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Financial Law Board

Debt Equity Swaps under the Commercial Code of Japan

1. What exactly is a Debt Equity Swap?

   The term “Debt Equity Swap” generally refers to a method that allows a creditor to exchange a monetary claim against a company with shares of stock in that company. More simply put, the creditor exchanges debt for equity.

   In this memorandum we will first review several arguments concerning the use of Debt Equity Swaps in the restructuring phase of companies with negative net worth. Then, we will examine Debt Equity Swaps in general, including the use of Debt Equity Swaps in other cases.

   A Debt Equity Swap is described as follows: “a method to exchange debt with equity under an agreement between a creditor and a debtor. The transaction has a built-in mechanism to restructure the debtor’s business in a manner more amenable to the creditor than a simple waiver of claims……” “This method is more attractive to the creditor than a simple waiver of claims because it provides the creditor with the opportunity to recover an amount equivalent to its claim (or even more in certain circumstances) should the debtor successfully restructure its business, while extending the debtor benefits from reduced debt. ” [1]

2. Legal Structure

   Different legal structures have been adopted for Debt Equity Swaps to date, depending upon their purposes, such as to: (i) avoid investigation by an inspector as required in the case of capital investment in kind, (ii) eliminate the trouble of calculating the actual value of a debt, or (iii) use substitute share certificates. However since the adoption of the so-called “par-value theory”, or "kenmengaku-setsu", by the Tokyo District Court in the year 2000, it has become easier to use a legal structure that regards a Debt Equity Swap simply as an “issuance of new shares in exchange for the contribution of a debt as capital investment in kind.” According to the “par-value theory,” the issue price of the newly issued shares is interpreted as the nominal amount of the monetary claim (debt) invested for such issuance. In contrast to this theory, some people have advocated an “appraised-amount theory” under

[1] Hideki Kanda, “Debt Equity Swap,” *Jurist*, No.1219, p. 30. Debt Equity Swaps can lead to discrepancies in the treatment of different classes of creditors in bankruptcy, but we do not cover this aspect in this memorandum.

which the issue price of the newly issued shares is interpreted as the actual and current value of the claim (debt) invested (that is, an amount calculated based on considerations of recoverability). Through the adoption of the "par-value theory" by the Tokyo District Court and other jurisprudence, an inspector appointed for the investigation of capital investment in kind is only required to investigate and confirm the existence of the invested claim (debt) and its nominal amount. Practically, this has greatly reduced the time and cost spent on investigations.

3. Arguments

a. Debt Equity Swaps and regulations of investments in kind (Article 280-8, Paragraph 1 of Commercial Code)

(1) Article 280-8, Paragraph 1 of the Commercial Code provides, "When a person makes capital investment in kind, the directors must apply to the Court for the appointment of an inspector to investigate the particulars mentioned in Article 280-2 Paragraph 1 Item (3) (i.e., the full name of the person who makes the capital investment in kind, the investment property, the value of the property, and the class and number of shares to be exchanged for the aforesaid property)."

The following is an explanation regarding the requirements mentioned in the preceding paragraph: "The duties of an inspector are, firstly, to investigate whether the value of an investment property and the class and number of shares to be exchanged for such investment are adequate, and secondly, to provide a written report on his/her investigation to the court by which he/she was appointed, … the investigation by the inspector is conducted essentially as a review of the adequacy of the appraisal of the investment property by which the investment in kind is made. This appraisal should also take into consideration general economic and social criteria, as well as the rationality in light of such purpose as the enabling and promoting the execution of the business objectives of the issuing company and its corporate size. Accordingly, the appropriateness of the appraisal will be based on its general adequacy and rationality. …in addition, the appraised amount should reflect the usefulness and earning power of the investment property " .[2]

(2) The par-value theory has the practical advantage of simplifying the investigation procedure required for capital investments in kind.[3] An inspector is only required to

[2] Yoichi Nagahama, *Annotated Company Law* (7), *new edition* p. 248.

[3] Jun Harizuka (in "Present Status of Inspector Appointment Cases Associated with Investments in Kind Filed in the Tokyo District Court, Commercial Division," in *Shojihomu*, No. 1590, p. 9) points out, "The inspector's investigation is sufficient if the investigation confirms the existence of the debt with which the investment in kind is

confirm the existence of the monetary claim (debt) and its amount (nominal amount of the monetary claim (debt); not the actual value obtained through appraisal process) in the investigation under this theory, therefore the application of this theory serves to reduce the time and cost burdens of Debt Equity Swaps. (While some experts maintain that these advantages have become irrelevant since investments certified by an attorney-at-law, Certified public accountant, tax attorney, etc. no longer require investigation (Article 280-8 Paragraph 2, Article 173 Paragraph 2 Item 3 of CC). This assertion, however, misses the mark, since an attorney-at-law or other expert certifying an investment would be required to investigate the actual value of the claim (debt) if the appraised-amount theory is applicable.).

