” with respect to each dissenting class.¹²⁴ Section 1129(b)(2)(A) provides specific requirements the plan must meet to be “fair and equitable” to a dissenting class of holders of secured claims. Using the example in the last paragraph, if the debtor wants to retain the collateral over the objection of the secured creditor, the plan must, in principle,¹²⁵ (1) retain the lien securing the allowed secured claim and (2) promise the secured creditor the deferred payments whose value is at least equal to the value of the collateral, that is, \$120.¹²⁶

2. Some Complication Concerning Debtors’ Availability of Cramdown Options

In fact, there is some uncertainty about the availability of cramdown as an ext option of the debtor. This is because, while a debtor in the Civil Rehabilitation Act can apply for extinguishing security interests in her own decision at any time before the end of the proceeding, a Chapter 11 debtor can ask for cramdown at the stage of confirmation of the plan only if all the requirements of section 1129(b) are satisfied. Among others, the plan must be accepted by at least one impaired class, without including any acceptance by any insider.¹²⁷ In some circumstances, this requirement may give some secured creditors an effective veto power against cramdown.

¹²⁴ See 11 U.S.C. §1129(b)(1).

¹²⁵ Alternatively, the plan must provide for realization by the secured creditor the “indubitable equivalent” of his secured claim. See 11 U.S.C. §1129(b)(2)(A)(iii).

¹²⁶ See 11 U.S.C. §1129(b)(2)(A)(i)(II) (requiring that each holder of the secured claim receive “deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property”).

In addition, if the secured creditor has made a “section 1111(b) election,” see *supra* note 116, such deferred payments must also total at least \$150 in our example. The latter requirement is only *nominal*, however, not in a sense of present value. For example, a plan promising to pay the secured creditor \$10 for 15 years satisfies this requirement. Furthermore, if the secured creditor makes section 1111(b) election, he can no longer make a claim as an unsecured creditor for the deficiency (\$30). Overall, making the section 1111(b) election is not necessarily advantageous for secured creditors. As for the circumstances where the secured creditors find such election meritorious, see JAMES J. WHITE & RAYMOND T. NIMMER, *CASES AND MATERIALS ON BANKRUPTCY* 573-74 (1996); Theodore Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 VAND. L. REV. 931, 934-40 (1985).

¹²⁷ See 11 U.S.C. §1129(a)(10)&(b)(1). For definition of an insider, see 11 U.S.C. §101(31).

For instance, suppose a corporate debtor has (1) one secured creditor having a claim of \$150 secured by some property worth \$120, (2) many unsecured creditors whose total claims amount to \$20, and (3) one shareholder who is also a manager (thus an insider). No other claim/interest-holders exist in the debtor corporation. In this case, the secured creditor's allowed secured claim is \$120, which consists of one class by himself, and his deficiency claim, \$30, becomes an unsecured claim. If the court requires this deficiency claim to be classified into the same class as other unsecured claims (as a number of Circuit Courts do¹²⁸), then the deficiency claim consists of the majority of the class of unsecured creditors. Consequently, if the secured creditor objects to the plan, both as a holder of an allowed secured claim and as a holder of an unsecured (deficiency) claim, then the plan won't be accepted by any class other than the insider's class (i.e., the owner-manager). Thus, cramdown is not available.

Cramdown may be available even in the above example if the plan can classify the deficiency claim into a different class from the class of other unsecured creditors. Indeed, the Seventh Circuit Court not only allows but also *requires* such separate classification,¹²⁹ at least when a secured loan was originally made without recourse and the deficiency claim is created by section 1111(b)(1).¹³⁰ If the deficiency claim is treated in this way, the debtor (or, more accurately, the debtor's owner-manager) has a chance to obtain acceptance of the plan by the class of unsecured creditors (other than the deficiency-claim-holder). Even in this case, however, the secured creditor will reject the plan as a holder of the deficiency claim (which now consist of one class by himself), and then, section 1129 (b)(2)(B) – the absolute priority rule – will

¹²⁸ See, e.g., *Barakat v. Life Insurance Company of Virginia (In re Barakat)*, 99 F.3d 1520, 1525 (9th Cir. 1996) (citing cases); *Lumber Exchange Bldg. Ltd. Partnership v. Mutual Life Ins. Co. of New York (In re Luber Exchange Bldg. Ltd)*, 968 F.2d 647, 649 (8th Cir. 1992).

¹²⁹ See *In re Woodbrook Assocs.*, 19 F.3d 312 (7th Cir. 1994).

¹³⁰ In Chapter 11, a secured creditor is treated as if he had recourse against the debtor even when the secured loan was made without recourse. See 11 U.S.C. §1111(b)(1)(A). For details of inclusion of this apparently peculiar provision into the statute and critical analysis of it, see Eisenberg, *supra* note 126.

stand before the debtor's owner-manager as an obstacle to cramdown.¹³¹ Because the class of the deficiency claim rejects the plan, the plan must provide that the holder of the deficiency claim receive the value at least equal to the allowed amount of such a claim (\$30, in our example). Otherwise, the absolute priority rule prohibits the holder of any junior claim or interest (the owner-manager, in our example) from receiving or retaining, on account of such junior claim or interest, any property. Such requirement can be a heavy burden to the debtor (or the debtor's owner-manager) pursuing confirmation.¹³²

Although cramdown may not be available in such circumstances as described above, it can still work as an exit option of the debtor against secured creditors in other situations. In one case, the face value of the claim of the secured creditor may not exceed the value of the collateral, so no deficiency claim may arise.¹³³ In another case, the amount of the deficiency claim may be small and consist of only a minority of the class of unsecured creditors (assuming the deficiency claim is classified into the same class as other unsecured creditors). In such cases, the plan may be accepted by the class of unsecured creditors, so no violation of the absolute priority rule may arise. Thus, the plan can be crammed down on the secured creditor if the requirements of section 1129(b)(2)(A), which generally requires to give the secured creditor the value of the

¹³¹ See 11 U.S.C. §1129(b)(2)(B). For the absolute priority rule, see 7 COLLIER ON BANKRUPTCY, *supra* note 122, ¶ 1129.04 [4].

¹³² One additional complication remains. There has been a long-standing debate whether, in spite of the absolute priority rule, the equity holder (the owner-manager in our example) can retain the interest by providing the property whose value is equal to the value of the equity of the reorganized business (the "new value" exception). In *Bank of America National v. 203 North LaSalle Street Partnership*, the U.S. Supreme Court denied the confirmation of the plan which vested equity in the reorganization business to the equity holder "without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan." 526 U.S. 434, 454 (1999). It is not clear whether or to what extent this decision has denied the new value exception. Compare 7 COLLIER ON BANKRUPTCY, *supra* note 122, ¶ 1129.04 [4][c][iv][E], at 1129-137 ("[p]ractice in the wake of *203 North LaSalle* has been uncertain... Lawyers for new value proponents will likely argue that simply terminating plan proposal exclusivity under section 1121 should be sufficient, in that this would expose the debtor to the market, and cause any interest to manifest itself in competing plans") with Barry E. Adler & George G. Triantis, *The Aftermath of North LaSalle Street*, 70 U. CIN. L. REV. 1225 (2002) (proposing extended use of the market test suggested by the Supreme Court).

