



ICLG

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Japan

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1 Issues Arising When a Company is in Financial Difficulties

1.1 How does a creditor take security over assets in Japan?

Mortgages (*Teito-ken*) and Revolving Mortgages (*Ne-teito-ken*) on Real Estate

Mortgages and revolving mortgages on real estate may be granted as security for a debt. Ownership of the underlying asset is not transferred, but rather its transfer is restricted by the possible enforcement of the mortgage through judicial foreclosure.

Pledges (*shichi-ken*) on Real Estate, Moveables (including Securities) and Monetary Obligations

A pledge is a security interest on ownership of the underlying asset or title for a debt. A pledge on real estate or moveables is created by an agreement between the owner of real estate or moveables (pledgor) and the pledge-holder (pledgee). A pledge on a monetary obligation is created by agreement between an obligee (pledgor) and the pledge-holder (pledgee).

Note that, as listed securities are subject to electronic registration with Japan Securities Depository Center, Inc. (JASDEC), pledges should be created and perfected on the listed securities by registration of the pledge with JASDEC.

Transfer Pledges (*Joto Tampo*) on Real Estate, Moveables (including Securities) and Monetary Obligations

A transfer pledge is a security interest created by agreement between the transfer-pledgee and either the owner of the real estate/moveables or the obligee of the monetary obligation (pledgor).

1.2 In what circumstances might transactions entered into whilst the company is in financial difficulties be vulnerable to attack?

As explained in section 2, there are Civil Rehabilitation Proceedings, Corporate Reorganisation Proceedings and Bankruptcy Proceedings. The following explains avoidance by a trustee in Bankruptcy Proceedings, a supervisor in Civil Rehabilitation Proceedings and an administrator of Corporate Reorganisation Proceedings. Note there are other avoidance actions available as well.

A. Avoidance of Fraudulent Transfers

Any transaction by the company (excluding a transaction for providing collateral by the company or discharging an obligation of the company) can be avoided if:

- (i) the company knows that the transaction is detrimental to creditors; however, the transaction will not be avoided if a person who is subject to an avoidance action and receives a benefit from the transaction (the “Beneficiary”) proves that he had no knowledge of such fact at the time of the transaction; or
- (ii) the transaction is detrimental to creditors and executed after the company suspends payment or a petition for Civil Rehabilitation Proceedings, Corporate Reorganisation Proceedings or Bankruptcy Proceedings is filed; however, the transaction will not be avoided if the Beneficiary proves that he had no knowledge of such facts at the time of the transaction.

B. Avoidance of Preferences

Any transaction by the company which provides collateral to a creditor for an existing obligation of the company or discharges an existing obligation of the company is avoidable if:

- (i) the transaction is executed after: (a) the company becomes unable to pay its debts when due; or (b) a petition for Civil Rehabilitation Proceedings, Corporate Reorganisation Proceedings or Bankruptcy Proceedings is filed; and
- (ii) the creditor knows that: (a) the company becomes unable to pay its debts when due or suspends payments in case of (i)(a); or (b) a petition for Civil Rehabilitation Proceedings, Corporate Reorganisation Proceedings or Bankruptcy Proceedings is filed in case of (i)(b).

In addition, if the above transaction occurs within 30 days before the company becomes unable to pay, and (i) the company is not obligated to perform the transaction, or (ii) the transaction constitutes the performance of an obligation by the company that is not then due, the transaction can be avoided. However, the transaction cannot be avoided if the creditor proves that he does not know that the transaction is detrimental to other creditors.

C. Avoidance of Transaction in Exchange of Reasonably Equivalent Value

Disposition of an asset by the company in exchange for a reasonably equivalent value can be avoided only if all of the below requirements are met:

- (i) the disposition results in changing the form of the asset, such as, by way of example, disposition of real estate for cash, and creates a present danger that the company will take further action which would be detrimental to creditors (“Malicious Action”), such as, by way of example, hiding the asset, providing the asset for no consideration to specific creditors or taking other action;
- (ii) the company has an intent to take Malicious Action at the time of the disposition; and
- (iii) the counterparty to the disposition knows that the company has the intent above at the time of the disposition.

