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Recent Enhancement in Protection of Trade Creditor Claims in Japan – Amendments to the Industrial Competitive Enhancement Act



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Japan



and provision of financing to debtors), and (c) the scheme administered by the SME (Small & Medium Enterprises) Rehabilitation Support Association, a state-owned organization that facilitates workouts by advising SME debtors of their restructuring options and helping them with restructuring plans, among others.

Need for protection of trade creditor claims in judicial insolvency proceedings following failure of out-of-court workout

Under out-of-court workouts (including Turnaround ADRs), debtor companies and creditors (comprising banks and other financial creditors in most cases) reach agreement on a plan of reorganization under which debt repayment is rescheduled or discharged. In general, trade claim creditors are not involved in out-of-court workouts, which results in the value of a debtor's business being sustained during such workouts.

To get a reorganization plan approved in an out-of-court workout, a debtor company must obtain unanimous approval for the plan from the creditors involved in the plan. As this requirement may be difficult to surmount in some cases, there have been suggestions of lowering this standard. The most noteworthy alternative that has been proposed recently is the lowering of the unanimous approval requirement to a majority approval requirement. Due to a provision in the Constitution of Japan that guarantees property rights as inviolable, this proposal has been shelved for the time being.

Accordingly, an out-of-court workout would be doomed to fail even if only one creditor is against the reorganization

The Industrial Competitive Enhancement Act (the "Act") was amended with effect from July 9, 2018 to enhance the protection available to trade creditor claims in judicial insolvency proceedings that are commenced following the failure of a Turnaround Alternate Dispute Resolution (ADR) (as defined herein), an out-of-court workout scheme available in Japan. This article outlines some of the key amendments to the Act.

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 like civil rehabilitation and corporate reorganization proceedings. There are several out-of-court workout schemes available in Japan, including (a) the turnaround ADR, the process of which is supervised by mediators ("Turnaround ADR"), (b) the scheme administered by the REVIC (a state-owned organization that facilitates workouts through coordination of lender activities

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plan. In such cases, it is not uncommon for a debtor to file for judicial insolvency proceedings, such as civil rehabilitation or corporate reorganization proceedings. This state of affairs has long been criticized by insolvency professionals for the harm it inflicts on businesses. Many critics argue that implementation of a reorganization plan in a failed workout should be permitted immediately following the relevant judicial insolvency proceedings, if all of the following conditions are met, so as to achieve a successful turnaround within a relatively short period of time:

- (a) the reorganization plan conforms to the legal requirements applicable to the relevant judicial insolvency proceedings, such as the Civil Rehabilitation Act or the Corporate Reorganization Act;
- (b) approval for the reorganization plan has been obtained from the majority of creditors; and
- (c) the debtor has sufficiently adequate cash flow to satisfy the claims of its trade creditors without defaulting on any of its other payment obligations.

For this proposal to work, trade creditor claims have to be appropriately treated. Trade creditor claims are generally irrelevant in out-of-court workouts (including Turnout ADRs), and are usually paid in full in such workouts. However, they stand to be affected in judicial insolvency proceedings following the failure of an out-of-court workout. For this reason, and in order to obtain approval in judicial insolvency proceedings for a plan that is substantively the same as that proposed in the failed out-of-court workout (i.e., a plan that enables full satisfaction of trade creditor claims), the creditors involved in the plan should be the same as those in the failed workout.

Amendments to the Act

Given the background above, the Act was amended with effect from July 9, 2018 to provide special rules for protecting trade creditor claims in civil rehabilitation and corporate reorganization proceedings following the failure of a Turnaround ADR (the “Special Rules”). The Special Rules are intended to apply in tandem with the involvement of the Japan Association of Turnaround Professionals (the

“JATP”). In summary, the Special Rules stipulate that if (a) the JATP provides confirmation that (i) the claim of a trade creditor involves a small amount and (ii) settlement of such claim is necessary to avoid significant impairment to the debtor’s business (“Confirmation Claim”) and (b) civil rehabilitation or corporate reorganization proceedings have been filed or commenced against the debtor following failure of a Turnaround ADR, the court will take the JATP’s confirmation into account in determining the extent to which trade creditor claims should be protected. Specifically, the court will take the JATP’s confirmation into account:

- (i) for purposes of determining whether settlement of the Confirmed Claim is prohibited by a temporary restraining order (in cases where the court wishes to issue a temporary restraining order prohibiting payment of pre-petition debts and disposition of the debtor’s assets);
- (ii) for purposes of determining whether a Confirmed Claim involves a small-amount and should be settled to avoid significant impairment to the debtor’s business (in cases where the debtor has filed a petition for court approval of such settlement); or
- (iii) for purposes of determining whether differences between an amended Confirmed Claim and pre-commencement claims would prevent all claims from being treated equally (in cases where a rehabilitation or reorganization plan submitted to the court or approved by creditors contains amendments to the terms of a Confirmed Claim, and such amendments are different from those pertaining to other pre-commencement claims).

The amendments to the Act will result in greater protection of trade creditor claims in judicial insolvency proceedings that follow the failure of a Turnaround ADR. This is expected to contribute to successful turnarounds within relatively shorter time periods after the failure of a Turnaround ADR, and provide more certainty of the protection available to trade creditor claims. The amendments would also facilitate continuation of business dealings between debtors and trade creditors under the same conditions over the course of the Turnaround ADR, and ultimately enable debtors to more easily restructure their businesses. 📌



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