¹³³ See, e.g., *In re Monnier Bros.*, 755 F.2d 1336 (8th Cir. 1985).

collateral, are satisfied.

B. Analysis of Relative Advantages of the Two Procedures

As was discussed in the last section, Chapter 11 and the Civil Rehabilitation Act have common aspects: they both give the debtor an “option” to retain a property necessary for her business notwithstanding the objection of the creditors who have security interests in it, basically by paying the value of such property. Still, there exists one important difference between the two regimes. *While the Civil Rehabilitation Act requires the debtor to make one-time payment of the collateral in order to extinguish security interests,*¹³⁴ *Chapter 11 allows the debtor to make deferred payments for cramdown.*¹³⁵ This section analyzes the relative advantages of these two rules.¹³⁶

1. Difficulty of the Civil Rehabilitation Act: the Debtor’s Liquidity-Constraint

To talk about the potential problem of the Civil Rehabilitation Act first, its requirement of one-time payment may make it too difficult for debtors to exercise their options because they are typically liquidity-constrained.¹³⁷ Of course, a debtor in liquidity-constraint will try to obtain a loan, and in so doing, she can collateralize the very property the security interests in which she tries to extinguish. Still, it may be difficult for the debtor to borrow the amount of

¹³⁴ See section II.C.2, *supra*.

¹³⁵ See *supra* note 126 and the accompanying text.

¹³⁶ Still another difference between the two procedures may exist; that is, the methods of evaluating the collateral appear different. See *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997) (holding that, in a Chapter 13 cramdown case, the collateral should be valued at its replacement cost, not its foreclosure value).

¹³⁷ Some practitioners in Japan have mentioned such difficulty. See, e. g., JAPANESE ASSOCIATION OF BUSINESS RECOVERY, *supra* note 111, at 20 (“Since the debtor must prepare the cash which amounts to the value of the collateral, it seems practically difficult for the debtor to use [the procedure of extinguishing security interests], except for the case where there appear sponsors for the debtor”) (translated by the Author). Lucian Bebchuk and Jesse Fried also view the debtor’s liquidity constraint as an important obstacle for the debtor to make a bargain with the secured creditors. See *Bebchuk & Fried*, *supra* note 85, at 2424-25.

money equal to 100% of the value of the property. The debtor may pledge other assets she owns as collateral, but doing so is also difficult if most of her assets have already been encumbered.¹³⁸

Theoretically speaking, as long as the going concern value of the collateral exceeds its liquidation value ($G > L$), it is possible for the debtor to promise a positive expected return to the creditor lending L and, at the same time, to promise all the existing creditors more returns than what they would receive if the debtor failed to obtain a loan and let the collateral be seized and sold at auction.¹³⁹ In reality, however, it is likely that G is uncertain and the debtor has private information on it. Such information asymmetry, which makes bargaining between the debtor and the secured creditors costly,¹⁴⁰ may also prevent the debtor from obtaining a loan. Overall, we cannot deny the possibility that the debtor fails to prepare the amount of cash enough to extinguish security interests.

Cramdown in Chapter 11 may mitigate the problem of liquidity-constraint by allowing the debtor to make deferred payments of the value of the collateral. We must consider carefully, however, whether addressing the problem of liquidity-constraint by this way is truly a better policy.

2. Problems of Chapter 11: Difficulty of Evaluation by the Court

A difficulty of Chapter 11 is that it requires the court to determine much more complicated

¹³⁸ Law of DIP (debtor-in-possession) financing can also affect the debtor's ability to obtain a loan. A loan to the debtor in the Civil Rehabilitation proceeding becomes a "claim of common benefits (*kyoeki saiken*)" and enjoys priority over unsecured claims. See CRA §§119(v) & 120. Common benefits claims will receive a ranking after secured claims, however. See Anderson, *supra* note 32, at 387-88. In contrast to the American law, see 11 U.S.C. §364(d), the Civil Rehabilitation Act has no procedure to authorize the debtor to issue debt secured by an equal or senior lien on already encumbered assets. Some commentators propose that Japanese reorganization law should also have such a procedure. See, e.g., Shinjiro Takagi, *Kinmirai no tosan jittai ho [Bankruptcy Law in the Near Future]*, 745 NBL 9, 17 (2002). Making it easier for the debtor to obtain secured loans may be problematic, however, because the debtor may have distorted incentives to borrow and invest in a too risky business at the costs of existing creditors. See George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901 (1993).

¹³⁹ This is another application of Coase Theorem. See *supra* note 87.

¹⁴⁰ See section III.B.1, *supra*.

matters than the Civil Rehabilitation Act does. In the procedure of extinguishing security interests, the court only has to estimate the value of the collateral. In cramdown, on the other hand, the court has to estimate not only the value of the collateral but also the value of deferred payments. In order to do so, the court must first examine the reasonableness of the plan's prospects of future revenues and costs, and determine whether the debtor is likely to earn enough amounts of cash to make such payments as promised in the plan (determination of the plan's "feasibility").¹⁴¹ Some courts make relatively strict reviews on these matters,¹⁴² while others easily accept the prospects offered by debtors.¹⁴³ Anyway, such reviews are clearly difficult and subject to quite a few errors.

After examining feasibility of the plan, the court must further determine proper interest rates ("cramdown rates") by which to discount the deferred payments in order to estimate the present value of those payments.¹⁴⁴ Speaking in an abstract way, the court should determine the rate which a creditor "would charge, at the time of the effective date of the plans, for a loan of similar character, amount and duration."¹⁴⁵ But to say so is much easier than to do so in practice.

¹⁴¹ See 11 U.S.C. §1129(a)(11) (confirmation of the plan must be denied if it is not feasible; that is, if it is likely to be followed by the liquidation or the need of further reorganization).

