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Aspects of Collective Will of Bondholders under Japanese Law

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1. Introduction

This article explores whether a contractual mechanism is needed under Japanese law to protect the interest of bondholders in the event of sovereign bond default. Let us examine the chronology of events regarding one typical individual Japanese investor, Mr. Suzuki, to illustrate main issues concerning holders of sovereign bond under the Japanese law.

Upon retirement after working 30 years, Mr. Suzuki invested his entire severance pay of ten million yen into yen-denominated bonds issued by the Argentine government.¹ At that time, he considered commercial bank deposits unattractive because their rates were less than one percent and the return on Argentine bonds was expected to be over five percent. Mr. Suzuki assumed that the bonds were not only lucrative but were also safe, because few bonds had defaulted in Japan at that time. It was therefore a complete surprise when he heard that the Government of Argentina, being in economic trouble and facing a foreign currency shortage, declared a moratorium on its public indebtedness on December 23, 2001. He gave up to collect on his investment because litigation against the Government of Argentina by himself was impractical.

Recently, however, he heard that the Government of Uruguay succeeded in the restructuring the payment terms of its own bonds with the support of a special financial institution named a “bond management company” and that payment continued even though Uruguay faced economic trouble. As a result, he started to wondering whether he should ask the bond management company, which announced it would not seek to accelerate payment of all outstanding debt of the Argentine government even after the default², to arrange a bondholders’ meeting to recover and preserve his interest in the bonds. This article will examine the possible and future legal options available for protecting Mr. Suzuki’s interest in the bonds so that he will have the best chance of receiving partial or whole payment.

¹ Based on a Nikkei article dated December 25, 2001 and March 21, 2002, the story assumes that Mr. Suzuki bought bonds issued by the Argentine government on March 24, 2000. Including these bonds, the Argentine government has issued public offering of bonds on four occasions in Japan’s financial market (see chart below), for a total 191.5 billion yen (around 1.5 billion U.S. dollars). Investors in such bonds are generally individuals, whose number would be over 20,000.

<Samurai bonds issued in Japan by Argentine Government>

Maturity date	Launch Date	Bill. yen	Coupon (%)	Issue Price	Interest Payment date	Lead manager	Commissioned Company
20.Dec.02	5. Dec.96	50	5.0	100.00	June 20, Dec.20	Nikkou	Shinsei Bank
17. Dec.03	2. Dec.99	20	5.4	99.90	June 17, Dec.17	Nikkou SSB	BOTM
14. June.04	24.May.00	60	5.125	100.00	June 14, Dec.14	Nomura	BOTM
26.Sept.05	22.Aug.00	61.5	4.85	100.00	Mar 26. Sept.26	Nomura	BOTM

² The Nikkei of March 14, 2002 reported that Bank of Tokyo-Mitsubishi Bank (BOTM) and Shinsei Bank had decided not to declare default because they thought it was better to await a comprehensive plan for economic recovery. Such decision is upheld until an ordinary resolution of a Bondholders' meeting or at the written request of the holders of more than one-half (1/2) of the aggregate principal amount request the declaration.

A certain default risk is inherent in purchasing high-yield bonds because risk is generally a source of more attractive returns: the principle of “high-risk, high-return.” This principle, however, does not mean that the entire investment is to be lost in the case of default. Partial repayment is desirable based on the economic balance between the degree of risk and the amount of the expected returns. The foundation of a well-developed market is the recognition of risk-adjusted return case-by-case basis.

Nevertheless, some individual investors like Mr. Suzuki, who bought bonds issued by foreign countries’ institutions in Japan’s financial market (samurai bonds³) do not recognize that such bonds inevitably carry the default risk above. In particular, investors purchasing samurai bonds issued by a government or a central bank of an “emerging market country” such as Korea, Thailand, Brazil, and Mexico, could some day face the same situation as Mr. Suzuki does.⁴ Like insolvent corporations, in the event of an economic crisis, foreign governments or central banks may not always be able to redeem samurai bonds on the promised due date.

Together with the default risk, Japanese individual investors are unintentionally shouldered with an additional higher risk due to the lack of definitive legal protections. Few Japanese investors have an occasion to wonder about the legal risks involved, as relatively few cases of default in corporate and sovereign bonds have occurred until recently. Only within the context of financial distress caused by such events as an economic crisis, does the true extent of such “legal” risk emerge, showing that most Japanese investors would have ineffective legal protections under Japanese law. Due to the lack of definitive and tested legal protections, and even the lack of foresight about such protections, Japanese investors are put in an inferior position relative to investors in other countries. Nevertheless, no studies have ever been tried to analyze the position of Japanese legal system and provide effective legal protection.

This article considers the question as to whether special contract clauses termed

³ Samurai bonds generally refer to yen-denominated bonds issued by non-resident organizations, including not only foreign governments but also foreign companies. In this article, the term only refers to bonds issued by foreign governments or foreign central banks. It is also assumed in this article that the governing law with respect to samurai bonds is Japanese law.

⁴ The number of emerging countries with outstanding Samurai bonds issuing bonds in Japan’s financial market since November 1999 is approximately twenty.

“collective action clauses” (CACs), which is endorsed by G-10 countries and International Monetary Fund (IMF), should be incorporated in samurai bond contracts to strengthen the position of Japanese investors. As conclusion, it support introduction of CAC for sake of all participants in financial markets as well as for Japanese investors The insufficient legal protection under Japanese legal system affects and impairs the interest of all sovereign market participants, including those in other countries, because of the possible “irrational behavior” of opportunistic creditors – rouge creditors⁵ – to maximize their own interests. Such behavior interferes with the orderly resolution of sovereign debt problems during a financial crisis. To solve such financial calamities in sovereign debt problems, wider use of CACs by emerging market borrowers helps to prevent insufficient legal structures from becoming a source of misalignment of the interests of the market participants.

Part 2 of this thesis illustrates the interest situation of both corporate and sovereign bondholders in general. Then, Part 3 shows, an overview of the contractual provisions currently existing in samurai bond contracts. Last, Part 4 evidences that no definitive legal impediments exist for the introduction of CACs under the Japanese legal system, taking into consideration differences between corporate and samurai bondholders’ interest.

2. Sovereign bondholder’s interest

(1) The practical need of special mechanisms for bondholders

The position of bondholders, including holders of not only corporate bonds but also samurai bonds, is generally rather weak vis-à-vis that of issuers. Compared with other financial creditors, bondholders are the passive receipt of payment from the issuer. In addition, bondholders are relatively numerous and potentially widespread, creating logistical and other difficulties to effective communication for the issuers at every stage, from bond issuance until redemption at the maturity date. For example, the bondholder’s interest are scattered and their type is various so that it is difficult to decide terms and conditions with the issuers. Until the maturity date, each bondholder is does not to monitor the issuers because it is simply not cost-effective. In the event of default, individual negotiation with and the enforcement against the issuer is practically impossible, given the time and cost involved for what may ultimately be of

⁵ In this context, “rogue” investor refers to a small number of creditors who aggressively use provisions designed to protect the rights of minority stakeholders to maximize the value of their own holdings.

a relatively small financial interest in the issuer.

Special mechanisms are needed for bondholders to be able to enjoy a stronger position by gathering and realizing the interests of all bondholders as a group. Such mechanisms include appointment of a representative with the necessary expertise and resources, and/or bondholder's meeting, which is a collective decision-making mechanism. If these mechanisms are effective for taking advantage of opportunities for sophisticated monitoring, practical negotiations and unified enforcement, they induce funding from various investors, especially individual investors.

While strengthening the position of bondholders as a group, it is also necessary for each bondholder's rights to be reasonably limited or restricted when the bond issuer runs into financial difficulties. Each bondholder's action is normally not limited because each bondholder has a separate contractual relationship with the issuer. For instance, bondholders have an option to opt out negotiation for bond restructuring. In addition, they have the right to pursue the enforcement of remedies. These actions of each bondholder can drastically affect the interest of all the other creditors in the financial distressed situation of the issuer where the overall interests of the bondholders as a group may be at stake. The limitation of each of the above rights is desirable to support the economic recovery of debtors in financial distress situations, even superceding each bondholder's fundamental right to bring his/her own legal claim to preserve the whole of his/her investment. Rather, it makes more financial sense for each bondholder to be the last remaining bondholder that "holds out" for the best possible terms from the issuer.

A particular situation generally referred to as the "collective action problem" or "holdout problem, where an individual's rational decision leads to an irrational conclusion, clearly shows the necessity of such limitations on individual actions. For instance, an issuer may be in financial distress yet hopes to achieve a restructuring of bond such as payment rescheduling, depending on future economic developments. If this restructuring were achieved, the payment would become larger than urgent remedy. Nevertheless, some bondholder pursues his/her own interests, by not participating in restructuring talks and by holding out on the payment rescheduling decision either for grabbing a issuer's assets ahead of other creditors or compelling to buy or his/her own

interest out on preferential term.⁶ This behavior results in the insufficient or partial recovery of the initial investment for each bondholder, which is unreasonable from the viewpoint of the bondholders when analyzed as a group. On the contrary, collective cooperative behavior with respect to a restructuring of repayment terms would lead to a more efficient conclusion for all bondholders.

Two possible legal structures come to mind, each which serves to protect and preserve the interests of bondholders overall by restricting individual bondholder rights: the first is to have majority resolution at bondholders meeting and the second is to appoint a representative to pursue the group interest of the bondholders.⁷ The majority resolution option, which binds dissenting bondholders by a majority vote (but NOT a unanimous vote) to any economically rational decision taken with the viewpoint of the bondholders' collective interest, is an effective mechanism for balancing the collective and individual interest of bondholders. Some civilian courtiers including Japan provide such mechanism through statute. The other effective mechanism is to empower a representative, like a trustee, with the sole authority to represent the bondholders' rights collectively and the power to limit the remedy of each individual bondholder. Some jurisdictions provide these mechanisms, which can optimally mitigate the problematic situation above by laying out clearly the constraints on individual action and thereby forcing each bondholder to cooperate in the future, if need be. In particular, trust deeds commonly found in English-style Eurobonds are used for this purpose, which typically provides that only the trustee may pursue legal remedies on behalf of bondholders.

Compared with corporate bondholders, sovereign bondholders and sovereign issuers have a greater need for the above mechanisms because bond restructurings in distressed nations potentially become substantially more difficult than corporations. In a corporate context, the statutory bankruptcy regime is such a powerful mechanism

⁶ It is of course important to protect the interests of minority stakeholders, but this type of behavior by "rogue investors" often stands in the way of a negotiated settlement that may increase total returns to bondholders.

⁷ These mechanisms for strengthening their weak individual position has long been recognized as needed in many jurisdictions. A good reference for a comparative analysis of various jurisdictions may be found in Philip Wood, "International Loans, Bonds and Securities Regulation" and Annex IV of "The resolution of sovereign liquidity crises-A report to the Ministers and Governors prepared under the auspices of the Deputies-" Group of Ten, May 1996 (G-10 report in 1996).

that it works well for solving holdout problems arising in financial distress. In contrast, as no major jurisdiction has prepared such bankruptcy regime against a sovereign nation, uncooperative creditors retain their legal rights to force sovereign issuers to comply with the original terms of bond indentures. Without a bankruptcy regime, a purely voluntary bond workout, negotiated in the middle of a market panic or financial meltdown, is expected to be a messy and time-consuming affair. Thus, it is desirable to have a mechanism to restrict each individual bondholder's rights in advance, as a part of the original bond documentation or by statutory law.