D. Avoidance of Perfection

Perfection can be avoided if the act of perfection:

- (i) occurs after the company suspends payments or a petition for Civil Rehabilitation Proceedings, Corporate Reorganisation Proceedings or Bankruptcy Proceedings is filed;
- (ii) is taken after 15 days from creation, transfer or change of creditors' rights; and
- (iii) is taken with knowledge of the company's suspension of payments to creditors or the filing of a petition for Civil Rehabilitation Proceedings, Corporate Reorganisation Proceedings or Bankruptcy Proceedings.

1.3 What are the liabilities of directors (in particular civil, criminal or disqualification) for continuing to trade whilst a company is in financial difficulties in Japan?

There are no specific statutes imposing civil or criminal liability on directors under the circumstances described above. However, if a director of the company knows, or reasonably should know, that payment for an obligation will not be made at the time of the transaction, then such director may be liable for damages incurred by the counterparty to the transaction.

2 Formal Procedures

2.1 What are the main types of formal procedures available for companies in financial difficulties in Japan?

A. Civil Rehabilitation Proceedings

Civil Rehabilitation Proceedings are debtor-in-possession ("DIP") proceedings, where incumbent management remains in place and proposes a rehabilitation plan to creditors. DIP proceedings are subject to the supervision of a supervisor appointed by the court. The DIP's rehabilitation plan must be approved by the creditors. Secured creditors are excluded from the proceedings and are free to enforce their collateral.

B. Corporate Reorganisation Proceedings

Corporate Reorganisation Proceedings are the most powerful insolvency proceedings, whereby all secured creditors and unsecured creditors are subject to the proceeding. After the petition for commencement, the court issues: (i) an Administration Order, which divests the authority of the incumbent management and appoints an Interim Administrator; and (ii) a Protection Order, which prohibits the company from paying any debt (with certain exceptions). The court may also issue a Comprehensive Protection Order prohibiting any secured creditor from enforcing its rights in collateral. After the Interim Administrator's review and investigation, the court may appoint an administrator who has full responsibility to manage the company and create a reorganisation plan, which is subject to approval of the creditors and the court.

Recently, the Tokyo District Court started DIP-type Corporate Reorganisation Proceedings, where the court does not issue an Administration Order and the incumbent management remains in power. In such proceedings, the court issues (i) a Protection Order prohibiting the company from paying any debt (with certain exceptions), and (ii) a Supervision and Investigation Order, pursuant to which the court appoints a Supervisor/Investigator to carry out an initial review of whether the DIP proceeding is appropriate for the case. After the Supervisor/Investigator's review, in typical cases one of the company's directors is appointed as administrator to carry out the business of the company.

C. Bankruptcy Proceedings

Bankruptcy Proceedings are liquidation proceedings administered by a court-appointed trustee. Secured creditors are not subject to the proceeding and are free to enforce their collateral. The company is liquidated and there may be a distribution at the end of the proceeding to creditors.

2.2 What are the tests for insolvency in Japan?

The test is whether the total liabilities of the company exceed the total assets of the company. If so, then the company is regarded as "insolvent" under the Company Act. However, as described below, the grounds for commencing insolvency proceedings are not necessarily triggered by insolvency alone.

2.3 On what grounds can the company be placed into each procedure?

A. Bankruptcy Proceedings

If a company is generally and continuously unable to pay its debts when due, Bankruptcy Proceedings may be commenced. As a matter of law, a company is presumed to be generally and continuously unable to pay its debts if (i) the company fails to pay a promissory note or important debt such as the principal of a corporate bond or bank loans, or other obligations in general, or (ii) the company is "insolvent".

B. Civil Rehabilitation Proceedings and Corporate Reorganisation Proceedings

A company may file a petition to commence the proceedings if (i) there is a possibility that the grounds for commencing Bankruptcy Proceedings may occur, or (ii) the company is unable to pay its obligations without creating a significant burden for continuing its business.