(3) Given that the provision of Article 280-8, Paragraph 1 of the Commercial Code (the provision requiring investigation by an inspector in the case of a capital investment in kind) provides only for the investigation of (i) the full name of the person making the capital investment in kind, (ii) the investment property, (iii) the value of the property, and (iv) the class and number of shares (Article 280-2 Paragraph 1 Item 3), we can argue that "the par value theory is the theory that interprets 'the value of such property' (i.e., the above-mentioned item (iii) among items (i) through (iv) to be investigated by the inspector) as the par value (nominal amount) of the monetary claim against the issuing company as the debtor when such claim (debt) is contributed to in the form of a capital investment in kind."

(4) The substantive reason can be explained as follows: "In the context of the regulation of an investment in kind, an inspector must conduct an investigation to determine 'the proprietary value to be received by the issuing company as the consideration for the newly issued shares.' As such, since the issuer's debt is a debt that cannot be extinguished unless an amount equivalent to its nominal value is paid, and since such debt is in fact extinguished by way of the Debt Equity Swap, we may consider that a proprietary value equivalent to the nominal amount of the debt is received. While, on the other hand, the actual value of debt is at stake from the viewpoint of 'how much proprietary value should the investor be required to contribute?' this does not fall within the purpose of the investigation."[4]

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executed and the amount of the debt. Such an investigation requires much lower costs (remuneration) and time compared with the investigation under the appraised-amount theory."

[4] People observing the traditional principle of capital sufficiency, a principle that esteems the "actual value" of property in which the investment in kind is invested, may object to this explanation (see, for example, Article 280-13-2 of the Commercial Code). From the viewpoint of capital sufficiency, the above explanation may well appear to be a somewhat "strained" interpretation. To take advantages of the par-value theory while respecting the traditional principle of capital sufficiency, we may be able alternatively and simply to explain, "The duties of an inspector in the regulation of investments in kind are to investigate whether or not the price of the investment

b. Debt Equity Swaps and the protection of existing shareholders or regulation of new share issuance with favorable conditions

(1) No well-deliberated conclusions seem to have been reached on the issue of protection of existing shareholders in relation to the regulation of investments in kind according to the par-value theory.

Firstly, although existing shareholders should accept declines of their shareholding ratios insofar as the issuance falls within the authorized number of shares, the debtor (issuing company) should issue new shares within the limit of the value corresponding to the actual value of the debt for which the investment in kind is executed. If the issuing company issues new shares with a value exceeding the actual value of the debt, the issuance will be regarded as a specially favorable issuance to a third party, a transaction that would require special resolution of the shareholders' meeting which needs approval by more than two-thirds of the total voting rights (Article 280-2 Paragraph 2).[5] Thus, according to this view, the "issue price" as mentioned in Article

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property and the class and number of shares to be issued are adequate, and to report the results to the court. In so far as the court that will receive the report accepts and allows the inspector to rely on the par value theory in conduction the investigation and the reporting, the inspector can be deemed to have performed his/her duties sufficiently when the inspector has conducted the investigation according to the par-value theory and has submitted a report specifying the bases of the investigation to a court."

[5] Kanda, p. 33. In this regard, the following statements have been issued from experts who stress the function of the regulation of investments in kind in protecting existing shareholders: "This argument may affect not only the shareholders' shareholding ratios, but also the economic value of their shares, depending on which theory is adopted. The problem here is not simply the acceptability of the capital increase through allocation of new shares to a third party, but the adequacy of permitting a certain favorable issuance." (Tomotaka Fujita, "Acquisition of Treasury Stock and Company Laws (Volume II)," *Shojihomu*, No. 1616, p.8.); "The number of shares to be allotted to a creditor is very important in a Debt Equity Swap. The creditor wants as many shares as possible, while the issuing company wants to limit the number of shares to prevent the issuance from injuring the interests of existing shareholders (that is, to prevent a favorable issuance to a third party). To meet these requirements, we can determine the number of shares to be allotted as a quotient of the appraised amount (actual value) of the debt used for the Debt Equity Swap divided by the actual value per share. The appraised value for this purpose means an amount determined with due consideration of any collateral or guarantee on such claim, if any, while the actual value per share means the amount that includes the expected effect of such Debt Equity Swap. Debt Equity Swaps according to this method will not injure the interests of existing shareholders." (Jun Harizuka, "Debt Equity Swap Re-discussed," *Shojihomu*, No. 1632, pp. 18-19); and "Shareholders are not in the position to oppose a company's repayment of its debt with a nominal amount of such debt. Thus, a Debt Equity Swap will not be deemed to provide insufficient protection of existing shareholders provided that such transaction brings about a result comparable to the case where a company first repays a debt to a creditor and then the creditor invests in the company using the money repaid by the company. Therefore, insofar as a Debt Equity Swap is executed within the limit of authorized capital (in principle, existing laws do not protect existing shareholders' interest to the shareholding ratio unless a company's articles of incorporation restrict the transfer of shares or provide shareholders with the right to subscribe to new shares), one can say that the investment has been made with a nominal amount (par value) of the company's