In addition to the theoretical needs above, the continual economic crises in emerging market countries in recent years encourage market participants and official sectors to examine the feasibility of practical mechanism for sovereign countries in financial difficulties. To address this complicated issues, finance ministries and central banks of the G-10 nations explores, in close collaboration with the IMF, the possibility of new approaches to deal with bond restructuring. Before turning to a close examination of Japanese situation of bondholders, it is helpful to describe the recent situation which needs such approaches.

(2) The compelling need for collective action clauses

(a) Collective action clauses and central issue of the enforceability

The practical and broadly acceptable reform is currently contractual approach, under which sovereign borrowers and their creditors, especially bondholders, introduce CACs stipulating as precisely as possible how a restructuring will occur. As main issues for this articles are the necessity of CACs under Japanese legal system, it is desirable to make it clear what this article intends to mean by CACs. Two following clauses are referred to as CACs in this article.⁸

- Majority clauses, which enables to bind bondholders within the same issue to allow for a qualified majority to agree to a change in the terms of a debt contract, and for the new terms to be binding on any dissenting bondholders within the same issue. Especially, the clause that enables a qualified majority to bind all bondholders within the same issue to the *financial terms* of a restructuring either before or after a default is important. This provision is recently referred as “majority restructuring provisions” so that this article uses this term.⁹

⁸ In addition to the clauses above, other clauses such as engagement clause are also important but in this article the discussion is limited to these three clauses, same type of which exist in Japan.

⁹ Please see the IMF staff paper “Collective Action Clauses: Recent Developments and

- No action (or non-acceleration) clauses, which state that a minimum threshold of bondholders is required in order to enforce his or her rights (or accelerate the bonds in the event of a default). Recently, the clause, which prevents a minority of creditors from pursuing disruptive legal action including litigation and acceleration after a default and prior to the reaching of a restructuring agreement, is referred as “majority enforcement provision”¹⁰, which this article uses from here.

In addition to above two CACs, a bondholder representative in advance or collective representation clauses, which set out the process of choosing an interlocutor to with the issuer, support the CACs above. They provide for mechanism for coordinating discussions and possible action between the issuer and bondholders. Such representative is beneficial to both issuer and creditor since both parties has an interest in effective communication method with each other. Use of such representative is also able to confer the right to initiate litigation on behalf of all bondholders upon such representative by its discretion.¹¹ Thus, some jurisdictions recognize such importance and this thesis sometimes referred to them.

Among CACs above, the central feature of a successful bond restructuring process depends on validity, enforceability and effectiveness of a majority restructuring provisions. Together with majority restructuring provisions, majority enforcement provisions have strong effect on whether the bond restructuring is achieved or not. As for majority restructuring provision, the controversial points are measures to balance the objective of resolving collective action problems and protection of minority creditors’ rights. There are some methods to balance majority will and minority protection. For example, judicial review again bondholder’s resolutions is one method of balancing mechanism. Statutory restrictions on the powers of the majority to bind the minority are another way for preventing majority tyranny, too. Further, adequate thresholds, straight majority (1/2) or super-majority like 2/3 or 75% of quorum, achieve that goal. For calculating quorum as to whether a certain type of voting threshold has been met, there are two ideas: one based on the outstanding principal of the bond or one on the claims of bondholders present at a duly convened meeting.

The extent of limitation of each enforcement action is also pivotal issue. If the

Issues” March 25, 2003 (IMF Recent Development).

¹⁰ See above.

¹¹ The discretionary power of representative is usually overridden under some conditions such as passage of reasonable time or request of majority decision at bondholders.

ability of legal actions by each bondholder is not limited, single bondholders are allowed to pursue litigation by enforcing their claims after a default and prior to a restructuring agreement as usual, thereby disrupting the process of bond restructuring. The majority enforcement provisions are expected to prevent each bondholder from pursuing such disruptive lawsuits by requesting threshold for enforcement action while the workout is in progress. Such limitation through majority enforcement provision, however, raise concern on how to provide adequate complementary enforcement measures for bondholders. Otherwise, such limitation would be unenforceable because of impairment of fundamental right of creditors.

(b) Increasing concern for collective action clauses

The growing concern for CACs relates to continual economic crises in emerging market countries and criticism against policy measures taken to solve such crises. Since the late 1990s, international financial markets have encountered a string of financial crises in emerging market economies ranging from Asia and Russia to Latin America. With cross-border capital flows to emerging market countries ballooning, the debtor countries have accumulated repayment burden. As a result, IMF has expanded rescue packages to prevent or resolve ongoing currency crises. First turning point of such large-scale package by IMF is crisis in Mexico, facing foreign exchange crisis in 1994. Some Asia countries including Thailand, Malaysia and Korea faced economic crises in 1997. After that, Russia, Brazil and Argentine also experienced economic crises.

Although effective in containing these economic crises, such large-scale IMF financial assistances entailed some side-effects: policy slippage (moral hazard of issuer countries) in borrowing countries, the excessive bail-out of private creditors, the near-depletion of IMF resources, etc. Among such side-effects, the bailout of private sector situation where public funds to the emerging market, are, in turn, used to repay at least some private investors has been harshly criticized as creditor moral hazard. If private creditor is bailed out in any situation, they are more likely to extend bad credit, thereby decreasing market discipline on sovereign borrowing. While this adverse ramification is not new, the intensity of the recent crises, coupled with the sharp increase in international capital flows, results in growing calls for urgent policy responses.

In reply to these critics, some measures have been taken to prevent and solve the

crises by disciplining investment from private sectors. They include informative disclosure of emerging countries' economic data to appropriately evaluate its situation, modalities of dialogue between sovereign countries and their creditors, and ongoing reform to strengthen the framework for IMF surveillance. In addition, an argument has emerged that in resolving acute debt crises after its occurrence, not only the public sector (most typically the IMF) but also private creditors should bear due cost. Private creditor should not expect to be bailed out and be asked to reduce or rescheduled their claim against financially distressed sovereign. This idea is called as "Private Sector Involvement (PSI)."

The idea of PSI is reasonably cogent from the viewpoint of mitigating the negative side-effects, especially creditor's moral hazard, caused by the IMF's financial support. If the concept of PSI prevails, lending to sovereigns would be disciplined and the number and intensity of sovereign debt problem would be decrease. Further, the need for the provision of public funds to distressed countries from the IMF or other countries would be decreased. Consequently, the pre-arranged mechanism based on PSI has now been increasingly advocated by the public sector. Moreover, a consensus has appeared between the IMF and the G-10; there must be some pre-arranged mechanism possible for private creditors to seek redress.

The diversity of creditors, however, currently makes it no easy task to encourage private creditors to shoulder some of the costs associated with crisis resolution: a major change has happened in the shift from banks loan to bond debts. In the 1980s, most of the external debt of the emerging economies was in the form of commercial bank loans. Restructuring of such credit was undertaken at London Club. In contrast, sovereign bonds have currently become more predominant (See Table A). Together with absence of forum like London Club, the diverse nature of bondholders makes it difficult to solve sovereign debt problem when debt is unsustainable and require debt restructuring. Now, holders of sovereign bonds are sometimes retail sector so that they may be less knowledgeable than banks that deal with international loan syndication. In addition, they are more divergent in their location and interest. Against this backdrop, the involvement of a variety of sovereign-bond holders in the process of crisis management is becoming increasingly necessary.

<Table A>The Form of External Debt Outstanding of Emerging Market Countries

In response to this situation, and with a view to enhancing the international financial system's functionality and to strengthen the framework for crises resolution, the IMF and the Group of Ten have recently discussed approaches to sovereign bond restructuring, providing at least some certainty as to how to move forward the process of resolving situations of financial panic or distress. Government sectors have expected them to provide predictability regarding sovereign debt. Two complementary approaches have been considered for several years:¹² (i) a contractual approach, in which sovereign bond restructuring would be facilitated by enhanced use of CACs, and/or (ii) introduction of quasi-bankruptcy procedures, the establishment of a universal statutory framework which would create a legal framework, "Sovereign Debt Restructuring Program (SDRM)." Among two approached, statutory framework approach, SDRM has been almost failed. Thus, it is not necessary to enter into a detailed discussion of SDRM for the purpose of this article.¹³

(c) Studies on collective action clauses

CACs have recently been endorsed in both official and private sector. For example, IMF has explored legal issues in some jurisdictions in some staff papers¹⁴. In addition, Some of G-10 countries have expresses the intention to incorporate the CACs into foreign-currency-denominated bonds issued by its sovereign (termed as "lead by example"). Furthermore, G-10 countries, with the cooperation of lawyers and others specialized in the relevant legal areas, have advanced collaborative studies on the concrete content of CACs, which are incorporated in the Model Clauses since June of the last year (2002). The study result is on available in a report entitled, "Report of the G-10 Working Group in Contracted Clauses."¹⁵ In this report, issues to be discussed in setting up examples of matters that can be resolved by a majority vote are enumerated.

Together with such coordinated work, harmonization of enforceability of CACs among major jurisdictions is necessary. If a particular jurisdiction allows them to

¹² Since 1996, the official sector encouraged the use of CACs in international sovereign bond contracts. The earliest achievements by G-10 countries are G-10 report in 1996 and "Report of the Working Group on International Financial Crises" in 1998.

¹³ The SDRM also raises interesting legal issues, but it is beyond the scope of this article. See Hal Scott, "A Bankruptcy Procedure for Sovereign Debtors?" *The International Lawyer*, Vol.37. No.1

¹⁴ Design

¹⁵ This report titled as "Report of the G-10 Working Group in Contracted Clauses"(G-10 report in 2002) is available on the IMF home page.

obtain satisfaction of court judgment, the strategic behavior of holdout creditor would be effective. In addition, cross default clause---which have the effect that if some debtor default on one debt and as a result holders of such debt are entitled to demand full and immediate repayment of principal, this would automatically constitute a default on any other bond containing --- gives a critical effect on other creditors. From such a point of view, major jurisdictions have examined the feasibility and desirability of incorporating CACs. Especially, major jurisdictions are now studying the applicability of the issues indicated in the report above within their own legal systems. Here, studies on the above mentioned issues undertaken by some countries are briefly introduced.¹⁶

In the major sovereign bond markets of New York and London, the main discussion is regarding trustees and fiscal agents in bond indentures based on existing contracts (such as Trust deeds and Trust indentures).¹⁷ In England, it is long-standing market practice to incorporate CACs. For example, majority restructuring provisions has been common both in corporate bond and sovereign bond indentures. In addition, individual bondholders' legal action in the case of the non-performance of principal and interest payments is, to some extent, restricted in many cases.

On the contrary, in the U.S.A. CACs have not been commonly used due to restrictions on corporate bonds under the Trust Indenture Act (TIA), a special law governing corporate bonds, and even for sovereign bonds, negative views on the adoption of CACs were more common. For example, TIA does not recognize any debt restructuring except for cases of postponement of interest payments for 3 years, if resolved by three-quarters of votes. Further TIA does not impose bondholders' right to sue in the case of nonperformance of principal and interest payments. Recently, however positive opinions are increasing for the development of CACs with recognition that TIA is not applicable to sovereign bond. Especially, there have been practically important developments regarding inclusion of CACs governed by New York law in 2003.

