

General overview of and recent developments in Japanese rescue-type insolvency proceedings

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In Japan, the most significant historical difference between civil rehabilitation proceedings and corporate reorganisation proceedings were whether it is debtor-in-possession (DIP) or trustee-type. However, due to the certain number of trustee-type civil rehabilitations, as well as the increasing number of quasi-DIP type corporate reorganisations, this difference has become less pronounced over the past few years. Therefore, debtors seeking to restructure their business in Japan have more flexibility than before when considering which rescue-type proceedings to choose from.

The primary laws governing Japan's insolvency regulations are:

- the Bankruptcy Act;
- the Civil Rehabilitation Act;
- the Corporate Reorganization Act; and
- Chapter IX of Section 2 (Special Liquidation) of the Companies Act.

Of these legislations, the civil rehabilitation proceedings (*minji saisei*) pursuant to the Civil Rehabilitation Act (Act No 225 of December 22, 1999), and the corporate reorganisation proceedings (*kaisha kosei*) pursuant to the Corporate Reorganization Act (Act No 154 of December 13, 2002), aim to rehabilitate and rescue insolvent debtors and preserve their businesses as ongoing concerns.

These laws are applicable to foreign companies as long as the respective foreign companies have: (1) a business office or assets in Japan for civil rehabilitation proceedings; or (2) a business office in Japan for corporate reorganisation proceedings.

The Civil Rehabilitation Act

Influenced by Chapter 11 proceedings under United States law, Japan's civil rehabilitation proceedings adopt the debtor-in-possession (DIP) model in principle, with the courts keeping a watchful eye through court-appointed supervisors. The Civil Rehabilitation Act also

allows a trustee-type process when the administration or disposal of a debtor's estate through DIP is inappropriate or there is a particular need to rehabilitate the debtor. This trustee-type process has been implemented in a certain number of cases during recent years.

Corporate Reorganization Act

The precursor to the current Corporate Reorganization Act was enacted in 1952. Pursuant thereto, the debtor's business was always administered by a court-appointed trustee. That practice changed when major amendments adopted in 2002 enabled the court to appoint the management of the debtor as its trustee. This so-called 'quasi-DIP' practice has rendered the corporate reorganisation process closer to the US Chapter 11 proceedings and Japan's civil rehabilitation proceedings.

This article provides a general overview of the differences between the Japanese civil rehabilitation and corporate reorganisation proceedings. It then focuses on certain trustee-type civil rehabilitation and quasi-DIP corporate reorganisation proceedings, along with other trends. While recent developments seem to blur the differences between these two proceedings, each still has its pros and cons: we hope to highlight certain elements to be taken into consideration when opting for the most suitable proceeding.

Civil rehabilitation proceedings and corporate reorganisation proceedings

Both the civil rehabilitation proceeding and corporate reorganisation proceedings aim to rehabilitate the debtor's business operations in accordance with a rehabilitation/reorganisation plan and preserve it as an ongoing concern.

One of the major differences between the two is that creditors' rights are automatically stayed in a corporate reorganisation, while the secured creditors' rights are still enforceable in a civil rehabilitation proceeding unless the court grants a specific injunction.

Another distinguishing feature to note is that the civil rehabilitation proceeding is a DIP-type process (ie, the debtor has the power to control the business) whereas a corporate reorganisation proceeding is managed by a court-appointed trustee rather than the debtor's former management. Table 1 summarises the key elements of these proceedings.

Petition

A debtor or any of its creditors may file a petition for commencement of civil rehabilitation proceedings. A petition for commencement of corporate reorganisation can be filed by a debtor, a creditor (or creditors) holding claims equal to ten per cent or more of the debtor's paid-up capital or a shareholder (or shareholders) holding ten per cent or more of the debtor's voting shares.

Commencement order

The court will enter an order for commencement of the proceedings if the petition satisfies the substantive test provided in the Civil Rehabilitation Act/Corporate Reorganization Act. To issue a commencement order (*kaishi kettei*), the court may investigate all relevant facts of the petition *ex officio*.

