



# Out-of-Court Workout Procedures under the SME Business Revitalization Guidelines



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## I. Introduction

Out-of-court workout procedures are methods by which a company can restructure its debts or revive its business through voluntary negotiations with creditors, without involving the courts. Such private workouts are characterized by greater flexibility, speed, and confidentiality compared to formal insolvency proceedings like bankruptcy or civil rehabilitation proceedings, thereby minimizing damage to the company's credit and limiting the impact on its business counterparties.

In Japan, prior rule-based out-of-court workout procedures (conducted according to rules set by certain associations or organizations) included the turnaround alternative dispute resolution process provided by the Japanese Association of Turnaround Professionals ("JATP"), and the restructuring assistance provided by organizations like the Small and Medium-sized Enterprise Revitalization Support Council, the Regional Economy Vitalization Corporation, the Resolution and Collection Corporation, etc. However, as briefly featured in a past article,<sup>1</sup> in April 2022, the new "Guidelines for Business Revitalization, etc. of Small and Medium-Sized Enterprises" (the "SME Guidelines")<sup>2</sup> began being implemented. The out-of-court workout procedures set out in the SME Guidelines were at that time a relatively new private restructuring

framework that was created to support small and medium-sized enterprises ("SMEs") that were severely affected by the COVID-19 pandemic by reducing the burden of their debts and facilitating their business restructuring or closures. Since the introduction of the SME Guidelines, an increasing number of workout cases have been conducted thereunder. This article will describe the two main out-of-court workout procedures in detail to provide a better understanding of these remedial options.

## II. Main Parties and Participants

Under the SME Guidelines, the following are the key parties and participants of out-of-court workout procedures:

1. **SME Debtor.** The SME (the debtor company) who is undertaking the private workout under the SME Guidelines to rehabilitate or wind down its business.
2. **Target Creditors.** The creditors whose rights are expected to be modified (for example, via payment deferrals or debt forgiveness) if a business revitalization plan or repayment plan is agreed to. These are typically financial institutions or credit guarantee corporations but can include other creditors (such as trade creditors) as necessary. In a liquidation-type proceeding, lease creditors can also be included as creditors.

1. See Yuta Shozaki, *Overview of Revitalization Support for SMEs in Japan*, Oh-Ebashi Newsletter (Autumn 2023) at [https://www.ohebash.com/jp/newsletter/NL\\_en\\_2023autumn\\_Shozaki.pdf](https://www.ohebash.com/jp/newsletter/NL_en_2023autumn_Shozaki.pdf).

2. See <https://www.zenginkyo.or.jp/fileadmin/res/news/news340304.pdf> (in Japanese).





3. **Main Creditors.** From among the Target Creditors, the creditors who hold a major share of the claims against the SME Debtor.
4. **External Expert.** A professional, such as an attorney or a certified public accountant, who supports the SME Debtor from the consultation stage of the workout process until the end of the out-of-court workout process.
5. **Third-Party Support Expert.** An independent specialist, such as an attorney or a certified public accountant, who is neutral and not related to either the SME Debtor or the creditors. This expert will verify and investigate the SME Debtor's proposed business revitalization plan or repayment plan and provide a report on the viability thereof. The Third-Party Support Expert is appointed by the SME Debtor with the consent of the Main Creditors.

### III. Key Features of the SME Guidelines

#### 1. Two Types of Procedures: Reorganization-Type and Liquidation-Type

The SME Guidelines provide for two distinct private workout procedures: a reorganization-type out-of-court workout (aimed at business continuity) and a liquidation-type out-of-court workout (aimed at an orderly wind-up of the business). Each has its own specific procedures and requirements. Traditionally, rule-based out-of-court workout procedures in Japan were predominantly reorganization-oriented, premised on the company's business continuing after the process. The introduction of the new liquidation-type workout procedure under the SME Guidelines was significant in that it began offering an additional option for a "soft landing" business closure without resorting to formal insolvency proceedings like bankruptcy proceedings.

#### 2. Coordination with the Guidelines on Management Guarantee

The Guidelines on Management Guarantee<sup>3</sup> set forth

an out-of-court workout process for situations where a company's debts are personally guaranteed by its owner or manager, thereby allowing the settlement of debts without the owner or manager undergoing bankruptcy if the company files for bankruptcy or other related procedures. In either a reorganization-type or liquidation-type workout, the SME Guidelines explicitly encourage parties to actively utilize the Guidelines on Management Guarantee when dealing with debts guaranteed by the business owner or manager, so that their guarantee obligations are resolved in tandem with the SME Debtor's debts. The expectation is to leverage the Guidelines on Management Guarantee to avoid the business owner or manager undergoing personal bankruptcy and facilitate the prompt business rehabilitation or orderly liquidation of the company.