280-2 Paragraph 2 of the Commercial Code (regarding issuance with favorable conditions) should be interpreted as the quotient of the 'actual value (not the par value) of the debt divided by number of shares to be issued.'[6]

However, in the case of Debt Equity Swap by a company with substantial negative net worth, the negative corporate value eliminates any problem of favorable issuance regardless of the issue price per share or number of shares to be issued. Thus, if such company intends to issue new shares in such number based on the par value of the claim, it will not be required to seek a special resolution of shareholders' meeting—an endorsement that would otherwise be required for the issuance of shares with specially favorable issue price or number of shares.

(2) In the inspector's investigation, the inspector is required to investigate not only the value of the investment property, but also "the class and number of shares" (Article 280-8 Paragraph 1, Article 280-2 Paragraph 1 Item 3 of the Commercial Code). Assuming that the inspector should also investigate the adequacy of the number of shares to be issued in the Debt Equity Swap, and further that the number of new shares to be issued should be based on the actual value of the debt, a question arises. Does the inspector have to use the par value of the debt to determine "the value of the investment property" on the one hand, but have to use the actual value of the debt in relation to "the number of shares"? If the question is answered in the affirmative, the inspector must also investigate the favorableness of an issuance of new shares, and in doing so must thus appraise and determine the actual value of the debt, as would an inspector conducting an investigation under the appraised-amount theory. As this would diminish the advantages of simplicity and convenience under the par-value theory, we should not adopt this view. As long as we adopt and rely on the par-value theory for the inspector's investigation in the context of the regulation of investments in kind, the requirement regarding "the number of shares" to be investigated should be deemed satisfied merely if the number mathematically agrees with the quotient of the "par value of the debt divided by the issue price."

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debt, and that the Debt Equity Swap is acceptable if the new shares are issued at the fair price" (Masao Yanaga, "Debt Equity Swap—with reference to their treatment in Europe," *Jurist*, No. 1226, pp.88-89)

Generally speaking, even within the limit of authorized capital, the issuance of a huge number of new shares can be considered unfair under Article 280-10 of the Commercial Code. However, since a Debt Equity Swap is carried out in the restructuring/remedy phases in the case of companies with substantially negative net worth, there is little need to address this point.

[6] If we adopt this view, the "issue price" required to be disclosed under Article 280-3-2 of the Commercial Code should be interpreted in the same manner. See also Section 4, b below.

4. Practical application

a. Inspector's investigation report on investment in kind

When an investment in kind is made, Article 280-8 Paragraph 1 of the Commercial Code requires that the directors apply to the court for the appointment of an inspector to investigate the particulars mentioned in Article 280-2 Paragraph 1 Item 3 of the Commercial Code (that is, (i) the full name of the investor, (ii) the investment property, (iii) the value of the property, (iv) the class and number of shares to be issued).

As already stated, according to the par-value theory, "Of the particulars to be investigated by the inspector, the 'value of the property' mentioned in item (iii) above means the par (nominal) value of the debt in the case where the debt owed by the issuing company is contributed in the form of an investment in kind."

It has been generally accepted that the adequacy of the 'class and number of shares to be issued' mentioned in item (iv) above ('adequacy' here means proportionality to the appraisal value of the object of investment in kind) should be investigated and reported. If, in such investigation, the inspector has to investigate and report the adequacy of the 'kind and number of shares to be issued' in relation to the actual value (as opposed to the par (nominal) value) of the debt, the inspector must first appraise and determine the actual value (as opposed to the par (nominal) value) of the debt as mentioned above—a step that would diminish the advantages of the par-value theory. Therefore, in the "class and number of shares to be issued" column of the investigation report under the par-value theory, it might be prudent to simply enter the class and the number of shares to be issued (without reference to their adequacy), or add a disclaimer such as "The number of issued shares is adequate in relation to the amount of capital to be increased (that is the amount equivalent to the par value of the debt). However, no investigations have been conducted to determine the favorableness and fairness of this issuance of new shares."