2.4 Please describe briefly how the company is placed into each procedure.

Voluntary Petition

A voluntary petition is generally commenced by evaluating the financial status of the company and the selection of the appropriate proceedings with the assistance of attorneys and accountants. The board then adopts a resolution to file a petition for one of the proceedings.

Involuntary Petition

The proceedings may also be commenced by an involuntary petition, although such practice is uncommon. Under Corporate Reorganisation Proceedings, only creditors who have claims in excess of a minimum threshold are entitled to file involuntary petitions. Requirements for commencing involuntary cases include the petitioner's proof that the company has grounds for the commencement of the proceedings, which are the same as those for commencing voluntary Bankruptcy Proceedings.

2.5 What notifications, meetings and publications are required after the company has been placed into each procedure?

With respect to Civil Rehabilitation Proceedings, Corporate Reorganisation Proceedings or Bankruptcy Proceedings, no actual notice to creditors is required with respect to commencement of the case, the filing deadline for a proof of claim (bar date), etc. Instead, the law provides that any notice shall be publicly posted in Government Official Gazettes. There are some exceptions where the actual notice by the court is necessary.

3 Creditors

3.1 Are unsecured creditors free to enforce their rights in each procedure?

Unsecured creditors are prohibited from enforcing their unsecured claims outside of each proceeding. However, the following exceptions are applicable to unsecured claims:

A. Civil Rehabilitation Proceedings

With respect to unsecured claims, “Common Benefit Claims” and “General Priority Claims” can be enforced outside the proceeding.

“Common Benefit Claims”, as a rule, include:

- (i) a claim for expenses necessary for execution of the proceeding (e.g., remuneration of a supervisor); and
- (ii) a claim arising from the business operations of the company after the commencement of the proceeding.

“General Priority Claims” include:

- (i) a claim for wages or salary of an employee; and
- (ii) a tax claim.

B. Corporate Reorganisation Proceedings

With respect to unsecured claims, only “Common Benefit Claims” can be enforced outside the proceeding, in principle. “Common Benefit Claims” in Corporate Reorganisation Proceedings, as a rule, include the following:

- (i) a claim for expenses necessary for execution of the proceeding (e.g., remuneration of an administrator of the proceeding);
- (ii) a claim arising from the business operations of the company after the commencement of the proceeding; and
- (iii) a claim for an employee’s wages or salary for a certain period.

Courts have been recently allowing the administrator to pay a certain amount of claims arising from commercial transactions outside the proceeding (e.g., trade creditors). The purpose of this practice is to make it easier to continue the company’s business operations by discouraging essential suppliers from ceasing to do business with the company.

C. Bankruptcy Proceedings

With respect to unsecured claims, “Estate Claims” can be enforced outside a bankruptcy procedure. “Estate Claims” in bankruptcy proceeding, as a rule, include:

- (i) a claim for expenses necessary for execution of the proceeding (e.g., remuneration for a trustee of the procedure); and
- (ii) a claim for the wages or salary of an employee for a certain period.

3.2 Can secured creditors enforce their security in each procedure?

A. Civil Rehabilitation Proceedings and Bankruptcy Proceedings

Secured creditors can generally enforce their security outside of the proceedings. However, under certain conditions, the security will be cancelled by the court or its enforcement by the creditor will be stayed.

B. Corporate Reorganisation Proceedings

Secured creditors can only enforce their securities within the proceeding as a “Creditor with Security in Corporate Reorganisation Proceedings”. Thus, claims of secured creditors will be paid pursuant to the reorganisation plan. However, claims

of secured creditors are entitled to priority in Corporate Reorganisation Proceedings. Further, under certain conditions, a secured creditor can enforce its security outside the proceeding with the approval of the court.

3.3 Can creditors set off sums owed by them to the company against amounts owed by the company to them in each procedure?

A. General Rule

Generally speaking, creditors can exercise the right of set off.