Table 1: comparing civil rehabilitation and corporate reorganisation proceedings

	Civil rehabilitation	Corporate reorganisation
Applicable entity/ individual	Individuals and all legal entities.	Stock corporations only.
Petitioner(s)	Debtor or creditor(s).	Debtor or creditor(s) holding claims of ten per cent or more of the debtor's paid-up capital, or shareholder(s) holding ten per cent or more of debtor's voting rights.
Business operations control	In principle, DIP-type procedures – the debtor has the power to control the business under the scrutiny of a court-appointed supervisor.	In principle, trustee-type procedures – the court-appointed trustee has the power to administer and dispose of the estate.
Effect of stay, etc	In general, automatic stay applies upon commencement of the proceeding. However, the rights of secured creditors are not automatically stayed.	Automatic stay applies upon commencement of the proceeding. The rights of even secured creditors are automatically stayed.
Class of creditors	One class of general unsecured claims.	Different classes for different types of creditors. In practice, usually there are only two classes – secured and unsecured creditors.
Plan approval	<ul style="list-style-type: none"> An affirmative vote by a majority of the creditors present or represented at the creditors' meeting, or voting on a ballot; and an affirmative vote by holders of 50 per cent or more of the amount of claims held by such creditors. 	<ul style="list-style-type: none"> Unsecured creditors class: when creditors whose voting rights account for more than half of the total voting rights of holders of unsecured or preferred claims support the plan. Secured creditors class: if a plan seeks to extend the due date for repayment of secured claims, the consent of creditors holding voting rights that account for not less than two-thirds of the total voting rights held by secured creditors is required. In addition, a reorganisation plan that intends to discharge all or part of the secured claims can be approved only after the consent of creditors holding voting rights that account for not less than three-quarters of the total voting rights held by secured creditors is obtained.

Business operation control

In civil rehabilitation proceedings, the debtor's management will generally continue to operate and control the business and assets as a 'debtor in possession', with the courts keeping a watchful eye through court-appointed supervisors. The court has the option to appoint a trustee (*kanzainin*), but in most cases only nominates a supervisor (*kantoku-iin*) to oversee the proceedings. If no trustee is appointed, subject to the supervisor's oversight, the debtor's management retains the power to carry out the debtor's business operations. A supervisor may be appointed by the court prior to the issuance of a commencement order and may remain in that role thereafter. The supervisor has the power to investigate the debtor's business and assets, report the outcome of such investigations to the court, attend creditors' meetings, allow administrative claims, oversee the performance of the rehabilitation plan and so on.

In corporate reorganisation proceedings, the court appoints a trustee (*kanzainin*) upon the commencement of the proceedings. It often nominates an interim trustee (*hozen kanrinin*) as soon as the petition is filed but before any commencement order is issued. A trustee, including an interim trustee, has the power to manage the debtor's business, administer and dispose of its assets and is entitled to exercise the power of avoidance. The trustee must, however, obtain the court's approval prior to engaging in certain activities, such as selling the debtor's assets outside of the ordinary course of business.

Having said this, where the court intends to appoint a former management member of the debtor as the trustee upon commencement of corporate reorganisation (ie, the quasi-DIP model), the court always appoints a supervisor rather than an interim trustee at the outset of the process. Where the quasi-DIP model is elected upon commencement, the court always appoints additional trustees (or at least supervisors) who are insolvency specialists in addition to the trustee who was a member of the debtor's former management, so that it can keep an eye on the debtor through trusted professionals.

Directors and officers of debtors

In civil rehabilitation proceedings, unless a trustee is appointed under certain circumstances, the debtor's directors and officers may remain in control. On the other hand, in corporate reorganisation proceedings, a trustee is appointed by the court to take control of the debtor. Other than when one (or more) of them is appointed as trustee under the quasi-DIP model,

the debtor's directors and officers do not remain in their positions.