Further, in Continental/Civil Law countries such as Germany and France, legal

¹⁶ IMF paper "The Design and Effectiveness of Collective Action Clause" (June 7, 2002) (hereinafter referred to as "IMF Design")

¹⁷ See Wood and IMF Design. In both England and U.S.A., sovereign bond contracts follow corporate bond practices. (See Lee C. Buchheit, G. Mitu Gulati, "Sovereign Bonds and the Collective Will" Emory Law Journal Vol. 51 Number 4, (Fall 2002)) .

arguments are presented primarily by comparison with their statutes. In such cases, in an environment where no statute governing sovereign bonds exists, negative views towards the adoption of any provisions restricting the rights of bondholders have tended to emerge.¹⁸ However, sovereign-bonds-specific discussions are finally being raised and will continue through studies of the Model Clauses in each country.

(d) The criticism for collective action clause

The adoption of CACs often faces counterarguments based on legal, economical and empirical argument. Especially, like other participants in international financial markets, Japanese financial institutions also raise questions on economical rationale of CACs. As full scope of such discussion is beyond scope of this article, this article briefly touches upon it for showing my standing point of the legal discussion.

For instance, some would argue, “Sovereign bond markets have developed on the assumption that no restructuring would occur. Adopting CACs in such an environment would lead to the shrinking of sovereign markets since such adoption is associated with the possibility of debt restructuring. It also increases funding costs resulted from restructuring.” In view of the historical background of the development of sovereign bond markets, such argument regarding the possible shrink of markets, in a sense, might be true. The sovereign bond markets originates with the Brady Bonds that had been issued in order to solve accumulated debt problems in Latin America in 1980s. Therefore sovereign nations have felt fear that default and debt restructuring would cause difficulty in issuing bonds, thereby strongly preventing indebted countries from recurring default, on one hand. On the other hand, investors have belied in the tendency of sovereign countries. Both fear and belief are one of driving forces to develop sovereign bond market.

One must, however, pay attention to the change in main source of funding from bank lending to bond. Until recently, emerging market countries has been allowed to avoid sovereign bond restructuring during their financial crisis because the ratio of

¹⁸ For example, in Germany negative views against incorporation of CACs into sovereign bond (non-resident) were often presented in contrast with “Act on the Joint Rights of Bondholders of December 4, 1899” that applied to bonds issued by residents in Germany (See IMF Design, Page 7). Counterarguments against such views are seen in, “Statement by the German Federal Government on the admissibility of including collective action clauses in foreign sovereign bond issues subject to German Law”(February 14, 2000) by the German government and Bundesbank.

bonds in their funding sources is relatively small. In contrast, some of them currently amount to tremendous amount of bonds as the top of their funding sources. Under such changes, they inevitably restructure its payment terms to orderly debt disposal. For example, recent cases exist that private restructuring was implemented: Pakistan in December 1999, Ukraine in February 2000 and Ecuador in July 2000. In addition, Uruguay succeeds to exchange most of its market debt for new bonds with longer maturities and roughly unchanged interest rates in May 2003. Taking such cases into consideration, bond restructuring is bound together with real economic situations and appears to be unavoidable, regardless of the contractual terms and conditions.

Regarding the cost of funding, there is some opposition against opinion stated above. First, empirical research provides various results. Some empirical studies suggest that the existence of CACs does not necessarily lead to the increase of bond prices, the argument lacks empirical evidence.¹⁹ Second, if default risks reflect the economic situation, then the existence of CACs does not have any effect. Last, granted that a sovereign price increase occurs due to the adoption of CACs, this increase should be accepted as the movement towards their normal prices to adjust default risks. In other words, such increase should be merely interpreted as a precise assessment of the actual economic situation, thereby correct interaction for misallocation of capital. If chances of sovereign bond debt restructuring are not zero (i.e. there are risks), informing such possibility to investors can be viewed as a precondition for the principle of self-responsibility and for creating an orderly sovereign bond market.

In adherence with such understanding, this article advances discussions from a standpoint that, on the assumption that “bond debt restructuring could actually happen”, regardless absence or presence of CACs, CACs would be useful to provide an effective legal framework for further development of sovereign bond market. CACs would be rather expected to reduce the uncertainty surrounding the sovereign debt workout process and provide predictability.²⁰ If CACs provide investors with

¹⁹ For example, see Becker, Richards and Thaicharoen, “Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?” IMF Working Paper No.WP01/92(July 2001) and IMF Design, Page 12. As those leading to a different conclusion, see Barry Eichengreen and Ashoka Mody “Would Collective Action Clauses Raise Borrowing Costs” National Bureau of Economic Research Working Paper No.7458 (2000). IMF materials, titled Progress Report to the International Monetary and Financial Committee (IMFC) on Crisis Resolution, show the effect of recent fund raising with incorporation of CACs.

²⁰ By saying, “Bond debt restructuring could actually happen”, the author does not

confidence that a fair and transparent process was used for bond restructuring, I believe that investors, especially individual investors, are more likely to invest into the bonds. In that sense, the risk for investors lies in the prospect of ineffective or ill-deficit legal mechanism rather than current legal ambiguity. Thus, this article argues that efforts on how to eliminate the legal ambiguity of CACs are necessary from the perspective that, instead of having a situation where debt default occurs and investors end up holding defaulted bonds, investors would be better off receiving at least a part of what they are entitled to under the unavoidable default resulted from economic situation: Argentina's catastrophic debt default.²¹

(3) Current samurai bond market

The necessity of practical legal framework for preserving and materializing bondholder's interest is apparent. Nevertheless, in Japan, while bond default is actually now in progress in Argentine sovereign bond, no legal measures for collecting the interest has been taken for individual investors. The absence of practical legal mechanism to collect their investment resulted from insufficient legal protection would put Japanese investors unfair position. It would be better if bondholders at least receive some portion of payment instead of holding the defaulted bonds, and therefore further development of the legal system is necessary. A more widespread of CACs helps to resolve the current legal climate in Japan.

The current legal climate in Japan may also give ill effect for international financial markets. Japan is one of the biggest countries where emerging market countries have issued bonds for some period. Actually, many governments and financial authorities of emerging market countries that issue their bonds in international financial markets do issue samurai bonds in the Japanese market. According to the recent bond issuance trends, sovereign bond market in Japan, along with that in Frankfurt, is the third or fourth largest market, comparable only to those in New York and London (See Table B). If the samurai bond market were small, any single person's behavior in the Japanese market would have only negligible effects. But in such large-scale markets, unless one acts in cooperation with other creditors in other countries, such individual behavior would threaten to inhibit debt disposal overall and consequently decrease the amount

intend to recommend bond debt restructuring, nor does he positively affirm that bonds are inferior to any trade credit and credit by international organizations.

²¹ In Argentine case, the non-performance of principal and interest payments has not been resolved under Argentine government bonds. Current situation shown in prelude can be viewed such that debt deferment, one form of debt restructuring, is taking place.

able to recover.

<Table B> Outstanding Samurai Bonds of Emerging Market Countries

In line of thinking, financial authorities of G-10 have given great attention to the contractual as well as legal systems related to Samurai bonds.²² Legal analysis of CACs in Japan, however, has been superficial so far. Moreover, the view has been expressed that CACs are not reliable under the Japanese legal system. Specifically, it is sometimes believed that Japanese domestic law does not allow the rights of a majority of creditors to be modified without each bondholder's consent. Even though this view does not necessarily reflect the true legal situation, no clear conclusion on bond restructuring is reached. Very little litigation and no market practice on bond restructuring have been takes so far. Further, the lack of legal discussion regarding CACs under Japanese law has created great legal uncertainties.

Such legal analysis of CACs in Japan is also important for future development of Japanese market from the viewpoint of the globalization of financial markets. If legal norms and interpretations that differ from other countries' are adopted without deep analysis, such a legal climate in Japan might lead to the obstruction of the globalization of financial market practices and thus produce disadvantageous results as a whole. Such legal differences could also have an adverse affect on the international competitiveness of the Japanese market amid the advance in the globalization of markets. On the other hand, analysis based on empirical experience in Japanese market and current legal system restoring to the administrative function of the civil court to oversee corporate debt workout would facilitate discussion for further goal of sovereign bond restructuring.

The Chapter 3 explores the current samurai bond contract and show the fact that the Japanese legal system has already included clauses in a foreign sovereign's bond issue terms, whose function is comparable to CACs, especially the use of a majority clause, Then, it will identify the source of legal uncertainties in Japanese legal system.

²² For example, "IMF Design" and "Collective Action Clauses in Sovereign Bond Contracts- Encouraging Greater Use"(June 7, 2002) (hereinafter referred to as "IMF Encouraging Greater Use") prepared by the International Monetary Fund (IMF) refers to relevant Japanese laws.

3. Bond restructuring provisions under current Japanese law

(1) Issues of samurai bond contract

(a) Basic structure of samurai bondholder's protection

All samurai bond contracts currently provide regime for bondholder's protection to gather their collective will. It is not something alien or new in samurai bond contract to incorporate CACs. Especially, the idea behind CACs that the bondholder's will is balanced between as group and as individual. Rather, the contract usually include similar type of clause such as the majority clause, non-acceleration clause, and the representative clause to implement the will of a bondholder's majority, while one occasionally finds some minor drafting differences. As these clauses are now a regular feature of samurai bonds, lack of legal precedents of CACs should NOT be cited as a reason for omitting majority restructuring clauses or other type of CACs in samurai bonds. In contrast, however, the contract rarely includes the clause that limits the power to initiate litigation on such representative or non-action clauses.²³

For example, typical samurai bond contracts contain a certain type of majority restructuring provisions, under which a qualified majority (2/3) of votes at a bondholders' meeting can amend the contract term that will become binding on all bondholders. Such meeting typically requires the quorum for which is a majority of the outstanding principal amount of the bonds. The contracts also include a non-acceleration clause, which requires a request by bondholders holding more than 50% or 25% of the value of bond issuing to accelerate total payment after payment default. Further, they usually set out a certain type of bondholders' representative termed as a "Kanri Gaisya", ("Bond Management Company" or revised "Commissioned Company", hereinafter referred to as a "Bond Management Company"²⁴).²⁵

The two forms of collective bondholder representation, the Bond Management Company and bondholders' meeting, are very popular mechanism for preserving the

²³ G-10 report(2002)

²⁴ "A bond management company" is accurate term for describing *Kanri*(management) *Gaisya*(Company) in Japanese to distinguish old type of Commissioned Company one of whose function is to represents bondholders before 1993 amendment. Nevertheless, Commissioned Company is also used for current "Bond Management Company" under current market practice. This article uses Bond Management Company for the company under current market and Commissioned Company for former company. The differences will be explained later.