¹⁴² See, e.g., *In re Edgewater Motel, Inc.*, 85 B.R. 989 (Bankr. E.D. Tenn. 1988); *In re Landmark at Plaza Park, Ltd.*, 7 B.R. 653 (Bankr. D. N.J. 1980)

¹⁴³ See, e.g., *In re Orfa Corp.*, 129 B.R. 404 (Bankr. E.D. Pa. 1991); *In re Guilford Telecasters, Inc.*, 128 B.R. 622 (Bankr. M.D. N.C. 1991); *In re Computer Optics, Inc.*, 126 B.R. 664 (Bankr. D. N.H. 1991)

¹⁴⁴ As for legal issues concerning the cramdown rates, see 7 COLLIER ON BANKRUPTCY, *supra* note 122, ¶ 1129.06[1][c]; David G. Epstein, *Don't Go and Do Something Rash About Cram Down Interest Rates*, 49 ALA. L. REV. 435 (1998); Hon. John K. Pearson et al., *Ending the Judicial Snipe Hunt: The Search for the Cramdown Interest Rate*, 4 AM. BANKRT. INST. L. REV. 35 (1996).

¹⁴⁵ *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 70 (3d Cir. 1993). This approach in determining cramdown rates is called the "forced-loan" approach, and has been accepted by the majority of Circuit Courts. See the literatures cited in note 144. In a recent Chapter 13 cramdown case, however, the Supreme Court of the United States explicitly rejected the forced-loan approach and instead accepted the "formula" approach, which employs the national prime rate as a base rate and adjusts it to account for the greater nonpayment risk that bankrupt debtors pose. See *Till v. SCS Credit Corp.*, 541 U.S. 465, 477-80 (2004). Nevertheless, this decision appears significantly

The court might be able to refer to the current rates in a market of a similar loan if such a market really exists. In fact, courts often state that no market exists for a loan to reorganizing firms like the debtor with such terms as provided in the plan.¹⁴⁶ In one sense, it is no wonder that courts cannot find such a market; for, if the debtor were able to obtain a loan in such a market, she would simply obtain it and make one-time payment to the secured creditor objecting the plan. So no disputes concerning the value of deferred payments would arise. The fact that the debtor tries to force the term of deferred payments on the objecting secured creditor strongly implies that she cannot obtain a similar loan in the market.

Anyway, courts do not reject confirmation of the plan simply because they do not find proper market rates. Instead, they refer to publicly available interest rates, such as prime rates or rates of the U.S. Treasury Bills, to which they add some risk premium, usually 1 - 3%, and manage to construct cramdown rates.¹⁴⁷ Courts rarely fully analyze, however, how they find a particular risk premium to be appropriate for a particular debtor's business.¹⁴⁸ Determining an

influenced by the belief of the plurality of the Court that subprime auto-loan markets are neither competitive nor efficient, *see id.* at 481-83, so it is questionable whether the decision will be applied to a typical business reorganization case under Chapter 11, in which we can assume that relatively competitive loan markets exist. *See* Daniel J. Carragher, *What the Supreme Court's Prime Plus Ruling Means for Chapter 11*, 23-6 AM. BANKR. INST. J. 26 (July/Aug. 2004); Ronald F. Greenspan & Cynthia Nelson, *"UnTill" We Meet Again: Why the Till Decision Might Not Be the Last Word on Cramdown Interest Rates*, 23-10 AM. BANKR. INST. J. 48 (Dec. 2004/ Jan. 2005). I do not have to specifically examine this debate, anyway. Suffice it to say that determining a proper interest rate in cramdown context is so controversial that courts do not agree even on the basic policy on how to determine it.

¹⁴⁶ *See, e.g., In re Computer Optics, Inc.*, 126 B.R. 664, 672 (Bankr. D. N.H. 1991) ; *In re Aztec*, 107 B.R. 585, 588 (Bankr. M.D. Tenn. 1989).

¹⁴⁷ *See, e.g., In re Guilford Telecasters, Inc.*, 128 B.R. 622, 626 (Bankr. M.D. N.C. 1991); *In re Crane Auto., Inc.*, 88 B.R. 81, 85 (Bankr. W.D. Pa. 1988); *In re Aztec Co.*, 107 B.R. 585, 588 (Bankr. M.D. Tenn. 1989).

¹⁴⁸ *See* Friedman, *supra* note 123, at 1519-20 ("courts rarely fully analyze the proper components of the market rate, whether the components should be the costs of funds, administrative costs, profit, risk, or others").

appropriate cramdown rate by the court is a highly uncertain estimation, if not an utter guesswork.

By relying on cramdown, the debtor may be able to retain the collateral, and perhaps also retain her own business, even when she can obtain neither consents of secured creditors nor a loan in the market. In this sense, cramdown is characterized as a way for the court to save the debtor's business which has not passed the "test" of the market. Whether such an intervention of the court is socially beneficial needs a serious consideration. Certainly, markets may not function well in providing finance to reorganizing firms, especially when there is asymmetric information on the firm's value. But if the firm's value is not observable by the market players, it is difficult for the court to observe it, too. And if, on reverse, the court can (at least partially) observe the information on the firm's value, then it is hard to see why the market players cannot observe it. Because evaluating assets and businesses is one of typical business decisions, it is likely that market players have more incentives and ability in it than the courts.¹⁴⁹ Thus, when the debtor cannot persuade market players to finance the value of the collateral, it is dubious whether the intervention of the court will improve efficiency. Such intervention may well help inefficient businesses to survive, either by recognizing feasibility too easily or by setting cramdown rates too low. It may also encourage many debtors, whose businesses are not worth continuing, to petition for reorganization and impose costs of delay on creditors.¹⁵⁰ The large number of petitions¹⁵¹ and low success rates of reorganization¹⁵² of Chapter 11, compared with

¹⁴⁹ See Rasmussen & Skeel, *supra* note 90, at 93.

¹⁵⁰ Chapter 11 has long been criticized as imposing costly delay on creditors. See, e.g., Lynn M. LoPucki, *The Debtor in Full Control – System Failure under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 99 (*First Installment*), 247 (*Second Installment*) (1983) (cases of small businesses); Lawrence A. Weiss, *The Bankruptcy Code and Violations of Absolute Priority*, 4 J. APPL. CORP. FIN. 71 (1991) (cases of publicly held corporations).

¹⁵¹ See *supra* note 45 for recent number of filings.

¹⁵² See *supra* note 50 for confirmation rates and *supra* note 59 for consummation rates.

those of the Civil Rehabilitation Act,¹⁵³ suggest that the problems of Chapter 11 described above are really serious.

Considering difficulty created by permitting the debtor to make deferred payments, a good policy reason seems to exist for the Civil Rehabilitation Act to insist on one-time payment to extinguish security interests, even though such requirement may sometimes cause inefficient foreclosure sales, and therefore inefficient liquidation of the debtors' businesses, because of the debtors' liquidity constraint.¹⁵⁴

¹⁵³ See *supra* notes 44-59 and accompanying texts for comparison of the performances of Chapter 11 with that of the Civil Rehabilitation Act.