B. Exceptions

In a typical set off, it is necessary for the obligations of each party to be due and owing. However, upon the commencement of a Bankruptcy Proceeding, the obligations of the debtor become immediately due. In Civil Rehabilitation and Corporate Reorganisation, creditors cannot set off obligations owed by the debtor until the due date of such obligations. Further, in Civil Rehabilitation Proceedings and Corporate Reorganisation Proceedings, creditors can only exercise the right of set off within the period for the filing of their claims specified by the court.

4 Continuing the Business

4.1 Who controls the company in each procedure? In particular, please describe briefly the effect of the procedures on directors and shareholders.

A. Civil Rehabilitation Proceedings

In Civil Rehabilitation Proceedings, directors of the company maintain authority to control the company and administer and dispose of its assets. However, where the company will conduct material actions including disposition of assets, the approval of the supervisor appointed by the court is necessary.

When a Civil Rehabilitation Proceeding is commenced, directors and shareholders of the company do not automatically lose their positions or interests.

B. Corporate Reorganisation Proceedings

In Corporate Reorganisation Proceedings, an administrator appointed by the court is authorised to control the debtor and to administer and dispose of its property. As a rule, directors are removed from the board unless reappointed through the reorganisation plan. On the other hand, when the proceedings are DIP-type proceedings, one of the directors will be appointed as the administrator to continue administration and disposal of the company’s property and to operate the business of the company.

When a Corporate Reorganisation Proceeding is commenced, shareholders of the company do not automatically lose their ownership interests. However, reorganisation plans usually have the following provisions: (i) the company acquires all issued shares and cancels the acquired shares; and (ii) the company issues new shares to its sponsor. As a result, the shareholders forfeit their ownership interests.

C. Bankruptcy Proceedings

In Bankruptcy Proceedings, a trustee appointed by the court is authorised to administer and dispose of the debtor’s property. The directors are divested of such authority when a Bankruptcy Proceeding is commenced.

When the Bankruptcy Proceeding is completed, the debtor becomes a defunct entity, the directors lose their positions as a result thereof, the company is dissolved, and any remaining assets after

administration of the debtor's estate are distributed to the shareholders.

4.2 How does the company finance these procedures?

A. Bankruptcy Proceedings

The proceeding is for liquidation of the company and financing is, therefore, not necessary.

B. Civil Rehabilitation Proceedings

After the petition for commencement of Civil Rehabilitation Proceedings has been filed, but before any further steps are taken in such proceedings, the company can obtain financing with approval of the supervisor. A claim for such financing is one type of Common Benefit Claim (see question 3.1), which is accorded priority over other claims.

C. Corporate Reorganisation Proceedings

Financing is obtained in the same manner as with Civil Rehabilitation Proceedings described above.

4.3 What is the effect of each procedure on employees?

A. Contracts with employees

i. *Civil Rehabilitation Proceedings/Corporate Reorganisation Proceedings*

Contracts with employees continue even if Civil Rehabilitation or Corporate Reorganisation Proceedings are commenced.

It is often the case that a reduction in force is implemented as part of the restructuring of the company's organisation, which is carried out in accordance with labour regulations.

ii. *Bankruptcy Proceedings*

Contracts with employees are not terminated only because Bankruptcy Proceedings are commenced.

However, as Bankruptcy Proceedings are proceedings to carry out the liquidation of the company, all employees will be laid off by the end of the proceedings.

B. Claims of employees

In all of the proceedings, the employees' rights to wages and salaries are accorded priority (see question 3.1).

4.4 What effect does the commencement of any procedure have on contracts with the company and can the company terminate contracts during each procedure?

Generally speaking, a debtor cannot terminate the contracts for the sole reason that it has commenced one of the proceedings.

Nevertheless, in Civil Rehabilitation, Corporate Reorganisation, and Bankruptcy Proceedings, if both the obligation of the debtor and its counterparty under a bilateral contract is executory at the time of commencement of the proceeding, the debtor (or the administrator or the trustee) may (i) terminate the contract, or (ii) perform the contract and request the counterparty to perform.