²⁵ It receives payments under the bonds and to handle certain administrative duties in relation to the bonds.

bondholder's interest under Japanese legal system. These mechanisms come from the Japanese Commercial Code (the "Japanese Code" or the "Code"²⁶). Whereas the Code stipulates structure of corporations in Japan, allocation of power between stockholder and board of directors and procedures for issuance of corporate bonds and protective measure of corporate bondholders, it does not apply to samurai bond issued by foreign governments.²⁷ Nevertheless, the contractual clauses in samurai bond almost inevitably follow the statutory provisions in the Code. Such references of the Code in samurai bond are believed to enhance marginally the marketability of the samurai bonds by protecting bondholder's interest in the usual Code fashion. Thus statutory mechanism is usually chosen to attract investors by providing protective measures regarding the bondholders' interest as a matter of market practice.²⁸

Voluntary installment of a Bond Management Company is expected play an important role for preserving bondholder's interests. For example, it has "the powers and duties to do any and all judicial or extra-judicial acts necessary for obtaining payment of the principal of and interest on the Bonds for the Bondholders or for preserving the implementation of the rights of the Bondholders" solely. In accordance with this clause, a Bond Management Company has a discretionary power to accelerate following the occurrence of an event of default for quick action to be taken if necessary. It also has a power to monitor the situation of sovereign countries and inform it to the bondholders. Further, it has power to pursue enforcement proceedings to recover payments after due date. It basically follows the related provisions in the Code.

The reference of Code mechanism shows interesting features of interrelated developments of samurai bond and corporate bonds. Contractual clauses of samurai bond and statutory provisions in the Code have historically affected each other. At the first issue of samurai bonds in 1970 when the Asian Development Bank issued publicly offered yen bonds or in 1972 when Australian issued bonds, corporate bond market custom and practices or the then Code is referenced. Good example is inclusion of many contractual provisions in samurai bonds from the then Code.

²⁶ Chapter Four of Book Two in the Code is the main statute governing joint stock corporations (*Kabushiki-kaisha*) and is supplemented by various laws, including: the Securities and Exchange Regulation(SEA), and the Law on Commercial Registration.

²⁷ While these clauses are applicable to bonds issued in Japan by Japanese corporations, there are arguments as to whether the clauses are applicable to those issued in Japan by foreign domicile corporations, not foreign governments.

²⁸ G-10 report(1996).

Another example was a voluntary installment of entities termed as a commissioned company, a bond management company's antecedents to play the role for preserving bondholder's interest.²⁹ Since then, the contracting party in samurai bond has been a result of drafting conventions that followed the amendments of the Code.³⁰ On the contrary, amendment of the Code in 1993 mandatory requested installment of a commissioned company for corporate debenture and change its name to a bond management company.

(b) Issues of bond restructuring under the current samurai bond contract

The clauses in current samurai bond contract are in general relatively short and simple as compared to the English Trust deeds, thereby leaves some legal issues. As first step for legal analysis, it is better to focus existing samurai bond contract for a while for considering legal issues under Japanese law. Especially, as majority restructuring provisions is main device of bond restructuring, the current contractual clause whose function is same as majority restructuring provisions in samurai bond is examined here. The following is a related part of samurai bonds contracts for Argentine government bonds.³¹

● Bondholders' Meetings

To the extent permitted by law, resolutions of such meeting shall be adopted by a majority of the votes of the Bondholders attending the meeting (the "ordinary resolution"); provided, however, that in relation to giving grace periods, waiver of the liabilities arising from default, or settlement and other proceeding acts (including bankruptcy or other like proceedings) by the Bond Management Company for Bondholders in respect of all the outstanding Bonds, and in relation to matters (other than the Events of Default), as the Bond

²⁹ When introduced, such entity was ostensibly expected to protect bondholders, but actually to solve the conflict between securities companies and banking sectors. While the samurai bond issuing was so strictly controlled that no default was expected, a commissioned for samurai bond was introduced for avoiding confrontation between banking sectors and securities sectors by returning some portion of the underwriter's fee to banking sectors only through "subscription service" which was discussed later with out handling the collateral as trustee.

³⁰ The first step of samurai bond market is well summarized in "Japan's Financial Markets - *Conflicts and consensus in policymaking*" by James Horne. Sovereign bonds issued in the United States have also followed the convention of corporate bonds in the U.S. For a description of the sovereign bond contract situation in the US, see Lee C. Buchheit "Sovereign bonds and the collective will."

³¹ A full description of clauses appears in the Appendix of this paper.

Management Company for Bondholders may reasonably deem, with reference to the relevant provisions of law, to have a material effect on the interest of the Bondholders, resolutions shall be adopted by two-thirds (2/3) or more of the votes of the Bondholders present at such meeting which must be attended by the Bondholders holding more than one-half (1/2) of the aggregate principal amount of the Bonds then outstanding (the "extraordinary resolution"). Such ordinary or extraordinary resolutions shall be binding, to the extent permitted by the laws of Japan, on all the Bondholders whether present or not at such meeting and shall thereupon be carried out by the Bond Management Company for Bondholders.

The above clause clearly permits changes of terms and conditions in samurai bond contract without unanimous consent. It says that bondholders representing two-third of the bonds voting at a bondholders meeting, which meets quorum of which shall be the majority of the outstanding principal amount can change some type of bond terms as long as "to the extent permitted by (Japanese) law." Among such changes a certain type of bond restructuring is concretely admitted in the current clause above. For example, postponement of payment can be accomplished if, as is the case with most such contracts, an existing bond contract permits "giving grace periods" by majority decision. In contrast, as other type of bond restructuring including the reduction of principle is not stipulated, whether the extraordinary resolution may pass the decision on reduction of principal or not is unclear here. The question then arises as to what extent samurai bond restructuring may be achieved.

Different views exist on the robustness of bond restructuring through an extraordinary resolution.³² On one hand, some argue that any type of bond restructuring is achievable if a Bond Management Company considers that restructuring plan is adequate for the best interest of all bondholders. It has a power to decide agenda for bondholders meeting as long as any matters are deemed as "a material effect on the interest of bondholders." As bond-restructuring plan are inevitably considered matters having the material effect to bondholders, any bond restructuring plan is allowed to be adopted and sustained for majority resolution.

On the other hand, others insist that some type of bond restructuring, such as

³² Some of legal uncertainties are shown in IMF Design. IMF states such legal uncertainty based on legal opinions by Japanese lawyers.

reduction of principal, other than giving grace periods is invalid even a Bond Management Company admits. Change of contract clause is not principally achieved unless holder consents under Japanese legal system, any bond restructuring should be clearly stipulated. Otherwise, a resolution cannot deprive any further rights of each bondholder. Such argument relies on an interpretation of the wording “to the extent permitted by law of Japan” in current contractual clause. Whereas the word “to the extent permitted law” is traditionally supposed to make reference to any type of Japanese statute including the Civil Code³³, no concrete limitations regarding the impairment of rights exist even in the Civil Code. Japanese courts are, however, allowed to depart from specific provisions and reach equitable results by invalidating resolution at bondholders meeting if an equitable resolution cannot be reached by relying specific provisions of the Civil Code.³⁴

Two general provisions in the Civil Code are relatively important in this context. One is Section three of Article one of the Japanese Civil Code states that “No abuse of right is permissible.” The other is Article 90 of the Civil Code saying, “A juristic act which has for its object such matters as are contrary to public policy or good morals is null and void.”³⁵

These provisions show the general principles and basic rules for exercise of private rights and contract and give the courts broad discretion.

For example, some argue that bondholder could invoke the “abuse of rights” provision to challenge some type of bond restructuring under the current provisions for bondholders’ meeting.³⁶ Whereas each bondholder has no direct contractual relationship between each other and majority bondholders has no obligation towards minority, the abuse of right provision prohibits the abusive exercise of one’s right. Thus, if a court finds that the exercise of the right provided by current contract infringes upon minority right, it invalids the bond restructuring. In addition, court

³³ The Civil Code is a basic private law covering property law and contract law and contains mandatory rules as general principal regarding any contract while it is taken priority by the Commercial Code whenever provisions of both codes apply. In the case that relevant provisions in the Commercial Code are absent, commercial custom is first applied, and only when no such custom exists, the Civil Code is applied (Art one of the Commercial Code).

³⁴ Oda 133.

³⁵ Jurist act includes contract. See Oda 141

³⁶ Oda 135 Abuse of right provision is generally used in cases where there is no contractual relationship,

finds that samurai contract is null and void through “public order and good morals” if such contract is concluded where one party is in a strong bargaining position and it contains clauses excessively disadvantageous to the other.³⁷ The legal uncertainties with regard to the bond restructuring deeply relates to this two provisions and little precedents.

The uncertainties can be divided into two types: questions common between samurai bonds and corporate bonds and questions peculiar to samurai bonds. The first type of legal questions results from the fact that the contracts of samurai bonds are originally modeled after clauses in respect to corporate bondholders found in the Code. One typical question is whether an “extraordinary resolution” permits to change the structure of a bond repayment or reduce repayment amount, shown above. While same word, “a material effect on the interest of bondholders”, is used for extraordinary resolution, the limit of extraordinary resolution has never been scrutinized even in the context of corporate bond restructuring. Consequently, there is no clear consensus as to whether reduction of principal payment under the samurai bond contract is allowable.

The second type of questions comes from the fact that these clauses’ mechanisms are done purely on a contractual basis, even though the current clauses basically track the existing statutory provisions of the Code for corporate entities. On one hand, general legal principle of “freedom of contract” applies to samurai bonds as a core principle of Japanese Civil Code. Thus, the related parties are basically at liberty to decide any terms and conditions for samurai bonds. On the other hand, some argue the freedom of contract principle is not limitless even after conceding the usual primacy of that principle. The “public policy or good morals” do not allow principal of “freedom of contract” to freely govern the relationship between issuer and bondholders. Further, some insist that any change of contract clause without the consent of bondholders is such an exceptional mechanism that these clauses need underlying statute.

The combination of these two kinds of questions makes it difficult to understand the effectiveness, validity and enforceability of samurai bond restructuring by way of the robustness of CACs, especially the majority clause. To better understand both types of

³⁷ Oda 142.

questions above, a precise understanding of the first type of question is needed. A good place to start for first questions is to examine the bondholders' meeting and the role of the bond management company as mechanisms for protecting the interests of corporate bondholders in the Code.

(2) The basic structure of corporate bond restructuring

The Code set forth a mandatory regime for the issuance of bonds and the basic relationships between related parties of corporate bonds to seeking to balance the interests of related stakeholders in corporations.³⁸ Further, it provides for many provisions regarding the bondholders' meetings, the bond management company and a joint representative to represent bondholder's interest as a whole. Among them, important clauses for this thesis are those stipulating the requirement and procedural conditions for binding resolutions at bondholders' meetings. In addition, clauses regarding a bond management company, which is expected to protect the interests of corporate bondholder's interest, should be considered.

First, the Code allows a majority of bondholders to pass resolutions that bind all bondholders at the bondholder's meeting, even if some are dissenting, upon the fulfillment of proper procedural requirements.³⁹ The Code does not confer a general authorization whereby bondholders meeting can decide matters of common interests, but list those matters which is the subject of a resolution at bondholder's meeting. For example, a resolution "granting a grace period and waiver of liabilities arising from default in respect of all outstanding bonds" requires a two-third (2/3) or more majority vote (super majority vote) of the bondholders (§309-2¶1(1)). A resolution also requires super-majority vote with regard to a legal suit filed on behalf of all bondholders and all further acts relating to the bankruptcy, composition, legal settlement, and liquidation proceedings of the issuer (§309-2¶1(2)). Further, the Code provides for a catch-up provision that states an extraordinary majority resolution can resolve by two-thirds "matters which have a material effect on the interest of bondholders" with previous court approval (§319¶1). In contrast, other matters such as declaration of payment default –acceleration of payment- (§334) and objection against merger and reduction of

³⁸ The Code not only stipulates the relationship between companies and stockholders but also provides the fundamental rights of creditors including bondholders. This is one prominent difference between corporate law in Japan and the United States, even though the Code has been strongly influenced of the U.S. corporate laws.