¹⁵⁴ Lucian Bebchuk and Jesse Fried proposed a novel auction regime which would, they argue, solve problems of both liquidity-constraint and evaluation of the collateral simultaneously. See Bebchuk & Fried, *supra* note 85. In contrast to ordinary foreclosure, what is sold at auction in their proposal is not collateral but a nonrecourse note with a face amount equal to the secured creditor's claim, backed by the asset serving as the creditor's collateral. Their auction scheme consists of three stages. In the first stage, which takes place shortly before the end of the bankruptcy proceeding, the nonrecourse note is sold at auction, and the proceeds from the auction will be used to pay off the corresponding secured claim. If the proceed is less than satisfy the full amount of the creditor's claim, the remainder of his claim becomes an unsecured claim. The second stage is completion of the bankruptcy proceeding, where the bankruptcy pie is divided and distributed to unsecured creditors and equity-holders. Such distribution can take place either in the present bankruptcy regime (i.e., in Chapter 11) or in recently proposed market-based mechanisms, such as an auction or option scheme. For market-based mechanisms, see section VI.A, *infra*. In the third and final stage, the debtor who has emerged from reorganization negotiates with the holders of the nonrecourse notes, who bought such notes at auction in the first stage, in order to resolve the notes. In the opinion of Bebchuk and Fried, the only obstacle for the debtor to reach an efficient agreement with the secured creditors is liquidity-constraint of the debtor. See *id.*, at 2396. Since the debtor has undergone reorganization, Bebchuk and Fried argue, the debtor should generally be solvent. See *id.* at 2423. Thus, the debtor and the noteholders will reach an efficient agreement in the third stage; that is, the debtor will retain the collateral if and only if she values it the most (or, in the terminology of this Article, if and only if $G > L$). Otherwise the collateral will be seized and bought at auction by a person who values it the most.

Several considerations put it into doubt whether their proposal would work well in practice, however. First, if liquidity-constraint is such a serious problem as Bebchuk and Fried are concerned, it is suspicious whether this problem will be solved even in the third stage. In particular, small firms often depend on secured loans from banks for their financial need. See *id.* at 2389 n.1 (introducing the survey which shows almost 80% of total volume of small business loans was secured). Such debtors may well still owe significant amount of (secured) debts and suffer liquidity-constraint even after they resolve their unsecured debts in reorganization.

Second, although Bebchuk and Fried consider the debtor's liquidity-constraint as the only obstacle in the negotiation between the debtor and the secured creditors, other factors, such as information asymmetry over the going concern value of the collateral or the hold-up of multiple secured creditors asking for larger share of the going concern surplus, may also prevent the parties from bargaining smoothly, as was discussed in section III.B.1, *supra*. These problems will remain even in the third stage, and make it difficult for the debtor and the secured creditors to reach an

V. Ex Ante Effects of Extinguishing Security Interests

So far I have analyzed social benefits of the procedure of extinguishing security interests from a perspective of *allocation* efficiency at the time of reorganization, that is, how this procedure can work in allocating an encumbered asset to more efficient use with less transaction costs. The procedure of extinguishing security interests may also affect *investment* efficiency, however; that is, a debtor's incentive to invest before reorganization may also be changed. We cannot appreciate net social benefits of this procedure unless we examine the latter effect.

Since the procedure of extinguishing security interests gives a debtor an option to recapture the collateral just by paying its liquidation value, it tends to reduce the return of secured credit in bankruptcy. In particular, consider a case where the going concern value of the collateral exceeds its liquidation value ($G > L$). If the procedure of extinguishing security interests did not

efficient agreement.

The third difficulty of their proposal concerns the second stage, especially if the distribution of the bankruptcy pie takes place in the present Chapter 11 proceeding. In such a scheme, a plan is presented to unsecured creditors and equity-holders for their approval or rejection. But holders of nonrecourse secured notes do not participate in this resolution; they are supposed to negotiate with the debtor *after* the bankruptcy resolution. Thus, unsecured creditors and equity-holders have to decide whether or not to approve the plan with no idea whether, after the resolution, holders of secured notes will also reach an accommodation with the debtor. This puts unsecured creditors and equity-holders into a very uncertain position. For example, if unsecured creditors approve the plan to cut their claims, but later (in the third stage) holders of secured notes foreclose on the assets, forcing the debtor's business to liquidate, then the return of unsecured creditors in liquidation will decrease because of their concession that turns out to be a meaningless sacrifice. Such an uncertainty makes it hard for unsecured creditors and equity-holders to judge the merits of the plan. Also, courts may well find it difficult to evaluate the plan's feasibility, which is necessary for confirmation of the plan. *See* 11 U.S.C. §1129(a)(11).

Under the Civil Rehabilitation Act, secured creditors are legally "separated" from the Civil Rehabilitation proceeding. *See supra* note 60 and the accompanying text. Since successful reorganization often turns on accommodation of secured creditors, however, courts usually recommend debtors to make concessions (so called "security agreements," *see supra* note 111 and the accompanying text) with the secured creditors before the plans are presented for approval of the unsecured creditors. *See* comment by Koji Mori, Judge of Osaka District Court, in: Yoichiro Komatsu et.al., *Zadankai: Saikin no Osaka Chisai no tosan jitsumu nit suite [Panel Discussion: On Recent Bankruptcy Practices in the Osaka District Court]*, 605 GINKO HOMU-21 6, 17-18 (2002). Under Bebchuk and Fried's proposal, in contrast, the debtor has not even begun negotiation with the secured creditors by the time the plan is presented to unsecured creditors for resolution. Such a scheme will make it hard for the plan to obtain consent of unsecured creditors, so even a debtor who has a strong prospect of reorganization may be forced into liquidation.

exist and the secured creditor were able to enforce his lien, then the debtor would have to bargain with the secured creditor in order to obtain his consent to stop foreclose. In compensation for his consent, the secured creditor could obtain L at minimum (if not, he would quit the negotiation and foreclose), and also some share of the going concern surplus ($G - L$).¹⁵⁵ In contrast, when the procedure of extinguishing security interests does exit, the secured creditor only receives L and has his security interest extinguished. Such reduction of the return of secured credit is, by itself, only a matter of transfer of income; to the extent the return of the secured creditor decreases, the joint returns of the unsecured creditors and the debtor's equity holders will increase. As has already been discussed in literatures, however, the priority of secured credit is likely to create some social benefits.¹⁵⁶ Thus, to the extent of curtailing such priority, the procedure of extinguishing security interests may diminish net social benefits. Instead of making a complete list of social benefits of secured credit that might be affected by this procedure,¹⁵⁷ this Part focuses on one social benefit which seems most relevant in this context: *preventing over-borrowing/ over-investment by the debtor*. Section A illustrates how the procedure of extinguishing security interests may diminish the benefit of secured credit and distort the debtor's incentive to borrow and make an investment. Section B discusses on the trade-off between the allocation (*ex post*) efficiency and investment (*ex ante*) efficiency.