#### 3. Involvement of a Third-Party Support Expert

The SME Guidelines adopt a three-party framework whereby a neutral Third-Party Support Expert would review the draft business revitalization plan or repayment plan prepared by the SME Debtor and provide an independent investigation report. On the basis of this report, and with the unanimous consent of all the Target Creditors, the plan is approved and implemented. The SME Guidelines define a Third-Party Support Expert as *"a professional (such as an attorney or CPA) qualified to carry out reorganization-type and liquidation-type private workouts, and who has been certified as such."*<sup>4</sup> In practice, lists of qualified candidate Third-Party Support Experts are published by bodies like the SME Revitalization Nationwide Headquarters (within the Organization for Small & Medium Enterprises and Regional Innovation) and the JATP. Accordingly, in most cases, the Third-Party Support Expert is selected from these published candidate lists.

Another notable feature is the method of appointment.

3. The Guidelines on Management Guarantee are available at <https://www.zenginkyo.or.jp/fileadmin/res/abstract/adr/sme/guideline.pdf> (in Japanese).

4. See the SME Guidelines, Part III, Section IV, Subsection (1).





The Third-Party Support Expert is chosen by the SME Debtor (subject to the Main Creditors' consent), with no outside institution directly assigning or appointing that expert. This contrasts with certain other schemes (e.g., ADR procedures) and underscores the flexible, debtor-initiated nature of the SME Guidelines-based process.

#### 4. Subsidies for Professional Fees and Tax Incentives

When utilizing an out-of-court workout procedure under the SME Guidelines, certain financial support is available for the fees of both the External Expert and Third-Party Support Expert. Subject to meeting specified conditions, the SME Debtor can receive a subsidy to cover these professional fees. This reduces the burden of costs on the SME Debtor and helps ensure the economic feasibility of the proposed business rehabilitation plan or repayment plan, thereby encouraging a more effective business turnaround or closure.

From the creditors' perspective, the SME Guidelines also offer a tax advantage. Under specified conditions, a creditor can write off, for tax purposes, the debt forgiven pursuant to an out-of-court workout procedure under the SME Guidelines without incurring tax on the forgiveness of such debt (a tax-free write-off). This makes the scheme more attractive for participating creditors.

### IV. Process Flow under the SME Guidelines

#### 1. Outline of the Procedure

Below is an outline of the procedure under the SME Guidelines (common to both reorganization-type and liquidation-type workouts):

- (a) **Application for an Out-of-Court Workout.** The SME Debtor consults an External Expert (e.g., a lawyer or accountant) and with the assistance thereof, notifies its Main Creditors that it wishes to consider

a private workout under the SME Guidelines. In a reorganization-type case, at the time of this application, the SME Debtor—with the unanimous agreement of its creditors—must select the Third-Party Support Expert.

- (b) **Commencement of Expert Support.** In a liquidation-type case, the External Expert, and in a reorganization-type case, the Third-Party Support Expert, begins to assist the SME Debtor in conducting surveys of its assets, liabilities, and profits and losses, formulating a draft business rehabilitation plan or repayment plan, and doing other necessary preparatory work, taking into account the intentions of the Main Creditors.

- (c) **Request for Standstill.** Once the above steps are underway, the SME Debtor may request that all Target Creditors temporarily suspend any debt collection or enforcement actions (a "standstill"), in case such pause is necessary to stabilize the company's cash flow. Then, if certain conditions are met—for example, the standstill request is made in writing to all Target Creditors simultaneously, and the SME Debtor has been acting in good faith and maintaining a constructive relationship with its creditors—then the creditors are expected to respond in good faith to the standstill request and refrain from their collection efforts during the agreed period.

- (d) **Formulation of the Plan.** The SME Debtor, with support from the External Expert (and the Third-Party Support Expert, as applicable), proceeds to draw up a business revitalization plan (for a reorganization-type case) or a repayment plan (for a liquidation-type case). Throughout this process, the SME Debtor, the External Expert, the Third-Party Support Expert, and the Main Creditors hold discussions and consultations as needed, in





line with the progress of the financial analysis and preparation of the relevant plan.

(e) **Investigation Report by the Third-Party Support Expert.** The Third-Party Support Expert examines the details of the proposed plan—by assessing the plan’s appropriateness, fairness and feasibility—and prepares an independent investigation report. This report is then provided to all the Target Creditors for their review and consideration.

(f) **Creditors’ Meeting and Plan Approval.** Once the proposed plan is ready, the SME Debtor and the Third-Party Support Expert work together to convene a creditors’ meeting with the attendance of all the Target Creditors. At this meeting, the SME Debtor explains the plan and the Third-Party Support Expert presents the findings of the investigation report, followed by a session for questions and answers, and an exchange of opinions.