³⁹ Meetings should be convened for each class of bonds respectively, if two or more classes of bond have been issued (§338).

capital (§376¶3, §416¶2) just require simple majority vote.

Specific procedural requirements must be followed for resolution to be effective while the Code does not stipulate any substantial prohibition on subject of a resolution.⁴⁰ Among such procedural requirements, clause stipulating that any such solution cannot be finalized until court review is important (§327). Concretely, the court will not approve a resolution if, inter alia, the resolution is adopted 1) in an improper manner, 2) is markedly unfair, or 3) is contrary to the interest of bondholders in general (§326). Through these three wordings, the court has very broad discretion as to whether it may choose to approve a majority or super-majority decision. The court function here is supervision rather than being a mediator for adversaries. The reason for court involvement is to ensure protection against minority creditor oppression and to balance majority and minority will at bondholders meeting,

These clauses in the Code, procedural requirements of resolution and the lists subject to a resolution, are mandatory regime which is not overridden by contract. Procedural requirements are considered useful for preventing majority oppression against minority will. In addition, the lists are considered matters which should be executed as a group will through a bondholders meeting. Through such lists, the Code limits exercise of some individual right vested in individual creditor for total interest of bondholders. In sum, the Code restricts the principle of “freedom of contract” by contracting parties for public policy reasons: protection of bondholder’s interest.

As second mechanism to preserve bondholders’ interests as a whole, a bond management company act on behalf of all bondholders to do anything necessary by exercising powers directly without obtaining prior approval from the bondholder’s meeting or a court approval. For example, a bond management company has the power to “do any and all judicial or extra judicial acts necessary for obtaining payment of principal and interest for preserving the implementation of claims”(§309¶1). It especially has the right to receive payment of principle and interest from the issuer; bondholders may demand these payments against a bond management company when

⁴⁰ The Code contains technical provisions for convening a bondholders meeting: 1) the right of a bond management company and the issuing company to convene a bondholders’ meeting (§320¶1); and 2) the right of bondholders holding more than one-tenth of the total amount of bonds to request a bond management company to convene the meeting (§320¶3).

it receives them (§309¶3). A bond management company may also recover a judgment for repayment in its own name against the issuer and can file claims under statutory corporate bankruptcy procedures.⁴¹ Further, a bond management company has the power to investigate the business and property of issuers with the permission of the court, when such investigation is necessary to perform its function (§309-3). It can also convene a bondholders' meeting (§320¶1) and exercise the resolutions thereof (§330). While each power of a bond management company above is authorized through the Code, the power can be added in accordance with bond contract unless such power is not consistent with its statutory power.

The installment of the bond management company is mandatory rule under the Code (§297¶1) for preserving bondholder's interest. Given scattered and small interest, each bondholder's monitoring for issuer is not cost effective. Considering that are rather weak against issuer and fragile to protect their interest by themselves, they are not able to protect his/her own interest. Individual enforcement action is also cumbersome. Thus, special entity is required to install for protecting bondholders in the amendment of the Code in 1993. The argument for introduction of mandatory regime of a bond management company will be explained later. .

In contrast, individual bondholder are allowed to execute other matters which are not on the lists of a resolution or a bond management company's powers in the Code. For example, there is a consensus that each bondholder can execute enforcement action against issuer to recover the payment of principal or interest after due date. This is because the bond management company is to safeguard the bondholder's joint interest by their own initiative, not to get rid of each bondholder's right. In other words, statute does not

In sum, the Code set forth a mandatory regime for bondholder's protection through bond Management Company and bondholder's meeting, on one hand. On the other hand, contracts are just expected to preserve bondholders' interests as supplemental measures to the extent that they do not override the basic structure of the Code. Contractual protections, in general, may properly govern the relationship between creditors and the debtor if the process of negotiation, monitoring and enforcement on terms and conditions has, and continues to, occur like large creditor as commercial

⁴¹ Japanese Bankruptcy Law §228 and Japanese Reorganization Law §126.

banks. For such creditors, it is unnecessary exist in the Code to displace the underlying contractual relationship as the parties' truest manifestation of intent and bargaining. As the presumption of contractual protection cannot be satisfied in bondholders, statutory protections should govern the debtor-creditor relationship. Consequently, the Code does not permit reduce statutory protection and, in contrast, does allow incorporation of contractual clauses such as covenants as more protective measures for bondholders.

(3) The limitation of corporate bond restructuring

The Code does not allow principal of "freedom of contract" to freely govern the relationship between issuer and bondholders. Rather, it restricts the issue's will (debtor corporation's discretion for contract) and limits majority will for minority protection. The question arises: whether bond restructuring under CACs are admissible under the Japanese legal system. This question will leads to the basis of conclusion regarding validity, enforceability and of CACs for samurai bonds.

(a) Majority Restructuring Provisions

The crucial issue is what kind of terms and conditions can be overridden through majority bondholders' resolutions under the Code. On this point, the court involvement prior or posterior should be reminded; whereas the prior approval is needed only in case for adopting the matter which is not clearly stipulated in the Code for bondholder's resolution, the posterior approval is inevitable for validating the resolution. Japanese law prefers a court's discretionary power under conditions such as improper procedure, marked unfairness, or actions contrary to the interest of bondholders in general to substantial restrictions of the restructuring plan. The court has broad power to evaluate bond-restructuring plan by interpreting the conditions for minority creditor protection.

The judicial review is expected to correct possible procedural and substantial flaws at the bondholder's meeting as a supervisory authority to protect the scattered and small interests of bondholders. This broad function of the court is, however, a source of legal uncertainty with respect to corporate bond restructuring. For instance, "improper manners" includes any procedural flaw such as any collusion between the issuer and the majority creditors. Further, "marked unfairness" directly prevents unequal treatment between majority holders and minority holders. Last, the wording "contrary to the interest of bondholders in general" is interpreted as the requirement that a new payment plan should yield at least as much as would be received on a

liquidation of the corporation and the distribution of the proceeds to bondholders. While these examples are acknowledged in legal writings but there have been no concrete court rulings on each wording, so that clear conclusion on the bond restructuring issue has not really been addressed.

The view has been sometimes expressed that some type of bond restructuring such as reduction of the principal payment are not allowed with suggestion that no comprehensive bond restructuring has been implemented. It is true that an actual default, which requires comprehensive bond restructuring, has not occurred in Japan until recently. But a lack of legal precedents on bond restructuring should not be cited as a reason for forbidding any bond-restructuring. The Japanese legal system currently predicts an occurrence of bond payment default so that the Code provides for the two mechanisms: bond management company and bondholders meeting. The two mechanisms are prepared for default of bonds which may occur under the principle of "high return and high risk" through the liberalization of bond markets. Current bondholder's protection is also achieved in the form of knowledge based on the sophistication of the investors together with strict disclosure rule under Japanese Securities Regulation.

(b) Majority Enforcement Provision

With regard to majority enforcement provision, it is unclear whether a clause limiting individual bondholder's right to initial legal proceedings would be valid under Japanese law. Under the present provisions of the Code, the bond management company is allowed to initiate legal proceedings for bondholders but it does not, in principle, generally restrict individual bondholders' enforcement act.⁴² As a general rule, the existence of a bond management company is only for the sake of individual bondholders to preserve their interest. Thus, it does not affect individual bondholders' rights: an individual bondholder is entitled to take individual enforcement action against issuer to recover its portion of any amount of principal or interest not paid on respective due dates.⁴³ One court decision admits that each bondholder has the right to initiate litigation even if bond Management Company has the right to litigation.⁴⁴

⁴² G-10 report in 1996.

⁴³ Apart from this individual action to recover overdue amounts, however, the Bond Management Company retain the right to accelerate other amounts pursuant to resolution at Bondholder's meeting: individual bondholders is not allowed to recover its portion which is not mature.

⁴⁴ Taishinin November 28, 1928, Minshy 7 at 1008. This court ruling relates to

Nevertheless, after the payment default there are two ways in consensus to limit individual enforcement action to prevent a multiplicity of litigation. One is a resolution to prohibit individual litigation at bondholders' meeting. Straight majority vote can pass any resolutions if approved by a court as required by the Code (§309¶1). Thus, if resolution decide the limitation of individual litigation, it will bind all bondholders, even those who voted against it. The other is that actual litigation by a bond management company. If a management company sues the issuer for payment of the bonds in respect of which it has been appointed, an individual bondholder would probably be precluded from suing the issuer concurrently to obtain payments in respect of its own bonds. Even there are no judicial precedents on these methods, legal scholars widely admit these two measures are effective to limit by enforcement by individual bondholders.

In contrast, it is not clear whether Japanese law would allow parties to limit the basic rights of individual bondholders to take legal action through contractual terms in advance. In addition, provisions that would delegate the sole power of initiation of litigation to the bond management company for bondholders, individual bondholders might challenge these provision based on the abuse of right in the Civil Code. While there is no intercreditor duty between bondholders who has separate contractual relationship between debtors, the prohibition against the abuse of right is generally used in cases where there is no contractual relationship.⁴⁵ Such clause will be the subject of legal scrutiny by the court if litigation is sustained. Even some legal scholars admit the rationale for such clause lies in the situation that claimants would otherwise be competing for a "limited fund" of assets, it might be difficult to make determinative conclusion one way or another since there is no precedent of this kind of provisions and thus no court ruling,

(4) Market situation supporting the lack of bond restructuring

The legal uncertainties stated above do not reflect a public policy prejudice against majoritarian debt restructuring in Japan, but just result from little actual bond default

relationship between litigation by individual bondholder and a representative company for administrating collateral, one of whose function is similar to bond Management Company. Scholars reach consensus that this court ruling is applicable to bond Management Company. For avoidance of confusion, it should be noted that the court decisions is made without litigation by the representative company.

⁴⁵ Oda 135

cases in history after the Second World War. The historical features of Japanese corporate bond market show that Japanese corporations had only very little access to the bond market and why such ambiguity regarding CACs had not been challenged. Until recently, public policy based on no practical and empirical argument has existed under the undeveloped bond market. Recently, however, it would be better to say that current public policy admits the possibility of comprehensive restructuring. The present Japanese legal climate and its political decision can be best understood in the historical context, especially statutory changes of the Code in 1993.

Before 1993, corporate bond market was artificially controlled, instead of the view that the market should select the appropriate bond-issuing company and terms and conditions of such bonds and solve the bond default situation through comprehensive bond restructuring. Two peculiar features that were tightly related to each other existed in Japanese financial market until 1990s. One is the regulations and statutes as well as market practices and customs, which practically exclude corporations to freely enter into the in the issuing-corporate bond market. The other is the peculiar customs, or moral obligation of repurchasing defaulted bonds by commissioned companies, in secondary market, thereby avoiding implementation of comprehensive bond restructuring.