¹⁵⁵ See *supra* note 86 and the accompanying text.

¹⁵⁶ See e.g., Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities among Creditors*, 88 YALE L.J. 1143 (1979); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Mann, *supra* note 92; Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J. 1 (1997); Clifford W. Smith, Jr. & Jerold B. Warner, *Bankruptcy, Secured Debt, and Optimal Capital Structure: Comment*, 34 J.FIN. 247 (1979); Rene M. Stulz & Herb Johnson, *An Analysis of Secured Debt*, 14 J. FIN. ECON. 501 (1985); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984). *But see* Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981) (arguing that social benefits of secured credit are not clear); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of the Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996) (suggesting that full priority of secured claims may cause excessive use of secured credit).

¹⁵⁷ For a variety of possible social benefits of security interests, see the literatures cited in note 156.

A. Ex Ante Effect of Extinguishing Security Interests: Problems of Debtors'

Over-borrowing and Over-Investment

1. Problems of Debtors' Over-borrowing and Over-investment and How Secured

Loan Can Mitigate Them

Once a debtor borrows money, the interests of the debtor sometimes diverge from those of creditors. Such diversion of interests creates a variety of agency problems.¹⁵⁸ One of these problems recognized by preceding literatures is that the debtor may have an incentive to newly borrow and invest in an overly risky (and inefficient) business at the expense of existing creditors.¹⁵⁹

Let me explain this point by a simple example (see Figure 1 below). Suppose now (at $t = 1$) the debtor owns a property, X, which is worth \$100. For now, I assume both the going concern value and the liquidation value of X are \$100. (This assumption will be changed later). The debtor owes \$100 to one creditor, C1, and does not have any other assets or debts. If the debtor just keeps operating her business and sees the maturity date of C1's claim to come (at $t = 2$), C1 will collect his entire claim from the value of X and the debtor will receive nothing. Suppose, however, that the debtor has an opportunity to invest in expanding her business at $t = 1$. This investment costs \$200, and its chance of success or failure is 50-50. The debtor's business will earn \$210 in case of success, and \$170 in case of failure, at $t = 2$. The value of X will remain \$100 in either case. For simplicity, I assume that all the parties are risk-neutral and do not have time preferences (\$1 at $t = 1$ has a value equal to \$1 at $t = 2$). I also assume that the finance market is competitive. These assumptions mean that the debtor can borrow \$200 at $t = 1$ if and only if she can promise a new lender (say, C2) an expected gross return of \$200.

¹⁵⁸ See, e.g., Triantis, *supra* note 156, at 234-38, for a list of agency problems.

¹⁵⁹ See Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J.FIN. ECON. 147 (1977).

[INSERT Figure 1 ABOUT HERE]

In this example, the net present value of the investment is negative ($\$.5 \times 220 + .5 \times 170 - 200 = -\5), so the debtor should not borrow and invest. The debtor has an incentive to do so, however, if C1's claim is unsecured. In this case, the debtor can borrow \$200 at $t = 1$ from C2 with an interest rate $r = .0778$. This interest rate makes sure that C2 will earn the expected gross return of \$200 and the debtor will earn a positive profit. To see this, suppose the debtor borrows from C2 at this rate and invests. If the debtor's business succeeds at $t = 2$, its total value will be \$320 (\$220 plus the value of X, \$100). The debtor will pay \$100 to C1 and $\$200 \times (1 + .0778) = \215.56 to C2, and retain \$4.44 for her own. If, on the other hand, the debtor's business fails at $t = 2$, then the debtor will be insolvent (the value of the debtor's entire business will be $\$100 + 170 = \270 , which is less than the total amount of debts, $\$100 + 215.56 = \315.56), and the two creditors will divide the value of the debtor's business pro rata in proportion to the face values of their claims. Thus, C1 will receive $\$270 \times 100 / (100 + 215.56) = \85.56 , and C2 will receive $\$270 \times 215.56 / (100 + 215.56) = \184.44 . Consequently, C2's expected (gross) return of lending is $\$.5 \times 215.56 + \$.5 \times 184.44 = \$200$, so the debtor can borrow \$200 from C2 at $t = 1$. Since the debtor expects a positive profit (she will obtain \$4.44 in case of success and \$0 in case of failure), she has an incentive to borrow and invest at the expense of C1 (see Table 2).¹⁶⁰

[INSERT TABLE 2 ABOUT HERE]

Preceding literatures have already mentioned that such an over-borrowing/ over-investment problem can be mitigated by making the original debt secured.¹⁶¹ In the above example, suppose C1's claim has already been secured by X at $t = 1$. Then C2 can no longer expect to

¹⁶⁰ In fact, C1 gets hurt even when the investment at $t = 1$ is efficient (for instance, when the probability of success is 80%), as long as the new borrowing and investment subjects C1's claim to the risk of default. But if this is the only problem, C1 can be compensated in advance by requiring a higher interest rate at the time of lending. There is no merit to make C1's claim secured and discourage the debtor from newly borrowing and investing in an efficient business.

¹⁶¹ See Mann, *supra* note 92, at 641-43; Mann, *supra* note 156, at 25-26; Triantis, *supra* note 156, at 248.

collect his claim from the value of X, and must rely solely on the return from the new investment. But the expected return of this investment is only \$195, so the debtor cannot borrow from C2 and invest.¹⁶²

2. How Extinguishing Security Interests May Diminish Benefit of Secured Credit

Problems may arise, however, when assets subject to security interests have low liquidation values. Some types of assets tend to have very low liquidation values compared with their going concern values. For example, machinery sometimes has only a thin secondary market, so its liquidation value decreases drastically once it has been equipped.¹⁶³ Inventory is also sold at a very low price when it is sold in liquidation.¹⁶⁴

Now change the assumption in the above example and suppose that the liquidation value of X is \$0 while its going concern value is \$100. Even in this case, C1's security interest in X may have some value *if* the procedure of extinguishing security interests does *not* exist. This is because, without this procedure, the debtor must bargain with C1 to redeem X when she is in default at $t = 2$, and through such bargaining, C1 may be able to enjoy some share of the going concern value of X. If C1's bargaining power at $t = 2$ is expected to be sufficiently strong, the debtor's borrowing and investment at $t = 1$ may be prevented. In particular, suppose that both

¹⁶² Instead of using secured credit, the debtor's over-borrowing (and over-investment) may also be prevented by including covenants in the loan contract between the debtor and C1. For instance, the covenant can require the debtor to obtain consent of C1 before borrowing. Such covenants, however, may not be effective because of their enforcement costs. Unlike security interests, covenants do not have an effect to make C1's claim superior to C2's claim when the debtor borrows from C2 in violation of the covenants. Thus, C1 has to monitor the debtor to see whether the debtor secretly borrows at $t = 1$. Because monitoring is costly, C1 may not be able to prevent the debtor from borrowing and investing. *See* Mann, *supra* note 92, at 643.