In civil rehabilitation proceedings, the debtor's management owes a duty of care to the creditors and may be – and practically, always is – subject to supervision by either the court or the court-appointed supervisor. For example, material transactions, such as the disposal of the debtor's assets not in the ordinary course of business, must be approved by the court or the supervisor as so ordered by the court. Meanwhile, in corporate reorganisation proceedings, the debtor's directors and officers no longer have the power to manage the business and dispose of assets; their power is limited to corporate administrative activities, such as convening shareholders' meetings, which have no real impact on the debtor's financial position. Unless taken in accordance with the relevant rescue plan and/or where statutory requirements are met, corporate actions – including the disposal of the debtor's business and the distribution of dividends – are prohibited during corporate reorganisations.

Effect of the stay

Once rescue-type proceedings commence, the enforcement of claims and the exercise of rights subject to those proceedings are automatically stayed.

However, in civil rehabilitation proceedings, unless a specific injunction is granted, the rights of secured creditors are not automatically stayed and do remain enforceable. In corporate reorganisation proceedings, the rights of both secured and unsecured creditors are stayed. In practice, however, debtors in civil rehabilitation cases usually settle with their secured creditors on the value of the collateral and promise to pay it out. Debtors lacking sufficient cash often sell the collateral to third parties to fund the payment to creditors.

Rescue plan

The debtor must propose a rehabilitation/reorganisation plan and submit it to the court within the period prescribed thereby. Creditors who have filed their proofs of claim may also propose separate rescue plans. Based on ordinary practice, the court sets a timeline so that a rescue plan is confirmed within five months in civil rehabilitation proceedings, and one year in corporate reorganisation proceedings, from the date the petition for the relevant proceeding was filed. Most cases are handled within these timeframes.

All creditors potentially affected by a proposed rescue plan are entitled to receive notice of, and vote on, such plans. In corporate reorganisation proceedings, votes should be cast separately by each class of creditors and

shareholders. In practice, however, usually only two classes, secured and unsecured creditors, are formed. In civil rehabilitation proceedings, there is always only one class of creditors eligible to vote – the general unsecured claims.

In corporate reorganisation proceedings, secured creditors, preferred unsecured creditors and general unsecured creditors are bound by a rescue plan approved by the statutory majority of creditors of each class. In civil rehabilitation proceedings, only general unsecured creditors are bound by a duly approved rescue plan. Hence, a rescue plan may be crammed down in corporate reorganisation proceedings, whereas the debtor cannot cram down a rescue plan in civil rehabilitation proceedings, which are governed by only one class of general unsecured claims.

In civil rehabilitation proceedings, a proposed rehabilitation plan may be voted on either by ballot or at a creditors' meeting, or both. Approval of the proposed plan requires: (1) an affirmative vote by a majority of the creditors present or represented at the creditors' meeting, or voted on ballot; and (2) an affirmative vote by holders of 50 per cent or more of the amount of claims held by such creditors.

In corporate reorganisation proceedings, a reorganisation plan is approved when creditors whose voting rights account for more than half of the total voting rights held by holders of unsecured or preferred claims support the plan. With regard to secured creditors, if a plan seeks to extend the due date for repayment of secured claims, the consent of creditors holding voting rights that account for not less than two-thirds of the total voting rights held by secured creditors is required. In addition, a reorganisation plan that intends to discharge all or part of the secured claims can be approved only after the consent of creditors holding voting rights that account for not less than three-quarters of the total voting rights held by secured creditors is obtained.

When the proposed rescue plan is approved, unless certain circumstances prescribed under the Civil Rehabilitation Act/Corporate Reorganization Act are present, the court will issue an order of confirmation of the approved rehabilitation plan. The confirmed plan becomes effective when the confirmation order is final and binding.