The first feature is that the strict controls by the financial institutions and government bureaucrats practically prohibited high-risk bond issuance of corporation and hindered development of corporate bond markets, thereby usually avoiding defaults caused by financial distress of issuers. Three main market customs, together with statute (the Code) or regulations⁴⁶ are important to control the bond issuance. First is the use of “qualification standards,” i.e., criteria (such as net capital, ratio of equity capital to debt, and other financial ratios) which issuing corporations had to meet. Second is the special meetings termed as a *kisai-kai*, once a month to decide how much money should be allotted to corporations wishing to issue bonds and terms and conditions of new bond issuance. Last is the requirement of collateral to preserve creditor’s interests.⁴⁷ These customs, especially collateral requirement, restricted bond issuance only to large-scale corporations for maintaining confidence in the bond

⁴⁶ The Code also set the restrictions on the total amount of bonds.

⁴⁷ This collateral requirement was introduced in 1930s, when a number of corporate bonds went default, and continued after the Second World War and remained until 1979. As corporations in limited industries could satisfy the collateral requirement, not many corporations could issue bonds.

market by protecting bondholders resulted from bond defaults.

The actual aim for controlling corporate bond market, however, was the to focus scarce money in domestic financial market on the key industries. During postwar reconstruction and the ensuing rapid economic growth, companies' prime source of finance is indirect financing, rather than direct financing from the securities markets. The necessary funds for economic growth of companies were mainly provided by banks (indirect financing), which actively offered loans to specific targeted industries while absorbing scarce funds in the form of deposits from individuals.⁴⁸ In addition, because of the scarcity of funds and few individual investors, the possible holders of bonds were financial institutions such as commercial banks and securities companies. Under this economic situation, only corporations selected by financial institutions were allowed to issue and issuances of bonds were highly restricted.

The second feature was, even in the very rare bond default events that occurred, the moral obligation, which is vested in financial institutions relating to bond issuance enabled to avert an implementation of comprehensive restructuring. Initially, some financial institutions including securities companies and commercial banks under the name of commissioned companies decided the bond-issuing corporations and amount of an issue. Then, they made underwrite such bonds to other financial institutions or some large investors such as insurance companies or purchased such bonds by themselves. If such bond defaulted, financial institutions involved in procedures of issuing bonds, especially commissioned company, customarily repurchase bonds from bondholders, not based on legal mandate but moral obligation. After such repurchasing, they negotiated with issuer and usually implemented private workouts or proceeded bankruptcy procedure. Last, if losses arouse from defaulted bonds, financial institutions collect their loss from collateral to bonds. As the last stage shows, the collateral requirement for bond issuing was very important in satisfying the moral obligation of financial institutions because it helped to avoided the loss of financial sectors. In sum, this secondary corporate bond market practices based on moral obligation by financial institutions enabled to smooth workout process in the relatively few cases of financial distress of the issuer.

⁴⁸ Banks are a kind of public institution, sharing the goals of the corporate sector and the government by promoting the national economy and expanding corporate business opportunities wherever possible.

The moral obligation of repurchasing bonds implicitly comes from various functions entrusted to financial institutions termed as a “commissioned company.” These functions of a commissioned company were the key to understanding the low level of bond issue. For example, a commissioned company was not regulatory mandate to install but customarily and practically played various important functions.⁴⁹ First, together with function as the main bank, a commissioned company practically acted as financial adviser to give advice as to the timing, method and amount of an issue, which is practically the permission from the special meetings (*kisai-ka*). Then, if bond issuance was agreed, a commissioned company were contractually involved in the procedure of bond-issuance through “subscription services”, which is administrative service in bond issuing such as drafting of various related contracts and other necessary documents, preparation of application forms for investors, the allotment of investors to bond after solicitation, receipt of full payment by investors and the roster of bondholders and roster of bondholders and bond certificate, and. If such bond was collateralized, a commissioned company was contractually designated as the trustee of the collaterals. In addition to these contractual basis relations, a commissioned company, if installed, has authority to do any and all judicial or extra judicial acts necessary for obtaining the redemption of bonds in former Code (§309¶1). These functions were also considered, or at least anticipated, as a source of implicit guarantee of bonds repurchase in default

Among these functions above of a commissioned company, provision of “subscription service” was a compromise between banking sectors and securities companies sectors and burden for corporate issuer, which was not only cumbersome and inflexible for bond issuing but also costly. While the banking sectors were allowed to be engaged in most of securities businesses before 1948, a Japanese Glass-Steagall type of regulation, Securities and Exchange Law (SEL) prohibited banking sectors essentially prohibited the banking sector from engaging in most securities activities, including soliciting and underwriting. Subscription service was left, however, to the banking sector as a kind of compromise for returning some portion of underwriter fee to banking sectors.⁵⁰ It was legally discretion, but practically mandate because of strong power of financial institutions for corporations to ask carry out the subscription service to commissioned

⁴⁹ Among following functions, only trustee function is regulatory mandated to install for collateralized bonds. In other words, debenture (non collateralized bonds)-issuing corporations did not have to set out a commissioned company, but practically had to.

⁵⁰ Thus, subscription services are only allowed to commercial banks, long-term credit banks, and trust banks with exclusion of securities companies.

company, Consequently, corporation intending bonds issuance had to ask securities companies to act as underwriters and banks to act commissioned companies. In other words, not only did corporate issuers have to pay underwriting fee for securities companies, but they also had to compensate for variety services.

Opinions from financial and corporate sectors following the oil crisis of 1973-74, however, requested to abolish of various practices on the bond market. This change basically resulted from various needs for greater market liberalization.⁵¹ For example, Japanese individual investors were assumed to want to diversify their assets, reflecting the accumulation of wealth that had taken place in Japan. For their part, corporations increasingly wanted to take advantage of various new capital-raising mechanisms, including debt financing in the capital markets. In addition, international integration of financial markets affected regulatory policy of corporate bond markets in Japan. For example, on one hand, the establishment of the samurai bond markets for foreign entities, which started in 1970s shown, facilitated corporate bond market situation to maintain consistency with other financial markets. It especially played a catalytic and supportive role for facilitating collapse of the market control methods such as collateral requirement even though the samurai bond market was firstly established to satisfy the desire of foreign sovereign and international organization. On the other hand, Japanese corporations deemed offshore issues very attractive for rounding cumbersome and inflexible procedures in the domestic market.

In reply to this request, the bond market was moved from a strictly controlled one to one with greater liberalizations under new concept, the principle of "high return and high risk", like other developed financial markets. Then, the legal and economic climate turned distinctly hostile to the former market practices and customs regarding corporate bond market custom. , At the same time it was requested to establish new mechanisms to protect bondholders for preserving bondholders' interests adequately instead of the practice of conservative pre-issuance restrictions. The bondholders' primary protection was largely eliminated by removing the prohibition of corporations issuing high-risk bonds, thereby permitting almost any grade of bond to be issued with

⁵¹ Explaining the whole bond market situation and its background would involve a discussion of economics beyond the scope of this article; the situation has been summarized below to the extent relevant to this article. On this point, see the discussion "History of corporate finance and the desirable regulation of it" (*Kigyō kinnyū no hennsenn to hou kisei no arikata*), Jurist No.1072 (1995) and Junsuke Matsuo "Japanese corporate bond markets."

minimum statutory protection. The revision of the Code in 1993 was a consequence of modernizing the law and practices and customs concerning bonds in accordance with the wider changes in the financial and economic environment.

In considering new mechanisms for protecting bondholder' interest, functions of a commissioned company became controversial issue and was streamlined to serve only as a representative to preserve bondholder's interest, One hand, the fee for subscription services was used as compensation for banking sectors who was not allowed to underwrite and sources of buy-back funds in default, thereby costly. Then, some argue that subscription service itself and was considered one of the obstacles for corporations to issue bonds at low costs and insist that such service was abolished. One the other hand, the commissioned company was also statutory entitled to do any and all judicial or extra judicial acts necessary for redemption of bonds, if asked to carry out subscription service before 1993. This type of commissioned company, however, was not mandatory forced to install in the former Code. To balance two functions, the 1993 legislation requested mandatory installment of new type of a commissioned company, a bond management company, whose function was reduced to play an effective role for bondholder's protection.⁵² In contrast, the subscription service was liberalized to any corporations.

Consequently, the current Code proposes for "Bond Management Company" and bondholders meeting for preserving bondholder's whole interest. As stated above, the mandatory bond management company...In addition, the Code restated the function of a bondholder's meeting, which had already been statutorily set before. Because of few default cases before, bondholder's meeting had never been held for the purpose of resolving bond restructuring due to few default before 1993. It was expected to balance the interest of each bondholder and as a whole after 1993.

Nevertheless practical legal climate has not changed drastically even after the amendment. For several years since enactment of 1993 amendment, actual default and comprehensive restructuring has not occurred recently: no comprehensive bond restructuring at bondholders meeting has been taken place until recently. Recently,

⁵² The 1993 amendment change the name of company who protect bondholders interest in Japanese from "commissioned company" to bond management company. Nevertheless, the contract in English does not reflect such change.

some bond default cases occurred, but seldom challenge legal issues so far.⁵³

4. Robustness of samurai bond restructuring

(1) Peculiar issues of Samurai bond restructuring

Now that common issues between both corporate and samurai bonds and backgrounds of absence of corporate bond restructuring are summarily clarified above, the issue peculiar to Samurai bonds, in turn, should be addressed. First issue is what kind of CACs, especially majority restructuring provisions, are effective valid and enforceable under Japanese legal system. Even current contract include a clause for majority resolution, whose function is almost same as majority restructuring provisions, such clause is in general relatively short and simple. Thus, it is desirable for current for majority resolution to be amended detailed sufficiently to clarify requirements and procedures for bond resolution for bond restructuring. In such drafting, the important issue is how to protect minority right against improper conduct by the majority.

There seems to be a perception that majority restructuring provisions are not enforceable under Japanese legal system even clauses for bond resolution has been already adopted in samurai bond contracts. Through discussions with me, some practitioners and legal scholars expressed some skepticism about the enforceability of majority restructuring provisions because such provisions impair the fundamental right of monetary claim vested in bondholders.⁵⁴ Among them, one extreme position insists that the exceptional mechanism under the provisions, which enables the individual bondholder's right to be impaired without his/her consent, is valid only if and to the extent statutes permit. They have the view that legislative clarification, not a contract but an underlying statute is necessary to sustain the validity of such exceptional effect. Whereas this view would be unsound considering samurai contract has already included such exceptional mechanism as market practice over thirty years, it is worth considering that there is some limitation for majority restructuring provisions under "public order and good morals" within the scope of the Civil Code.⁵⁵

⁵³ The flaw of procedure was found in bankruptcy procedures and amendments were accomplished thorough default.

⁵⁴ The following argument is very similar to the argument raised by many German legal climate, which still has strong influence over the Japanese legal system as one of original legal sources of Japanese legal system. See the Design.

⁵⁵ The provision on public order and good morals in Article 90 of the Civil Code serves a similar purpose of the abuse of rights.(See Oda 133)

Some acknowledge that such provisions are not against “public order and good morals” if majority restructuring provisions are modeled on the Code. This acknowledgement mirrors the tendency of a Japanese court, which sometimes respects the statutory provisions including the Code rather than the black letter of contracts. Courts also are likely to find clues in statutes for deciding whether a contract is against the public order and good morals or not. Then, they may refer that a samurai bond contract should be comparable to the Code applying the corporate bond for preventing the claim to invoke public order and good morals. The current samurai bond is implicitly relied on this acknowledgement, thereby follows the Code clause.