¹⁶³ *See* Shinjiro Takagi, *Saimu chousei tetsuzuki (kasho) ni okeru tanpoken shometsu seikyū no ranyo boshi saku* [*Proposals to Prevent Abuses of Extinguishing Security Interests in the New Debt Arrangement Proceeding (Temporary Name)*], 563 GINKO HOMU-21 35, 39 (1999).

¹⁶⁴ *See* CHIKAHIKO SODA, KAISHA KOSEI TETSUZUKI NO SHIN TENKAI: KYU NIHON RIISU SAIKEI NO HORI TO JISSAI [NEW DEVELOPMENT OF CORPORATE REORGANIZATION PROCEEDINGS: LAW AND PRACTICES IN REORGANIZATION OF FORMER NIHON LEASE, CORP.] 181 (2000). Inventory and equipment are often sold at very low prices in foreclosures sales in the United States, too. *See* Mann, *supra* note 156, at 15-16.

the debtor and C2 expect, at $t = 1$, that if the debtor is in default at $t = 2$ and has to bargain with C1 to redeem X, she will have to pay more than \$90 to C1. In this case, if C2 lends the debtor \$200 at $t = 1$, he can receive less than \$180 when the debtor's business fails.¹⁶⁵ Thus, to assure C2 the expected return of \$200, the debtor has to promise C2 to pay more than \$220 when the business succeeds. But if so, the debtor will be insolvent even when the business succeeds at $t = 2$,¹⁶⁶ so she cannot expect a positive return from the investment at $t = 1$. Consequently, the debtor has no incentive to borrow and invest at $t = 1$.

The above result will be changed if there exists the procedure of extinguishing security interests. In this case, when the debtor's business fails at $t = 2$, the debtor can extinguish C1's interest just by paying the liquidation value of X, that is, \$0. And C1 will make a claim of \$100 as an unsecured creditor. This result is exactly the same as the case where C1's claim is not secured in the first place. Consequently, as was mentioned above (see Table 2, above), the debtor can borrow \$200 from C2 at an interest rate $r = .0778$ and invest in the inefficient expansion of her business.

In sum, this example illustrates that curtailing the priority of secured claims by the procedure of extinguishing security interests may have an undesirable *ex ante* effects, in that the debtor may have an incentive to borrow and invest in an overly risky (and inefficient) business at the expense of existing secured creditors. Furthermore, such a problem of over-borrowing/over-investment by the debtor may create the problem of *under-borrowing/under-investment* in a still earlier period of time. Let me explain this point by the above example. Suppose the debtor tries to borrow from C1 and invest in X at $t = 0$.¹⁶⁷ If

¹⁶⁵ In case of failure, the debtor's business will earn \$170. In addition to this return, the debtor will redeem X worth \$100 by paying C1 higher than \$90. Thus, the value of the debtor's business will not exceed \$180.

¹⁶⁶ The value of the debtor's business in case of success will be \$320, and she owes \$100 to C1. Thus, if the debtor promises C2 to pay more than \$220, she will be insolvent at $t = 2$.

¹⁶⁷ For simplicity, I assume there is no uncertainty at $t = 0$ on the value of X at the time of $t = 2$. At t

there does not exist the procedure of extinguishing security interests and the debtor's borrowing and investment at $t = 1$ can be prevented by securing C1's claim, then the debtor can promise C1 to pay \$100 at $t = 2$. Thus, the debtor can borrow from C1 and invest as long as the investment cost in X at $t = 0$ does not exceed \$100. This result is efficient because the debtor makes an investment if and only if its net present value is positive. In contrast, if there exists the procedure of extinguishing security interests, the debtor is expected to borrow and invest at $t = 1$, and so the expected return of C1 is only \$92.78 (see Table 2, above). Thus the debtor can borrow and invest in X at $t = 0$ only if the investment cost in X does not exceed \$92.78, creating an under-investment problem.

B. Trade-off between Allocation Efficiency and Investment Efficiency

I have argued that the procedure of extinguishing security interests may distort the debtor's incentive to borrow and invest *ex ante*. On the other hand, this procedure may have benefits in allocating assets to more efficient uses with less transaction costs at the time of the debtor's reorganization, as was explained in Part III.C, above. Accordingly, in evaluating social benefits of this procedure, we face the trade-off between the allocation (*ex post*) efficiency and the investment (*ex ante*) efficiency. Which factor is more likely to dominate is an empirical question, and the answer to this question is likely to depend on a particular nature of each debtor firm.

For example, suppose the debtor is a small start-up business and has no assets other than those which will be sold at very low prices in liquidation (such as machinery and inventory). In this case, permitting the debtor to extinguish security interests by the payment of only the liquidation value of each encumbered asset would be almost equal to denying any priority of secured credit. The debtor's incentive of over-borrowing and over-investment could not be

= 0, both the debtor and C1 know that, if the debtor invests in X, its value will be \$100 at $t = 2$ for certain.

prevented by secured loans, and consequently, the debtor might not be able to obtain the secured credit and start up the business in the first place. The procedure of extinguish security interests may well be detrimental, rather than beneficial, for such a debtor.

Next, suppose the debtor is a matured firm and has a considerable amount of assets (such as real estate) which can be disposed of at relatively high prices. In this case, extinguishing security interests would not so much reduce the expected return of secured credit. On the other hand, since the reorganization of such a matured firm often involves multiple secured creditors, the transaction costs involved in the negotiation between the debtor and the secured creditors at the stage of reorganization could be high. In such a case, giving the debtor an option to exit out of the negotiation by paying the liquidation value of the collateral could considerably improve the allocation efficiency with little countervailing effect on the investment efficiency.

VI. Policy Implications to the U.S. Law

Although recent evidences suggest some changes may take place,¹⁶⁸ Chapter 11 has long been criticized as imposing costly delays on creditors without many prospects of successful reorganization.¹⁶⁹ Consequently, some law and economic scholars have proposed drastic changes to the present law.¹⁷⁰ In concluding the analysis of this Article, I compare these proposals with the regime of the Civil Rehabilitation Act (in section A), and discuss some policy implications to the U.S. bankruptcy law (in section B).

¹⁶⁸ See, e.g., David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003).

¹⁶⁹ See the literatures cited in note 150, *supra*.

