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Insolvency 2023

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Japan: Law & Practice and Trends & Developments

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JAPAN

Law and Practice

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Contents

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1. State of the Restructuring Market

1.1 Market Trends and Changes

Similar to other jurisdictions, due to various debt support and rescue measures by government and financial institutions for debtors that suffered financial difficulties during the COVID-19 pandemic, the total number of debtors petitioning for in-court insolvency protection in Japan was still low even in 2022. However, while the total number of in-court insolvency cases and civil rehabilitation proceedings (*minji saisei tetsuduki*, "civil rehab") have decreased on a nationwide basis, according to a report by a judge at the Tokyo District Court, the number of civil rehab cases at the Tokyo District Court has increased by approximately 10.6% in 2022 (and approximately 56.5% of total civil rehab cases were filed with the Tokyo District Court). Especially in 2023, it is reported that repayments for emergency loans have commenced in many cases. Without access to any official records yet, it is reported that the number of in-court corporate restructuring cases after having obtained emergency loans during the pandemic has rapidly increased recently, and the judge has also seen more corporate civil rehab cases at the Tokyo District Court. According to a survey by Teikoku Databank, the number of corporate civil rehab cases in the first half of 2023 has increased by 61.3% compared to the same period in 2022.

Figures for 2022–23 and the Marelli Case

In terms of statistical analysis, according to a survey by the Supreme Court of Japan, the number of bankruptcies in 2022 decreased by approximately 4% from 2021. There was one case in which a listed company filed a petition for bankruptcy proceedings in 2022. The total number of civil rehab cases was 92. The number of corporate reorganisation proceedings (*kaisha kosei tetsuduki*, "corporate reorganisation") was six, including three group companies' cases that were filed petitions by creditors.

One notable civil rehab case in 2022 was the case of Marelli Holdings Co, Ltd ("Marelli"), a global auto parts company. Originally, Marelli proceeded with a Turnaround ADR (*Jigyo-saisei* ADR), but it failed to obtain unanimous consent from its target creditors during the ADR procedure; therefore, it chose to move to simplified rehabilitation proceedings (*kanni-saisei*). Simplified rehabilitation proceedings aim to achieve restructuring in a more expedited manner than normal civil rehab, by omitting the claim assessment and determination process. The Act on Strengthening Industrial Competitiveness provides a way for a debtor where a restructuring plan devised during the Turnaround ADR can be a restructuring plan in a subsequent civil rehab filed by a debtor after the ADR process has failed, if a debtor meets certain requirements in the Turnaround ADR. In Marelli's case, as the first case utilising this special treatment in Japan, the debtor was able to obtain a plan confirmation from the court within one month from the filing. In general, it takes six months or more until a plan confirmation is obtained in civil rehab cases, but Marelli achieved smooth and prompt civil rehab by utilising the continuity from the Turnaround ADR. While discussions regarding a new out-of-court workout scheme that allows in-class cram-down (not via in-court proceedings) among the lawmakers are ongoing (see below), more simplified rehabilitation cases may be seen, since Marelli has proved that the regime works efficiently.

Support and Rescue Measures for SMEs

According to the survey by Tokyo Shoko Research, 99.9% of corporate restructuring

cases are SMEs. Support and rescue measures for SMEs have been provided and renewed in recent years. The Guidelines for the Restructuring of Small and Medium Enterprises (*Chusho-kigyo no Jigyo-saisei-tou ni-kansuru* Guidelines) were published and became effective on 15 April 2022. SME Vitalisation Councils (*Chusho-kigyo Kasseika Kyogikai*) were established on 1 April 2022 to support the restructuring of SMEs by reforming the former support organisation of SMEs. SME Vitalisation Councils provide various support: support to establish a restructuring plan; support for out-of-court workouts with financial institutions, etc. According to the survey by SME Vitalisation Councils, the total number of SMEs that requested support from April 2022 to March 2023 was 6,409 (this is a 51% increase from FY 2021). According to SME Vitalisation Councils, approximately 40% of SMEs have completed the Councils' support to establish its restructuring plan. Among such SMEs, 80% of them could continue hiring all of their employees. With respect to restructuring measures, approximately 90% of cases were extensions of terms, but approximately 10% have required claim write-offs.

New Out-of-Court Workout Scheme

The Japanese government has been considering presenting a bill to introduce a new out-of-court workout scheme to facilitate business restructuring by allowing in-class cram-down in combination with court approval, but it has not yet proposed it to the Diet as of the end of September 2023.