One question, however, remains: whether a judicial involvement for bond resolution. Whereas the court approval is a mandatory requirement to a bondholder’s resolution in corporate bond, such approval is not incorporated in current samurai bond contract. Such absence might reflect the idea that courts have no jurisdiction *in rem* on that issue as supervisor unless the statute admits. Some argue, however, that situations of both samurai and corporate bondholders are relatively similar in the context of bond restructuring courts should protect minority from majority tyranny. Thus, whether the judicial approval would be necessary or not also add legal uncertainty.

The skepticism above also relates to the second issue: effectiveness of bond restructuring under the majority restructuring provisions.⁵⁶ Even majority restructuring provisions are valid and enforceable; acceptance of a restructuring by a majority resolution is permitted only if the resolution is not considered as the “abuse of rights” by majority within the Civil Code. If minority bondholders succeed to demonstrate that a majority decision jeopardizes the rights of the minority bondholders, such decision constitutes an abuse of rights, thereby be invalidated. Since there have been no court rulings and no clear consensus among legal scholars on this issue, it is not clear whether such challenge would be successful. The argument also leads the same idea that bond restructuring should follow the Code fashion.

In contrast, some argue any clauses are effective, valid and enforceable and any restructuring is acceptable at its core. They argue that no statutory limitation explicitly exists for samurai bond contract so that the “principle of freedom of contract” weighs in the direction of permitting the contracting parties and thereby any contract

⁵⁶ The Design and G-10 report (2002) shows the following opinion.

including introduction of CACs is allowed. In addition, if bondholders enter into the contract with acknowledgement that it includes majority restructuring provisions, such bondholders should obey the resolution of majority. This idea concludes that majority decision based on such contract mechanism should be considered robust.

It seems to me that the views above are indecisive because they seem so dogmatic. As they interpret the meaning of contract or the Code on surface, the substantial issue regarding samurai bond restructuring remains untouched. The substantial issue here is whether CACs is sensible to actually protect bondholders as whole after a sovereign default take place. In other words, the robustness of samurai bond restructuring through CACs must be judged in light of the consideration of actual context of samurai bondholders rather than text of current statute or contract. Wider observation on bondholder's situation for such consideration is necessary. Nevertheless, it seems to me that opinions above interpret text of current statute without substantive analysis of minor bondholder's protection. As first step for such substantive analysis, the differences between corporate bond and sovereign bond should be focused.

(2) Difference between corporate and sovereign bonds

The situation of stakeholders surrounding a sovereign issuer differs so greatly from a corporate issuer that the Code does not, and should not give effect in considering the effectiveness, validity and enforceability of a samurai bond contract. Especially, given two salient features peculiar to sovereign, samurai bond contracts do not have to be perfectly consonant with the Code. One feature is that the situation surrounding interested parties assumed by the Code is totally different from the situation in sovereign bond context. The other feature is no bankruptcy regime against sovereign exists as alternative mechanism to solve holdout problem in sovereign debt problem.

First feature is that no corporate bankruptcy alternative, either by way of a reorganization or a liquidation against sovereign. In a corporate context, a wholly contractual bond restructuring is not necessarily needed, because bond restructuring can usually be achieved far more effectively and comprehensively through the existing bankruptcy regime. In contrast, sovereign bond restructuring cannot be achieved under current legal system. This brings two possibilities. On one hand, there is usually no means of bringing pressure to bear on each bondholders to reschedule their terms, or to prevent them from suing the sovereign issuer in local courts; there is no commonly accepted standstill mechanism or proceeding. This

brings advantage for strong creditor like large-scale commercial banks. On the other hand, it should be considered practically impossible to recover much of anything through each bondholder's litigation against a sovereign country. From such perspective, the sovereign bondholder's position has nothing to do except wait until voluntary payment by debtor states. Current situation of bondholders in Japan is exactly latter situation, thereby CACs would strengthen the individual bondholder's position

Second feature is the Code provides for provisions balancing all of stakeholders' interests, especially with sometimes-conflicting goals of maximizing shareholders' interests while sufficiently protecting the creditor's interest.⁵⁷ According to modern financial theory (a full discussion of which is beyond the scope of this article) investors' interests may sometimes conflict over such basic matters as proper investment of funds, size of dividends, financing the corporation, or approval of a merger. Stockholders can authorize directors, who represent the stockholders' interests, to take such actions that create huge gains for stockholders but potential capital losses for bondholders. Concretely, the Code provides bondholders with some rights that prevent their interests' undue impairment.⁵⁸

In this context, one explanation for obligatory court approval in resolution at corporate bond may be that it is a measure to prevent abuse by majority bondholders collusive with corporate insider rather than to prevent the general tyranny of the majority. As shown above, the Code is generally designed to mitigate possible conflicts of interest by striking a delicate balance among stakeholders, thereby expecting to protect seniority of creditor's interest against equity holder's interest. In contrast, for a sovereign issuer, the possible abuse of a majority vote to overturn the normal priorities in a bankruptcy are not relevant; the sovereign borrower has no equity holders. Even court involvement is vital for ensuring that the rights of individual creditors have not been abused in the context of corporate bondholders, this type of

⁵⁷ There is consensus that one of the aims of the Code is to adjudicate the diversity of interests among affected parties even though there is no article about the general purpose of corporate law in the Code.

⁵⁸ Creditors have a right of inspection over corporate minutes (§260-4¶4), the articles of incorporation (§263¶2), the register of all shareholders (§282¶2), and the register of debentures (§480-2¶2) to collect necessary information. Creditors also have the right to object to any basic structural changes to the corporation, including capital reduction or a merger of the corporation. Dissenting creditors receive adequate security.

protection is not necessary for sovereign bond. In other words, just because sovereign bondholder may be scattered and small, it does not follow that such bondholders are in same position as corporate bondholder and that the court involvement is required in same fashion of corporate bond.

In contrast, the U.S. financial market history provides an example of the concern that bond majority could abuse minority right with corporate insiders through majority clause.⁵⁹ Following the stock market crash of 1929, the equity owner of some companies bought up their bonds at heavily discounted rate and compose majority required to forgive or defer payment of bonds. After such abuse of the majority clause by corporate insiders, the U.S. Congress enacted two statutes. One is a bankruptcy procedure (the predecessor of the modern Chapter 11) for facilitating corporate debt reorganizations under the supervision of a bankruptcy court. The other is the Trustee Indenture Act, which explicitly includes an absolute prohibition on changing bond terms in order to protect the minority holder's rights.⁶⁰ This history shows that corporate abuse by insider is expected to be preventive by either court approval or substantial prohibition. From this historical experience, the court involvement can be thought not to protect the minority from the majority generally, but rather to prevent abuse by a special type of majority creditor - a majority that was able to collude with the stockholders.

Last, the basis for requesting court approval might be inapplicable. Rather, it is not hard to imagine how difficult it may be for a court to accurately judge, in a time-constrained manner and insufficient information of debtor countries; whether a majority vote resolution is truly reasonable among various stakeholders. The court may simply not have the professional expertise to evaluate the short- or long-term economic situation of the foreign sovereign issuer then undergoing a financial or market liquidity crisis. Thus, strict procedural rules for obtaining court approval for substance judgment in any cases may not work as an effective mechanism for protecting all of the bondholder's interests. The study of basis of court involvement in context of the Code has been strangely neglected under Japanese legal system.

⁵⁹ Buchheit.

⁶⁰ 15 U.S.C. §§77aaa *et seq.* While TIA basically prohibits any reduction in the principal amount due from a publicly issued corporate bond, without express consent of each bondholder (Section 316 (b)), there is a small concession to majority voting, in that the law does authorize short deferments of payment dates (up to three years) with the consent of holders of at least 75% of the bonds.

Considering these differences, it should be sensible to devise contractual mechanism, apart from corresponding clauses of the Code, to ensure the effective mechanism for bondholders and sovereign debtors to re-contract the payment terms. If such CACs cannot be added in samurai bond contracts consistent with the contracting parties' will, not only is the general principle of freedom-of-contract disregarded, but also the collective interest of all bondholders would be potentially undermined. Rather, such contractual mechanism would induce many individual investors to invest samurai bonds if they were confident that fair and transparent procedure in accordance with CACs was used to resolve payment difficulties. From such a point of view, the cooperative participation by all bondholders through CACs should be encouraged as much as possible to preserve their collective interests.

(3) Protection for minority bondholders under Japanese legal system

From above features, the contracting parties of samurai bonds should be at liberty to design into their samurai contracts. In designing majority restructuring provisions, it is important to ensure that small minority of dissident creditors are protected while the will of majority are respected. Voting threshold and/or quorum of resolution are critical for balancing the interests of both majority and minority bondholders. Compared to the Code, it is worth considering that the threshold of sovereign bond's restructuring shall be made stricter than those set for bondholders meeting governed by the Code. Mandatory court approval for corporate bond restructuring is interpreted to make the threshold to adopt the resolution at the bondholders meeting relatively moderate. Such design would be worth to considering for preventing the future argument for invalidating the majority restructuring provision itself and/or bond restructuring.

In addition to high quorum and threshold, there are several ways to protect minority bondholder's interest under Japanese legal system. First is the mandatory disclosure rule. As long as the contract of samurai bond is adequately disclosed to public including investors, even individual investors can knowingly takes the risk of bond restructuring through CACs when purchasing the bond. Japanese current disclosure rule in Securities Exchange Code requests bond issuer, who offer newly issued securities or to sell outstanding securities to public, to file a securities

registration statement with Prime Minister. Such filing provides information such as bondholder's resolution. In addition, a prospectus must be directly provided to the investors at the time of offer. Such prospectus must contain the information relevant for protecting investors included in the registration statement. Thus, investor's would acknowledge the possibility through majority restructuring provisions in advance.

Second, a Bond Management Company can be functioned to protect minority holder's interest. As shown previously, the current samurai bond contract stipulates that resolution on those matters that "the Bond Management Company for Bondholders may reasonably deem... to have a material effect on the interest of the Bondholders" shall be adopted by two-thirds voting at bondholders meeting. If this mechanism were kept, a Bond Management Company should first need to approve any modification of the terms. As long as it approves a modification proposal only if it determines that such a proposal would be in the best interest of all bondholders, the minority bond holder's interest is not impaired.

Third, this article insist that Japanese courts should not refuse to hear a challenge to the legitimacy of a majority's decision when the minority bondholders challenge the procedural flaws even court approval in advance is unnecessary, which is provided for the Code. Courts do not necessarily hesitate to regard exercise of majority's rights as abuse of right if it unreasonably impairs minority's interests in order to attain equitable results.⁶¹ Courts should scrutinize the procedural operation of majority bondholder's decision in cases where the minority bondholders show a collusive or corrupt oppression of the minority bondholders by the majority. Quasi-equitable power of the Japanese court should be admitted in considering the protection of minority bondholders. In contrast, the following opinion below stating that total limits of judicial scrutiny may not always make sense is quite agreeable.

We are not suggesting that a decision of a supermajority of bondholders taken pursuant to a majority action clause should be overturned lightly, nor should a court substitute its own view about what might be in the bondholders' best interest for what the holders themselves have, as a group, decided. But where a majority or supermajority cannot articulate a commercial justification for its action, a judicial inquiry into motives may be warranted.⁶²

⁶¹ Court may have subject matter of jurisdiction.