¹⁷⁰ For introduction of those proposals, see Rasmussen & Skeel, *supra* note 90. Of course, efforts to improve the present system have also been taken. See, e.g., NATIONAL BANKRUPTCY REVIEW COMMISSION, *BANKRUPTCY – THE NEXT TEN YEARS* (1997).

A. Civil Rehabilitation Act Compared with Recent Proposals to Reform Chapter 11

1. Alternative Bankruptcy Regimes Proposed by the Scholarship

Since the late 1980s, many commentators have advocated the replacement of Chapter 11 with some creative alternatives. Some scholars suggest that the entire assets of the bankrupt firm should be sold in an auction.¹⁷¹ Others advocate the procedure of “equity cancellation,” where all the interests of existing shareholders of the firm are automatically eliminated and new shares are issued to its creditors.¹⁷² Still others propose an “option” approach.¹⁷³ According to their proposal, new stocks of the bankrupt firm are distributed to its senior creditors in lieu of their claims, and members of each lower class are given, in lieu of their claims or interests, options to purchase a pro rata share of such stocks by paying their pro rata portion of the senior claims. After the exercise period of the options has expired, the firm will have only stocks and no debts.

The common feature of these proposals is to abolish the present Chapter 11 regime, which attempts to help a bankrupt firm to be reorganized through the negotiation among the firms’ existing stakeholders (secured and unsecured creditors and equity-holders), and to establish some completely new regimes, which let the residual claimants of each firm determine the destiny of their firm. In the auction approach, acquirers would determine the destiny of acquired firms, whether to reorganize or to liquidate. In the equity cancellation and option approach, new shareholders would make such a decision. These proposed systems, if ideally work, would eliminate the need of costly negotiation altogether and save a lot of transaction costs. However, the mechanism to transfer the control of the bankrupt firm to its residual claimants would also

¹⁷¹ See Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J.LEG. STUD.127 (1986).

¹⁷² See Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE. L.J. 1043 (1992).

¹⁷³ See Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523 (1992); Lucian Arye Bebchuk, *A New approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988).

involve costs. As for the auction approach for instance, the costs necessary for potential bidders to raise funds and gather information about the bankrupt firms being acquired could be substantial.¹⁷⁴ It is not necessarily clear whether the costs involved in the proposed regimes would be less than the costs involved in the traditional, negotiation-based reorganization regimes such as Chapter 11. Considering this unclarity, recent trend of the scholarship seems to endorse the “menu” approach.¹⁷⁵ Under the menu approach, Congress would enact alternative bankruptcy systems, including the current procedure and the newly proposed procedures described above. Firms would be required to select, at the time of incorporation, which bankruptcy regime would apply if they later encounter financial distress.¹⁷⁶

2. Evaluation of the Civil Rehabilitation Act, Compared with Proposed Mechanisms

Compared with those proposals (aside from the menu approach), the Civil Rehabilitation Act looks more like Chapter 11 in that it basically attempts to help the firms be reorganized through the negotiation among the firms’ stakeholders. The Civil Rehabilitation Act differs from Chapter 11, however, in that it gives both the secured creditors and the debtor exit options. By giving the secured creditor an option to enforce his right, -- perhaps after some limited period of temporary stay¹⁷⁷ -- the Civil Rehabilitation Act attempts to prevent the debtor from prolonging the bankruptcy procedure at the costs of the creditors without many prospects of successful reorganization. At the same time, by giving the debtor an option to extinguish

¹⁷⁴ For assessment of the costs of the auction regime and other proposals, see MARK J. ROE, CORPORATE REORGANIZATION AND BANKRUPTCY: LEGAL AND FINANCIAL MATERIALS 600-06 (2000); Rasmussen & Skeel, *supra* note 90, at 106-10; David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 477-91.

¹⁷⁵ See Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992). Rasmussen further elaborated his proposal in his article coauthored with David Skeel. See Rasmussen & Skeel, *supra* note 90, at 110-15.

¹⁷⁶ See Rasmussen & Skeel, *supra* note 90, at 111.

¹⁷⁷ For temporary stay, see section II.C1, *supra*.

security interests by paying the liquidation value of the collateral, the Act also attempts to prevent the negotiation from delaying because of the hold-up of each secured creditor demanding larger share of the going concern surplus. To the extent that the court must estimate the liquidation value of the collateral when the parties do not agree on it, this approach premises on the intervention of the court. This type of intervention may not be very costly, however, because estimating the liquidation value of an individual asset is arguably not very difficult, at least compared with estimating the going concern value of a financially distressed firm. In this respect, the Civil Rehabilitation Act may be relieved from the criticism often brought against Chapter 11 – that the courts are not well equipped for evaluation of businesses.¹⁷⁸

Of course, the solution of the Civil Rehabilitation Act does not necessarily lead to an efficient result. First, if the court cannot estimate the liquidation value of the collateral in an accurate and foreseeable way, then the procedure of extinguishing security interests may function poorly in reducing transaction costs in reorganization.¹⁷⁹ In addition, even if this procedure improves the allocation efficiency at the time of reorganization, it may involve *ex ante* social costs in that, by restricting the priority of secured claims, it may induce a debtor to over-borrow and over-invest at the expense of the existing creditors.¹⁸⁰

Considering these difficulties, we can hardly say that the regime of the Civil Rehabilitation Act always involves less cost than the Chapter 11 regime or the recently proposed regimes described above. Still, it is worthwhile to note that some 1,000 firms each year, involving dozens of publicly held corporations,¹⁸¹ apply for the Civil Rehabilitation proceedings,¹⁸² and a considerable percentage of these firms succeed in reorganization with

¹⁷⁸ See, e.g., Rasmussen & Skeel, *supra* note 90, at 93.

¹⁷⁹ See *supra* note 104 and the accompanying text.

¹⁸⁰ See section V.A.

¹⁸¹ See *supra* note 48 and the accompanying text.

¹⁸² See *supra* note 43 and the accompanying text.

relatively short periods.¹⁸³ This evidence suggests that a relatively simple system of the Civil Rehabilitation Act, which combines the negotiation among the stakeholders with a mild intervention of the court, can work fairly effectively in many cases. It also suggests that, at least for some firms, the reorganization system may be considerably improved without completely replacing the traditional negotiation-based regime with the proposed regimes which would dispense with the negotiation among the stakeholders altogether.