Trustee-type civil rehabilitation and quasi-DIP corporate reorganisation proceedings, and recent trends in connection with civil rehabilitation and corporate reorganisation proceedings

Trustee-type civil rehabilitation and quasi-DIP corporate reorganisation proceedings

As discussed above, trustee-type civil rehabilitation proceedings are deemed as the exception under the law. However, the Osaka District Court, which handles the second largest number of bankruptcy cases in Japan, has actively – and fairly often – used trustee-type civil rehabilitation proceedings. In recent years, the number of trustee-type civil rehabilitation proceedings in the Tokyo District Court, which handles the largest number of bankruptcy cases in Japan, has slightly increased as well. The Tokyo District Court had used the trustee-type civil rehabilitation only once in the past ten years prior to 2010, but since started to positively consider using such proceedings where truly necessary. Since then, the number of trustee-type civil rehabilitation proceedings in the Tokyo District Court has reached approximately 25 cases.

With respect to the quasi-DIP corporate reorganisation proceedings, following the amendments to the Corporate Reorganization Act in 2002, there are no provisions explicitly preventing the court from adopting quasi-DIP corporate reorganisation proceedings. However, since the prevailing view was that the Corporate Reorganization Act intended the court to appoint as trustees only turnaround manager, such as candidates proposed by the sponsor, rather than the prior management, the quasi-DIP model had not been implemented until the end of 2008. Only in January 2009, when the Tokyo District Court announced its intention to expand the practice of trustee appointments, was the quasi-DIP model implemented for the first time by appointing a trustee who had belonged to the previous management. The Osaka District Court also followed this practice. The number of cases using the quasi-DIP model has increased after the first case, reaching approximately 20. Please note that the number of corporate reorganisation proceedings in Japan is quite limited, with about 45 cases coming before the Tokyo District Court since 2009; hence, the quasi-DIP model now accounts for more than 40 per cent of all cases in the Tokyo District Court. The number of corporate reorganisation proceedings in Japan were historically limited: they were viewed as inflexible and time consuming, since an average corporate reorganisation proceedings takes around a year whereas civil rehabilitation proceedings take up to six months.

The quasi-DIP model requires that:

- the DIP does not have any management responsibilities;
- the major creditors do not oppose the quasi-DIP model;
- the sponsor gives its consent (in the event there is a sponsor candidate); and
- there are no elements which may lead to inappropriate conduct during the corporate reorganisation proceedings due to the DIP's involvement.

Recent trends in civil rehabilitation and corporate reorganisation proceedings

In rescue-type proceedings (ie, civil rehabilitation and corporate reorganisation proceedings), the sale of the debtor's assets as a going concern may take place within the rescue plan, or out of the rescue plan under court approval, where the court deems such sale necessary for the successful rescue of the debtor's business. In other words, a pre-packaged sale is possible.

Whichever the case may be, the debtor may reach an agreement with a prospective buyer before filing for the commencement of the relevant proceedings. However, such pre-filing agreement is treated as an executory contact and may be rejected following the commencement of the proceedings. Therefore, the common arrangement is that both parties agree prior to filing that the prospective buyer gets priority in the race to be the sponsor (ie, the successor to the debtor's business). No definite jurisprudence has yet been established as to when would an auction be required to determine the buyer and sale conditions, but market practice is fairly clear: the sponsor selection process must be fair. Fairness is determined by taking into consideration various factors, primarily the size of the debtor, the nature of its business, the degree of dependence on a specific individual and timing. In Japan, pre-packaged civil rehabilitation has become a popular process and the first so-called 'pre-packaged corporate reorganisation' was conducted earlier this year.

Conclusion

Due to the certain number of trustee-type civil rehabilitations, as well as the increasing number of quasi-DIP type corporate reorganisations, the previously significant differences between civil rehabilitation and corporate reorganisation proceedings – whether DIP or trustee-type – has become less pronounced over recent years. While corporate reorganisation processes were historically viewed as inflexible and time consuming, the recent introduction of pre-packaged sales is a step towards the simplification and efficiency of these proceedings. For debtors seeking to restructure their business in Japan, it can have more flexibility than before when considering which rescue-type proceedings to choose from.

About the authors

Masaki Fujita is a partner of Anderson Mori & Tomotsune. He is experienced in cross-border financial restructuring, insolvency and M&A. He has been appointed as the trustee by the Toyo District Court in various complex bankruptcy cases, and he is a co-author of *Restructuring and insolvency in Japan: overview*, published by Practical Law.

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