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Amendments to Act on Treatment of Trade Claims in Out-of-Court Workouts

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The Cabinet of Japan has recently provided to the Diet its proposed amendments to the Industrial Competitiveness Enhancement Act (the “**Act**”). These amendments (the “**Proposed Amendments**”), if enacted, will provide greater protection to the claims of trade creditors in judicial insolvency proceedings that are commenced following the failure of out-of-court workouts. This newsletter briefly outlines the Proposed Amendments and the reasoning behind them.

Out-of-Court Workout Schemes in Japan

In recent years, out-of-court workouts have gained in popularity in Japan compared to judicial insolvency proceedings. There are several out-of-court workout schemes available in Japan, such as the (a) turnaround ADR (*Jigyo Saisei ADR*), the process of which is supervised by mediators (“**Turnaround ADR**”), (b) scheme administered by the REVIC (a state-owned organization that facilitates workouts by coordinating the activities of lenders and provides financing to the debtor), and (c) scheme administered by the SME Rehabilitation Support Association, a state-owned organization that facilitates workouts by supporting SME debtors in exploring their restructuring options and preparing restructuring plans, among other things.

Concerns with Judicial Insolvency Proceedings following failure of Out-of-Court Workout

Debtors undergoing institutionalized out-of-court workouts (such as Turnaround ADR) may fail to obtain the necessary consents from their creditors in the workout process. In such cases, it is not uncommon for them to file for civil rehabilitation or corporate reorganization proceedings. Insolvency proceedings, however, give rise to two primary concerns, namely:

- (a). whether claims in respect of debtor-in-possession ("**DIP**") financing that are provided during the Turnaround ADR (i.e., prior to commencement of judicial insolvency proceedings) ("**Pre-DIP Financing Claims**") would be given priority over other pre-filing claims in the judicial proceedings; and
- (b). whether the claims of trade creditors would enjoy the same level of protection in judicial insolvency proceeding as they would in a Turnaround ADR.

Although unsecured pre-commencement claims should in principle be given equal treatment in judicial insolvency proceedings, it would be difficult, as a practical matter, for a debtor to obtain the DIP financing it needs to restructure its business in a Turnaround ADR, if the Pre-DIP Financing Claims will be given no priority over other pre-commencement claims should the debtor subsequently undergo judicial proceedings. In other words, lenders would be unwilling to provide DIP financing if their claims for such financing will not enjoy priority in any subsequent judicial proceedings.

Similarly, trade creditors, whose claims are generally paid in full in out-of-court workouts (including Turnaround ADR), are not guaranteed the same level of protection in judicial insolvency proceedings. Aware of this risk, trade creditors will sometimes cease their business dealings with a debtor in the course of a Turnaround ADR, if it seems to them likely that the debtor will eventually undergo judicial insolvency proceedings. This approach to risk mitigation by trade creditors has sometimes made it difficult for debtors to restructure their businesses.

Giving priority to Pre-DIP Financing Claims

A possible way of overcoming the aforementioned difficulties associated with Pre-DIP Financing Claims is found in Articles 58 through 60 of the Act, which stipulate that Pre-DIP Financing Claims have priority over other pre-commencement claims in judicial insolvency proceedings, if the following conditions are met:

- (a). the Japan Association of Turnaround Professionals (the "**JATP**") provides confirmation that (i) the corresponding DIP financing is indispensable to the continuation of the relevant debtor's business¹ and (ii) all the financial creditors participating in the Turnaround ADR have agreed to give priority to the Pre DIP Financing Claims over the other claims of such creditors; and
- (b). (i) civil rehabilitation or corporate reorganization proceedings will be initiated against the debtor in the event of the failure of a Turnaround ADR and (ii) (where a rehabilitation or reorganization plan

¹ DIP financing would be deemed indispensable to the continuation of a debtor's business if (a) such financing is reasonably necessary for the debtor to maintain cash flow and (b) the maturity date of such financing falls on a date on or after that on which consent from all of the participating creditors is expected to be obtained.

that is submitted to the court or approved by the creditors contains amendments to the terms of the Pre-DIP Financing Claims, and such amendments are different from those pertaining to other pre-commencement claims) the court takes the JATP's confirmation into account for purposes of determining whether the aforementioned difference would impair the requirement that the claims are treated equally.

The Proposed Amendments

There is, however, no similar carve-out in respect of trade creditor claims in judicial insolvency proceedings. To address this, the Proposed Amendments contain provisions that are analogous to Articles 58 through 60 of the Act, in order to render similar protection to trade creditors in judicial proceedings, if certain conditions are met. More specifically, under these provisions, if:

- (a). the JATP provides confirmation that (i) the claim of a trade creditor involves a small amount and (ii) the settlement of such claim is necessary to avoid significant impairment to the debtor's business ("**Confirmed Claim**"); and
- (b). in the event that a civil rehabilitation proceeding is filed or commenced against the debtor following failure of a Turnaround ADR, the court takes the JATP's confirmation into account²:
 - (x) (when, following a petition for commencement of civil rehabilitation proceedings, the court wishes to issue a temporary restraining order prohibiting payment of pre-injunction debts and disposition of the debtor's assets) for purposes of determining whether settlement of the Confirmed Claim is prohibited by a temporary restraining order;
 - (y) (when, following the commencement of civil rehabilitation proceedings, the debtor has filed a petition for the court approval for settlement of a Confirmed Claim on grounds that it involves a small-amount, and that such settlement is necessary to avoid significant impairment to the debtor's business) for purposes of determining whether such settlement is necessary to avoid significant impairment to the debtor's business; or
 - (z) (when, following commencement of civil rehabilitation proceedings, a rehabilitation plan that is submitted to the court or approved by the creditors contains amendments to the terms of a Confirmed Claim, and such amendments are different from those pertaining to other pre-commencement claims) for purposes of determining whether such difference would impair the requirement that the claims be treated equally.

The Proposed Amendments, if enacted, will provide greater protection to the claims of trade creditors in judicial insolvency proceedings that follow the failure of a Turnaround ADR. This would have the effect

² When the debtor undergoes corporate reorganization proceedings following failure of a Turnaround ADR, almost same provisions as above are proposed to be added by the Draft Amendments.

of facilitating continuation of business dealings between debtors and trade creditors under the same conditions over the course of a Turnaround ADR, and in turn enhance the ability of debtors to restructure their businesses.

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