⁶² Buchheit 1341

(4) Consistency with international custom

The contractual mechanisms available for international debt offerings in Japan should be largely market driven like market practice from a view point of market competitiveness. Contractual arrangements that are used in connection with international bond offerings need flexibility, because such flexibility improves the competitiveness of the Japanese financial market relative to other financial markets worldwide. As market participants are usually free to select the governing law for international bond offerings, they can opt for any legal system which allows them to freely adopt any mechanism for balancing various factors, including bondholders' protection, to suit their specific needs. If favored mechanism are not allowed to be incorporated into samurai bond contracts, market participants never chose Japanese law as governing law.⁶³ Furthermore, they are likely to decline the offering of sovereign bonds in Japan itself. Such a decline would be a huge disadvantage to Japan's position as a world financial center.

To be sure, binding power of an established international market practice is not limitless under Japanese law. Market practice may sometimes be inconsistent with public policy as explicitly stipulated in Japanese statutes; the supremacy of the written law is unquestioned, and contract terms may clearly be invalidated on that basis. Japanese market does not, however, find any compelling public policy or legal reason for invalidating majority restructuring clause. Arguments rose against CACs legality or effectiveness have been based almost exclusively on indecisive and dogmatic arguments, without the benefit of empirical research on market climate. If the bond market practice avoids proper risk appetite relating to each bond contract, the unilateral intervention of law is not legitimized. Japan, rather, has not faced such situation after the Second World War to introduce a number of market mechanisms until recently;

⁶³ Even if a court were to try to invalidate a CACs-like clause, the flexibility inherent in allowing market participants to choose different market mechanisms may also allow same market participants to circumvent statutory provisions that are perceived as inappropriate, too oppressive or just too cumbersome. Notably, market participants can try to select a governing law that will not prevent them from doing what they would like to do contractually. Considering this possibility, blind adherence to statutes may not always be the most effective way to preserve the bondholders' interests.

perhaps the law should not intervene in the sovereign bond process until such changes have been fully implemented.

In addition, under the Japanese legal system, the customs and norms of other nations, when contrasted to a unique anti-competitive Japanese oddity or singularity, can actually be included as a basis of law if such customs and norms become recognized as, or a “familiar” part of, all other jurisdictions. In simpler terms, the Japanese legal system may admit general, established, world-wide market custom as an integral and valid part of binding law through statute. For example, established international custom can be part of the Japanese legal system by virtue of Article of 98 the Japanese Constitution, which stipulates that “...established laws of nations shall be faithfully observed.” Second, market practice itself may also become a part of Japanese law in its Civil Code and Commercial Code. Pursuant to specific articles in these Codes, the general rules of international law are, in fact, meant to become an integral part of Japanese law. Clearly, then, if CACs become international custom in international bond issuing, it could today easily be incorporated into Japanese law.

5. Conclusion

No legal impediments presently should be considered to exist to incorporating CACs, especially majority restructuring clause in samurai bonds, provided that the bond restructuring serves to safeguard the joint interest of all bondholders. Rather, detailed clauses governing the bond restructuring are alien with the policy decision behind the recent amendment of the Code in 1993, which adopted the greater utilization of market-based legal mechanisms. The CACs driven by market participants are substantially desirable for correcting the weak position of Japanese bondholders, too.

Still, one may have misgivings on possible abuse of the process by majority bondholders, even though abuse of the insider remains theoretically impossible. Such misgivings can be, however, ameliorated through other types of contractual protections. One wise idea is the expanded use of bond management companies, who then becomes the authorized and expert legal guardians for the bondholders. The involvement of a representative like a bond management company, who has the necessary expertise and resources to recommend specific courses of action, is a significantly more effective mechanism to protect the bondholders’ interests as a whole. In addition, such representative can go much further toward achieving the goal of orderly sovereign debt

restructuring through effective communication among financial market participants. This article hopefully facilitates further discussion for aligning the interest of bondholders.

Appendix

4. Bond Management Companies for Bondholders

Bond Management Companies in respect of the Bonds (collectively, the “Bond Management Companies”) are the Long-Term Credit Bank of Japan, Limited, The Bank of Tokyo-Mitsubishi, Ltd. and the Fuji Bank, Limited. The representative of the Bond Management Companies (the “Representative Bond Management Companies”) is Long-Term Credit Bank of Japan, Limited.

The Bond Management Companies shall have the powers and duties to perform any and all judicial or extra-judicial acts necessary for obtaining payment under the Bonds for the Bondholders or preserving the implementation of the rights of the Bondholders under the Bonds for Bondholders.

The Bond Management Companies shall perform jointly the duties and functions of the Bond Management Companies provided for in these Conditions

The Bondholders shall be entitled to the benefit of all the provisions for the benefit of the Bondholders set forth in the Agreement with Commissioned Company for Bondholders (the "Agreement with Commissioned Company for Bondholders") relating to the Bonds dated February 26, 2001 between [State], [Central Bank] and Bond Management Company, relating to the Bonds and the powers and duties of Bond Management Company, and to the benefit of the exercise of such powers and the performance of such duties by Bond Management Company.

11. Events of Defaults

If any of the events (the "Events of Default") prescribed in the following subparagraphs (a) through (e) shall have occurred and be continuing irrespective of whether by reason of any governmental decree, order or enactment of law in the Public, the Bond Management Company shall may at their discretion, and (i) pursuant to an ordinary resolution of a Bondholders' meeting referred to in Condition 12 or (ii) at the written request of the holders of more than one-quarter (1/4) of the aggregate principal amount of the Bonds then outstanding made to Bond Management Company and accompanied by their Bond Certificates (or, in the case of recorded Bonds, the recording receipts relating thereto) shall, declare by written notice to the Public that all the Bonds then outstanding shall immediately become due and repayable:

- (a) the Republic fails to pay any interest on any of the Bonds when due and payable and such failure continues for a period of thirty (30) days; or
- (b) the Republic does not perform or comply with any one or more of its other obligations under these Conditions of Bonds, which default is incapable of remedy or is not remedied within ninety (90) days after written notice of such default shall have been given to the Republic by Bond Management Company; or
- (c) any event or condition shall occur which result in the acceleration of the maturity (other than by optional or mandatory repayment or redemption) of any Public External Indebtedness of the Republic having an aggregate principal amount of U.S.\$30,000,000 (or the equivalent thereof in any other currency) or more, or any default in the payment of principal of, or premium or prepayment charge (if any) or interest on, any such Public External Indebtedness having an aggregate principal amount of U.S.\$30,000,000 (or the equivalent thereof in any other currency) or more, shall occur when and as the same shall become due and payable, if such default shall continue for more than the period of grace, if any, originally applicable thereto; or
- (d) a moratorium on the payment of principal of, or interest on, the Public External Indebtedness of the Republic shall be declared by the Republic; or
- (e) the validity of the Bonds shall be contested by the Republic.

Upon such declaration by Bond Management Company, all the Bonds then outstanding shall immediately become due and repayable at a price equal to their principal amount together any accrued interest, unless prior thereto all such defaults shall been cured.

The Bond Management Companies shall exercise the above discretion in good faith and shall not be responsible for any loss or damage which may be incurred by an Bondholders as a result of making or not making such declaration upon their exercise of such discretion, except such as may result from willful misconduct or negligence on the part of the Bond Management Company.

For the purpose of this Condition 11, the Bonds, if any, then held by Republic shall be disregarded and deemed not to be outstanding.

If (i) any of the events specified in items (b) through (e) above has occurred or (ii) any circumstance

exists which would with the lapse of time or the giving of notice or both of fulfillment of other conditions, or would upon declaration by any creditors of the Republic, constitute any of such event, the Republic shall immediately, or in case of (ii) above immediately when such circumstance comes to knowledge of the Republic, notify the Representative Bond Management Company of such event, whereupon Bond Management Company shall immediately give public notice of such event. If the event specified in item (a) above or any circumstance exists which would with the lapse of time constitute such events, shall have occurred and to be continuing, the Bond Management Companies shall also immediately give public notice of such event.

If the Bonds shall have become due and repayable prior to their maturity pursuant to this Condition 11, Bond Management Company shall without delay give public notice to that effect. All reasonable expenses necessary for the procedures under this Condition 11 shall be borne by the Republic. Unless any then applicable Japanese law provides otherwise, the Bond Management Company shall be entitled to recover from the Bondholders, in proportion to their holdings of the Bonds, any such expenses, to the extent that they are not recovery from the Republic in accordance herewith, and to request the advance payment thereof from the Bondholders.

12. Bondholders' Meetings

When Bondholders holding one-tenth (1/10) or more of the aggregate principal amount of the Bonds for the time being outstanding, acting either jointly or individually, make a request therefore in writing accompanied by their Bond Certificates (or, in the case of recorded Bonds, the recording receipts relating thereto) or when the Bond Management Company for Bondholders deem it necessary, the Bond Management Company shall convene a Bondholders' meeting by giving at least twenty-one (21) days prior public notice of the meeting to consider any of the Events of Defaults or such other matters as the as the Bond Management Company may deem to have a material effect on the interests of Bondholders. The Republic may convene a Bondholders' meeting by giving written notice at least thirty-five (35) days prior to the proposed date of the meeting to the representative Bond Management Company, whereupon the Bond Management Company shall give public notice of the meeting at least twenty-one (21) days⁷ prior to the date of the meeting to consider any of the Events of Default or such other matters as Bond Management Company may deem to have a material effect on the interests of the Bondholders.

The Republic may have its representatives attend such meeting and express its opinion. At such meeting, each Bondholder shall have one vote for each ¥1,000,000 of the principal amount of the Bonds held by him; provided that the Bond Certificates or (in the case of recorded Bonds) the recording receipts therefore shall have been submitted to the Representative Bond Management Company at least seven (7) days prior to the date set for such meeting.

To the extent permitted by law, resolutions of such meeting shall be adopted by a majority of the votes of the Bondholders attending the meeting (the "ordinary resolution"); provided, however, that in relation to giving grace periods, waiver of the liabilities arising from default, or settlement and other proceeding acts (including bankruptcy or other like proceedings) by Bond Management Company in respect of all the outstanding Bonds, and in relation to matters (other than the Events of Default), as Bond Management Company may reasonably deem, with reference to the relevant provisions of law, to have a material effect on the interest of the Bondholders, resolutions shall be adopted by two-thirds (2/3) or more of the votes of the Bondholders present at such meeting which must be attended by the Bondholders holding more than one-half (1/2) of the aggregate principal amount of the Bonds then outstanding (the "extraordinary resolution"). Such ordinary or extraordinary resolutions shall be binding, to the extent permitted by the laws of Japan, on all the Bondholders whether present or not at such meeting and shall thereupon be carried out by Bond Management Company.

Any Bondholder who will not be present in person or by proxy at such meeting may exercise his voting rights upon delivery of the document stating the matters prescribed in the above public notice of the meeting to the Representative Bond Management Company. The number of voting rights exercised by such document shall be taken into account for the purpose of calculation of the above quorum and of the number of voting rights represented at such meeting.

For the purpose of this Condition 12, the Bonds then held by the Republic shall be disregarded and deemed not to be outstanding.

All expenses necessary for the procedures under this Condition 12 shall be borne by Republic.