B. Some Policy Implications

Based on the above discussion, what can we say as a policy implication to the U.S. reorganization law? First of all, I strongly agree with the advocates of the menu approach on the point that different firms may well find different bankruptcy regimes appropriate for them.¹⁸⁴ Taking the procedure of extinguishing security interests for instance, desirability of allowing debtors to extinguish security interests by paying the liquidation value of each encumbered asset may well depend on the characteristics of the debtor firms, as was discussed in section V.B, above. Similar consideration can apply to any other bankruptcy systems; the auction approach may be appropriate for some firms, while retaining the Chapter 11 regime may be preferable for others. This consideration leads me to support the menu approach. Instead of imposing a single bankruptcy system on all firms, Congress should prepare alternative regimes and require each firm to select a regime at the time of incorporation. Because firms which choose inefficient procedures will be penalized by higher interest rates required by their creditors, we can expect that firms have good incentives to choose bankruptcy systems which are the most appropriate for them.¹⁸⁵

¹⁸³ See *supra* notes 49-59 and the accompanying text.

¹⁸⁴ See Rasmussen & Skeel, *supra* note 90, at 110-11.

¹⁸⁵ A main difficulty of the menu approach is that, after selecting one regime and obtaining loans, a debtor firm has an incentive opportunistically to amend its selection to the one that is preferable for

Assuming the menu approach is employed, the recently proposed regimes – the equity cancellation, auction and option approaches – would be natural candidates of the “menu” which Congress should prepare as alternatives to the present Chapter 11 regime. I would argue, however, that Congress should also consider adopting (1) a regime similar to the Composition Act¹⁸⁶ and (2) a regime similar to the Civil Rehabilitation Act, as two additional alternatives. In the first regime, the secured creditors could freely enforce their rights.¹⁸⁷ This option of the secured creditors to exit out of the reorganization procedure would help to prevent the debtor from prolonging the procedure with little hope of reorganization. The negotiation between the debtor and the secured creditors with only the latter having an exit option, however, might become costly as was discussed in section III.B, above. In case of this, Congress should also allow the debtor firms to choose a regime similar to the Civil Rehabilitation Act, in which both the debtor and the secured creditors have exit options.

I argue that both regimes should be adopted as alternative menus; for, as was discussed in Part V, giving the debtor an option to extinguish security interests by paying the liquidation value of the collateral is not always desirable. In particular, if the debtor has only assets with very low liquidation values, such an option may seriously distort the debtor’s incentive to invest, and in turn, the debtor may not even obtain secured loans in the first place. In this case, a desirable regime may be the one which gives only the secured creditor an exit option. On the

its shareholders and managers. Still, such difficulty can be overcome by imposing proper requirement for the mid-stream amendment of the debtor’s choice. *See* Rasmussen & Skeel, *supra* note 90, at 111 (requiring the debtor to announce the amendment one year before such amendment, in addition to allowing each creditor to contract with the debtor in advance to prevent the mid-stream amendment).

¹⁸⁶ As was explained in section II.A.2, *supra*, the Composition Act had been a general reorganization law in Japan until its abolishment by the Civil Rehabilitation Act. The Composition Act had no restriction on secured claims.

¹⁸⁷ This Article is not the first one to suggest a regime where secured creditors are not subject to the automatic stay. Such a regime has already been suggested in Baird & Picker, *supra* note 87, at 349 (“The automatic stay of the secured creditor is neither an uncontroversial nor immutable feature of bankruptcy law”), and explicitly advocated as one “menu” available to all firms in Rasmussen & Skeel, *supra* note 90, at 111 (in the name of “selective stay”).

other hand, some debtor firms may have enough assets with relatively high liquidation values and obtain secured debts from multiple lenders. For such firms, the regime giving both parties exit options may be desirable.

Conclusion

This Article analyzed how secured creditors are treated in Japanese reorganization law. Although the Civil Rehabilitation Act neither imposes automatic stay on secured claims nor permits modification of secured claims by a rehabilitation plan, it has a unique procedure to restrict the rights of secured creditors: the procedure of extinguishing security interests. In essence, this procedure permits a debtor to cancel security interests in any property she owns which is necessary for continuation of the debtor's business, by paying the secured creditors only the liquidation value of the property. I analyze how this procedure can work as an "exit option" of the debtor and reduce the transaction costs which would arise if the debtor had to bargain with the secured creditors to avoid foreclosure.

I also compared the procedure of extinguishing security interests with cramdown in Chapter 11, and discuss relative advantages of these two rules. Although both procedures can be viewed as exit options of the debtor negotiating with the secured creditors, there exists important difference: While extinguishing security interests requires the debtor to make one-time payment, cramdown permits the debtor to make deferred cash payments. Each procedure has its own merit and demerit. While requirement of one time-payment may restrict the debtor's ability to use the procedure of extinguishing security interests because of liquidity-constraint, permitting the debtor to make deferred payments imposes the court a heavy burden of evaluating financially distressed firms. Considering that the court is not an expert of evaluation of businesses, a good policy reason seems to exist demanding the debtor to make

one-time payment, and letting the market decide whether to finance the debtor. .

Although I maintain that there exists a good policy in permitting the debtor to extinguish security interests for the purpose of efficient reorganization, it also involves costs. By curtailing the priority of secured claims, the procedure of extinguishing security interests may produce social costs *ex ante*. In particular, I argued that this procedure may induce the debtor to over-borrow and make an investment in too risky businesses at the expense of existing creditors.

After examining costs and benefits of the procedure of extinguishing security interests, the last Part of the Article discussed on some policy implication of the U.S. law. Based on the “menu” approach recently proposed by scholars, I argued that Congress should consider preparing a regime similar to the Civil Rehabilitation Act as one of the menus, from which firms can choose as a bankruptcy system applicable to them at the time of financial distress.

I hope this Article will enhance our understanding on how the law should treat secured creditors in a reorganization procedure, and will contribute to the improvement of our bankruptcy systems.

Table 1. Overview of Japanese Reorganization Laws

	Corporate Reorganization Act (1952-present)*	Composition Act (1922-2000)**	Civil Rehabilitation Act (2000-present)
Basic characteristics	Special procedure for stock corporations	General procedure for all types of businesses	General procedure for all types of businesses
Who manage firms during the proceedings?	Court-appointed trustees	Present management	Present management, except for special circumstances (e.g., mismanagement)
What types of claims/interests are subject to proceedings?	All types of claims/interests	Unsecured claims	Unsecured claims, in principle (but see below)
Any restriction on secured claims?	Yes (Automatic stay, bifurcation, & modification by the reorganization plan)	No (Secured creditors can freely enforce their interests)	Some (Basically, secured creditors can enforce their rights. But their rights are subject to temporary stay & extinguishing security interests)

*The Corporate Reorganization Act was thoroughly revised in 2002, but its basic structure remains the same.

**The Composition Act was replaced by the Civil Rehabilitation Act in April, 2000.

Table.2 : Expected return: With No Security Interests (Debtor borrows with $r = 0.0778$)

	Success (50%)	Failure (50%)	Expected Return
C1	100	85.56	92.78
C2	215.56	184.44	200
Debtor	4.44	0	2.22

Figure 1: Illustration of Borrowing and Investment