b. Public notice concerning the issuance of new shares

A public notice concerning the issuance of new shares must be specific and concrete enough to serve as a sufficient reference for shareholders to determine whether or not they need injunctive relief against the issuance of new shares.[7] As the issuance of new shares at a specially favorable issue price without a special resolution of a shareholders' meeting constitutes a reason for injunction, a public notice concerning the issuance of new shares is expected to disclose information that enables the company's shareholders to determine the favorableness of the issuance compared with the actual value of the debt. The company is

[7] Nagahama, (2), p. 248

therefore required to disclose the issue price (total amount) and number of shares to be newly issued.[8] However, mere disclosure of these figures without any explanation may not be sufficient in light of the objective of the public notice, given that such disclosure does not help the shareholders easily determine the favorableness of the issuance. A solution may be to use the amount calculated based on the actual/appraised amount of the debt for the (total) issue price. If this is still not sufficient to ensure an easy understanding of the public notice, we may insert an explanatory statement such as, "Though the amount constituting the basis of the increased capital is ¥X (that is based on the par value of the debt with which the investment in kind is executed), the actual issue price is ¥Y (that is based on the actual/appraised value of the debt).[9]

The above approach will not create the problem of a favorable issuance in the case of Debt Equity Swaps for companies with substantially negative net worth, as discussed above. Therefore, even with the public notice system that must ensure shareholders to have an opportunity to seek injunctive relief against the issuance with specially favorable or unfair conditions, there may be no practical benefits gained by indicating the relationship between the actual/appraised value and the par value of the debt with which the investment in kind is executed. As such, no specific problem will occur if the par value (and not actual/appraised value) of the debt is stated in the public notice without any of the details mentioned above. In this case, existing shareholders are of course entitled to seek injunctive relief from a competent court concerning the issuance of new shares if they believe that the company's net worth is not substantially negative and that the company should limit the number of new shares to such number calculated on the basis of the actual/appraised amount of the debt contributed as an investment in kind.

5. When the company's net worth is not substantially negative

In the above sections we have reviewed various arguments from the viewpoint of an issuing company with substantially negative net worth. As you see from these discussions, the par-value theory poses no problems with respect to the paid-in capital account, although it

[8] Article 280-3-2 of the Commercial Code provides, "The company shall, two weeks prior to the date for payment, either give public notice on the class, number, issue price, …date for payment, and the method of offering, or give notice thereon to the shareholders."

[9] In this case, the board of directors of the issuing company has to determine the actual value/appraised amount of the debt on its responsibility (the board may of course consult experts for advice). We find a similar case in the disclosure of issue conditions of convertible bonds, in which the value of acquisition rights (shinkabu-yoyaku-ken) is deemed to be zero, and determination is made by the board as to whether or not ¥0 is balanced with interest rate and other factors. The above-mentioned disclosure would force the issuer to acknowledge that the debt has a value lower than its par value.

might create problems with respect to the protection of existing shareholders (regulations of new share issuance with favorable conditions) given that Article 280-2 Paragraph 2 refers to a "specially favorable issue price." While the determination as to whether the shares are "issued in an unfair manner" (as provided for in Article 280-10 of the Commercial Code) shall be based on consideration of all relevant factors and circumstances, if a share having a value of ¥X is to be issued at a price substantially lower than ¥X (¥Y), it will be difficult to assert that ¥Y is not a "specially favorable issue price" compared with ¥X by taking into account the other relevant conditions including the restructuring plan. In the case of companies with substantially negative net worth, this kind of problem will not occur in Debt Equity Swaps since the theoretical value of X is zero. On the other hand, it is inappropriate to apply the par-value theory to all Debt Equity Swaps without limitation and to interpret the issue price as the equivalent to the par value price in the context of the regulations of new share issuance with specially favorable price. To address this problem, either of the following legislative measures could be taken: (i) to amend Article 280-2 Paragraph 2 by replacing the expression "specially favorable issue price" with "specially favorable issue conditions" (so that shares may be issued more flexibly with a focus on real fairness) or (ii) to abolish the favorable new share issuance regulations provided for in Article 280-2.

6. Conclusion

Since its adoption by the Tokyo District Court in 2000, the par-value theory in Debt Equity Swaps has been widely applied in practice, resulting in substantial convenience and merit of the reduction in time and costs required for the Debt Equity Swap procedure. Though this theory has not been fully discussed or accepted, particularly in respect of the favorable new share issuance regulations, we think Debt Equity Swaps according to the par-value theory shall be acceptable at least in the phases of restructuring companies with negative net worth, as its application would not substantially injure the interests of existing shareholders of those companies.