5 Claims

5.1 Broadly, how do creditors claim amounts owed to them in each procedure?

Broadly, except where a creditor is permitted to enforce its claim outside the proceeding (see question 3.1 and question 3.2), creditors can enforce their claims through the following steps:

A. Filing of a Claim

A creditor who intends to participate in the proceeding shall file its claim with the court within the period established by the court.

B. Investigation

A claim which was filed with the court ("Filed Claim") will be investigated by the company in Civil Rehabilitation Proceedings and by the administrator/trustee in Corporate Reorganisation or Bankruptcy Proceedings. Creditors can also investigate the claim.

C. Fixing of a Claim

If there are no objections to the Filed Claim, then the claim will be fixed.

If there are objections, the Filed Claim will be decided through a claims fixing procedure and ordinary litigation.

D. Payment/Distribution

In Civil Rehabilitation and Corporate Reorganisation Proceedings, a Filed Claim that has been fixed will be changed and paid on a *pro rata* basis with other filed claims pursuant to the relevant plan, which is voted on by the creditors and approved by the court.

In Bankruptcy Proceedings, the distribution will be made to creditors depending on the fixed amount of their Filed Claims.

5.2 What is the ranking of claims in each procedure? In particular, do any specific types of claim have preferential status?

A. Civil Rehabilitation Proceedings

Secured claims, Common Benefit Claims and General Priority Claims can be enforced outside the proceedings and accorded priority (see question 3.1 and question 3.2).

B. Corporate Reorganisation Proceedings

Common Benefit Claims can be enforced outside the proceedings and accorded priority (see question 3.1).

Also, secured claims and "General Priority Claims" are accorded priority and include:

- (i) a claim of an employee of the company; and
- (ii) a tax claim.

C. Bankruptcy Proceedings

Secured Claim and Estate Claim can be enforced outside the proceedings and accorded priority (see question 3.1 and question 3.2).

Also, "Preferred Bankruptcy Claims" are accorded priority and include:

- (i) a claim of an employee of the company; and
- (ii) a tax claim.

5.3 Are tax liabilities incurred during each procedure?

A. Tax Liabilities after Commencement of Proceedings

In Civil Rehabilitation and Corporate Reorganisation Proceedings, tax liabilities arising after commencement of the proceedings are paid outside the procedure and entitled to super-priority.

In contrast, in Bankruptcy Proceedings, tax liabilities arising after commencement of the proceedings are subordinate to prepetition claims in the bankruptcy case.

B. Taxation on Income from Discharge of Indebtedness

In Bankruptcy Proceedings, the discharge of the debtor's indebtedness may be deemed income under recently amended tax laws in Japan. However, insolvent bankrupt companies are not usually taxed.

In Civil Rehabilitation Proceedings and Corporate Reorganisation Proceedings, the debtor will continue to operate as a going concern, so the discharge of the debtor's indebtedness does result in a taxable event.

6 Ending the Formal Procedure

6.1 Is there a process for "cramming down" creditors who do not approve proposals put forward in these procedures?

A. Civil Rehabilitation and Corporate Reorganisation Proceedings

Plans of rehabilitation/reorganisation are voted on by certain creditors. If a majority of eligible creditors votes in favour of a plan and the plan is approved by the court, then dissenting creditors are bound by the plan.

B. Bankruptcy Proceedings

In Bankruptcy Proceedings, there is no cram-down. Rather, assets are simply converted into money, which is distributed to creditors on a *pro rata* basis.

6.2 What happens at the end of each procedure?

A. Civil Rehabilitation Proceedings/Corporate Reorganisation Proceedings

The plan voted on by the creditors and approved by the court is implemented by paying creditors' claims in accordance with the plan.

B. Bankruptcy Proceedings

The company will be dissolved.

7 Alternative Forms of Restructuring

7.1 Is it common to achieve a restructuring outside a formal procedure in Japan? In what circumstances might this be possible?