Any Target Creditor who wishes to oppose the plan must promptly explain the reasons for its opposition to the Third-Party Support Expert in good faith. If all of the Target Creditors agree to the proposed plan, then the business revitalization plan or repayment plan is formally approved (established). Upon approval, the SME Debtor is obligated to execute the plan and the rights of the Target Creditors are modified in accordance with the plan’s terms (e.g., deferred repayment schedules or debt write-downs will take effect as set out in the plan).

(g) **Monitoring.** After the plan has been approved and implemented, the External Expert and the Main Creditors will monitor the SME Debtor’s performance of its repayment and other obligations under the plan. This ongoing monitoring is meant to ensure that the SME Debtor adheres to the plan and addresses any issues in its execution.

## 2. Key Differences between Reorganization-Type and Liquidation-Type Proceedings

While the overall procedure is broadly similar for reorganization-type and liquidation-type workouts, there are several important differences in their requirements and mechanics, as outlined below.

### (a) Timing of the Third-Party Expert Selection

In a reorganization-type workout, the SME Debtor must appoint the Third-Party Support Expert at the time of making the initial workout application to its Main Creditors (i.e., the first step, item (a) above). In a liquidation-type workout, by contrast, it is sufficient to appoint the Third-Party Support Expert at the stage when the investigation of the proposed plan is about to commence (i.e., around the fifth step, item (e) above), although an earlier appointment is also permitted if deemed necessary.

This difference arises because the liquidation-type process is relatively simpler, and a thorough review of the plan can still be conducted even if the Third-Party Support Expert becomes involved from the fifth step. Delaying the appointment in liquidation-type cases can help keep the procedural costs lower.

### (b) Contents of the Plan

Both reorganization-type and liquidation-type plans must include certain common elements, but a reorganization-type plan—being a longer-term plan premised on continued business operations—tends to require more extensive terms than a liquidation-type plan.

In particular, a liquidation-type plan is expected to include the following points:

(i) **A detailed plan.** An overview of the SME Debtor’s business and the transition of its financial position, etc., with evidence that the plan incorporates sufficient self-help efforts by





the company.

- (ii) **Equality of creditors.** Equal treatment of the Target Creditors in the adjustments of their rights under the repayment plan.
- (iii) **Feasibility.** A demonstration of economic feasibility for the Target Creditors—for example, the anticipated recovery for creditors under the plan should exceed what they would likely receive through bankruptcy liquidation (i.e., the plan offers a better outcome than the liquidation value of the company).
- (iv) **Impact analysis.** Consideration of the broader impact, such as avoiding chain-reaction bankruptcies of the SME Debtor's business partners and mitigating negative effects on the regional economy.

A reorganization-type plan, in addition to meeting the above requirements, must satisfy certain financial benchmarks. Specifically, the SME Guidelines provide that a reorganization plan should aim to achieve:

- (i) **Resolution of insolvency.** Eliminating the SME Debtor's excess liabilities (substantive negative net worth) within approximately five years after the plan's approval.
- (ii) **Return to profitability.** Restoring the SME Debtor to profitability (on an ordinary profit basis) within roughly three years after the plan's approval.
- (iii) **Decreased debt to cash flow ratio.** Reducing the SME Debtor's ratio of interest-bearing debt to cash flow to about 10:1 or lower by the final year of the plan.

### 3. Transition from Reorganization to Liquidation

The SME Guidelines also allow for a transition from a reorganization-type process to a liquidation-type process if warranted by the circumstances. During the course of a reorganization-type workout, if the Third-Party Support Expert or the Main Creditors conclude that continuation of the business is not feasible, and the SME Debtor itself requests that its business be wound down, the procedure can be switched to a liquidation-type workout. In such a case, the SME may, if necessary, continue to receive assistance from the same Third-Party Support Expert who was involved in the reorganization-type process. The SME Guidelines also permit the liquidation-type process to commence from an appropriate intermediate stage, rather than starting over from the very beginning, to smoothly facilitate the transition toward an orderly liquidation.

## V. Concluding Remarks

In conclusion, the SME Guidelines offer a practical and accessible framework for SMEs seeking to either rehabilitate or responsibly exit their businesses without resorting to court-supervised insolvency proceedings. Their emphasis on consensus-based creditor coordination, neutrality through the use of Third-Party Support Experts, and the integration with the Guidelines on Management Guarantee help promote fair and efficient outcomes for all the stakeholders involved.

As post-pandemic challenges continue to affect SMEs' financial health, early engagement with legal and financial professionals under this framework can significantly enhance the chances of a constructive turnaround or an orderly wind-down. Companies facing financial difficulty are therefore encouraged to explore these procedures as a strategic option aligned with their long-term goals and responsibilities to their creditors, employees, and communities.