2. Statutory Regimes Governing Restructurings, Reorganisations, Insolvencies and Liquidations

2.1 Overview of Laws and Statutory Regimes

As is the case in many jurisdictions, Japan offers in-court insolvency proceedings and out-of-court restructuring processes.

In-Court Insolvency Proceedings

There are two types of proceedings:

- the liquidating-type insolvency proceedings (similar to US Chapter 7), namely bankruptcy and special liquidation; and
- the restructuring-type insolvency proceedings (similar to US Chapter 11), namely civil rehab and corporate reorganisation.

Out-of-Court Restructuring Processes

There are a variety of processes, from pure consensual, negotiation-based workouts among mostly financial creditors, to more formal, rule-based out-of-court workouts, the most popular in recent days (especially for larger-sized debtors) being the Turnaround Alternative Dispute Resolution process sponsored by the Japanese Association of Turnaround Professionals. Despite the title being an alternative dispute resolution, it is a process through which debtors may adjust or restructure debts owed to participating creditors with the consensus of those participating creditors (which typically would be limited to financial creditors).

Formal, rule-based out-of-court restructuring processes are, in most cases, based on a statute allowing specific entities to set a rule for a process offered to debtors through which a debt adjustment or restructuring can be achieved on a consensus basis with the participating

creditors. They do not, however, involve any court supervision or approval of the resultant workout plan, thus they are pure out-of-court processes.

Hybrid

There also is a new special conciliation (*Tokutei-Chotei*) procedure which is a hybrid between an in-court insolvency proceeding and an out-of-court process in that it is a non-public insolvency/restructuring procedure involving a court as an independent third party but where the court will be involved only if and when an agreement is unlikely to be reached between a debtor and a creditor, in which case the court may issue a necessary order to resolve the case. Such order will have the same effect as a successful conciliation if no parties object within a certain period of time.

Partnerships

For partnerships, available options are limited as corporate reorganisation is not available, for example, to partnerships, and bankruptcy would be applied to each of the partners rather than the partnership itself (save for limited partnerships to which bankruptcy would be applicable).

2.2 Types of Voluntary and Involuntary Restructurings, Reorganisations, Insolvencies and Receivership

See **2.1 Overview of Laws and Statutory Regimes**. All the proceedings mentioned here can be initiated by both the debtors themselves (ie, voluntary proceedings) and by creditors (ie, involuntary proceedings). Stakeholders other than creditors have standing to initiate some of these proceedings, but not all.

2.3 Obligation to Commence Formal Insolvency Proceedings

The current law does not require a company or its directors/officers to file for an insolvency proceeding.

2.4 Commencing Involuntary Proceedings

The commencement of proceedings is as follows.

Bankruptcy

A creditor may file a petition to commence a bankruptcy proceeding by providing evidence to show the existence of the creditor's claim, and facts constituting grounds to commence bankruptcy for the debtor ("debtor").

Civil Rehab

A creditor may file a petition to commence a civil rehab by providing evidence to show the existence of the creditor's claim, and facts establishing that there is a "threat" of insolvency.

Corporate Reorganisation

This can be initiated as follows:

- a creditor who holds claims that account for one tenth or more of the amounts of the stated capital of the debtor; and/or
- a shareholder who holds one tenth or more of the voting rights of all shareholders of the debtor,

may file a petition to commence a corporate rehab by providing evidence to show the existence of:

- the creditor's claim or shareholder's voting rights; and
- facts establishing that there is a "threat" of insolvency.

Special Liquidation

A creditor, a liquidator, a company auditor or a shareholder may file a petition to commence a special liquidation by providing evidence to show the existence of circumstances prejudicial to the implementation of the liquidation or a suspicion that the debtor is insolvent.

2.5 Requirement for Insolvency

The grounds to commence bankruptcy are facts showing that the debtor is unable to pay its debts or is insolvent.

As described in **2.4 Commencing Involuntary Proceedings**, since facts establishing that there is a "threat" of insolvency are required to commence a civil rehab or a corporate reorganisation, a risk of insolvency (or inability to pay debts) is required. Also, with respect to a special liquidation, a suspicion of insolvency is required.

2.6 Specific Statutory Restructuring and Insolvency Regimes

The Act on Special Measures for the Reorganisation Proceedings of Financial Institutions includes special provisions on the bankruptcy, civil rehab and corporate reorganisation options applicable to banks, insurance companies, financial instruments business operators and certain other financial institutions.