There are cases where the company is restructured out of court by agreement between the creditors and the debtor ("private restructuring").

One of the benefits of a private restructuring is its confidentiality. Whereas other types of restructuring could seriously affect a debtor's goodwill, image and ability to recover, private restructurings are not necessarily disclosed to the public.

Private restructurings do, however, have certain drawbacks. For example, the debtor cannot bind any creditors who do not agree to the private restructuring plan.

In recent years, the following procedures have become institutionalised.

A. Restructuring through Business Revitalisation Alternative Dispute Resolution Procedures

Business Revitalisation Alternative Dispute Resolution ("BRADR") Procedures have been carried out since 2009 by a certified dispute resolution business operator ("Operator") who is neutral and fair. The debtor may select at its own discretion which creditors will participate in the procedure (usually banks and financial institutions), and the debtor files an application. After commencement of the procedure, the Operator issues a notice which requests the participant creditors to suspend their collection. After all the participant creditors agree to the restructuring plan which has been entered into with the debtor, payment obligations of the debtor are potentially discharged or rescheduled according to the plan.

B. Restructuring by the Enterprise Turnaround Initiative Corporation of Japan

The Enterprise Turnaround Initiative Corporation of Japan ("ETIC") was established as an officially authorised corporation for the purpose of revitalising local corporations in 2009. ETIC provides assistance to corporations which have revitalisation potential but are burdened by excessive debt. The revitalisation process involves ETIC's assistance with financial restructuring through (i) purchase of the debts, (ii) provision of finance to the debtor by way of loan facilities, and (iii) provision of finance to the debtor through the purchase of equity in the debtor.

7.2 Is it possible to reorganise a debtor rather than realise its assets and business?

It depends on the case. Without realising its assets and business, a debtor can be reorganised by an equity injection from a new sponsor or by a loan from a new lender under Civil Rehabilitation or Corporate Reorganisation Proceedings.

7.3 Is it possible to achieve an expedited restructuring of the debtor by means of a pre-packaged sale? How is such a sale effected?

Pre-packaged sales are possible and Civil Rehabilitation Proceedings are often used for pre-packaged sales. Before filing a petition for the commencement of the proceedings, the debtor must locate a buyer and obtain the consent of the largest creditors for any such sale. After the petition is filed, such sale is carried out following court approval and may involve a competitive bidding process among other potential buyers.

8 International

8.1 What would be the approach in Japan to recognising a procedure started in another jurisdiction?

In order for a procedure started in another jurisdiction to be recognised in Japan, a recognition order and certain orders for assistance in relation to the foreign proceeding are required.

A. Recognition Order

An order recognising a foreign insolvency proceeding will be issued by the Japanese court except where:

- (i) it is clear that the procedure in foreign jurisdiction will not have any effects outside the jurisdiction;
- (ii) it is against public policy in Japan to support the procedure; or
- (iii) it is clear that the support is not necessary.

B. Orders for Assistance

Because the recognition order does not have any substantive effect, the following orders for assistance are necessary (depending on the case) in addition to the recognition order:

- (i) stay order;
- (ii) prohibition order on disposition of property and payment;
- (iii) prohibition order on compulsory execution; and
- (iv) administration order.

Please note that proceedings for recognition of a foreign insolvency proceeding and assistance to a foreign court shall be subject to the exclusive jurisdiction of the Tokyo District Court.

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Practice areas: Nobuyuki Maeyama has been engaged in an extensive range of practice areas at Anderson Mori & Tomotsune. Mr. Maeyama acts as a court appointed trustee in corporate liquidation proceedings, and he assists clients with civil rehabilitation and corporate reorganisation-related matters. He has also been involved in various financial transactions, including securitisation of real property and receivables, acquisition finance, CMBS (Commercial Mortgage-Backed Securities), project finance and PFI (Private Finance Initiatives). Further, he has also provided a wide range of advice to domestic and overseas clients in M&A transactions (including Management Buy Outs).

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