3. Out-of-Court Restructurings and Consensual Workouts

3.1 Consensual and Other Out-of-Court Workouts and Restructurings

In the last two decades, the Japanese restructuring market has seen an increase in the confidence towards out-of-court workouts, and thus gaining popularity. In particular, formal and rule-based out-of-court workouts are becoming more than an alternative to in-court insolvency proceedings (see **2.1 Overview of Laws and Statutory Regimes**). The major formal and rule-based out-of-court workouts are:

- the Guidelines for Out-of-Court Workouts (*Shiteki-seiri* Guidelines);
- the Guidelines for Restructuring of Small and Medium Enterprises (*Chusho-kigyo no Jigyo-saisei-tou ni-kansuru* Guidelines);
- Turnaround ADR (*Jigyo-saisei* ADR); and
- SME Vitalisation Councils (*Chusho-kigyo Kasseika Kyogikai*).

These procedures are perceived as less damaging to the debtor's going-concern value, more flexible and prompter than in-court insolvency proceedings, and for listed companies, they are preferable in that they do not cause an immediate delisting.

Financial creditors in many cases tend to explore both in-court insolvency proceedings and out-of-court workouts unless the cause of the financial difficulties the borrower is facing is related to compliance issues, and the extent to which lenders are willing to help the borrowers is determined on a case-by-case basis, with consideration of various factors such as their potential recovery rate, reputational risk, and impact on the local economy.

In Japanese out-of-court workouts, unanimous consent from all participating financial creditors (ie, trade creditors are not included, unless they are made part of the process, which is a rarity) is required to achieve restructuring. There is no requirement for mandatory out-of-court workouts before the commencement of in-court insolvency proceedings.

3.2 Consensual Restructuring and Workout Processes

Since the process and timeline of a formal, rule-based out-of-court workout differs depending on which procedure is adopted, the following will explain the process and timeline of a Turnaround ADR (TADR), which is the most commonly used procedure.

Filing of Application and Standstill Notice

The debtor files an application with the TADR operator authorised by the Minister of Justice, and the debtor prepares an outline of its proposed business revitalisation plan (the "TADR Plan"). First, the application is pre-assessed. The key points are:

- the potential to provide greater repayment than that in bankruptcy;
- the feasibility of the proposed TADR Plan; and
- the likelihood of obtaining unanimous consent from participating financial creditors.

Upon the pre-assessment and its passing, a TADR will commence by sending a standstill notice to the creditors under the joint names of the TADR operator and the debtor. The standstill notice requests that the creditors refrain from collecting claims, taking collateral and/or guarantees, foreclosing on collateral, or filing petitions to commence any in-court insolvency proceedings.

Creditors' Meetings

Creditors' meetings are expected to be held three times in TADR.

First meeting

At the first meeting, three mediators who will lead the process and the standstill notice need to be approved by the creditors.

Second meeting

By the second meeting, the debtor needs to draft the TADR Plan, which includes proposed methods of debt adjustments, in the form of, eg, rescheduling, haircuts, debt for equity swaps or debt for debt swaps, and submit it to the meditators for their review. The meditators scrutinise it from a fair and neutral standpoint and submit an investigation report on the TADR Plan to the creditors. Also, the debtor gives an explanation on the TADR Plan to the creditors after the second meeting and before the third meeting.

Third meeting

A vote on the TADR Plan is held at the third meeting. If all the creditors give consent to the TADR Plan, the TADR Plan is approved and the contents set out in the TADR Plan will be in effect. If, however, unanimous consent is not obtained, the TADR process ends in failure and the debtor needs to file a petition for in-court insolvency proceedings (in general).

Typical TADR case

A typical TADR case would involve three to four months. The debtor, in general, needs to conduct financial and business due diligence, evaluation of the assets based on the evaluation standard of the TADR and provide necessary information to the creditors so that they can make informed decisions. Organising a creditor steering committee is a rarity during the TADR; rather, the mediators consisting of third-party professionals would lead the process.

In the TADR Plan with a debt waiver by the creditors, the amounts to be waived are normally calculated on a pro-rata basis based on the non-secured amount of each creditor's claim; thus, contractual priority, security/lien priority, priority rights, and the relative positions of competing creditor classes would not be affected unless

by unanimous consent of all relevant creditors. Also, if a debt waiver by the creditors is required in the TADR Plan, part or all of the shareholders' rights need to be extinguished (in general).

Equity holders are usually not a part of the process, and thus would remain unaffected.

3.3 New Money

When the debtor borrows funds necessary to continue business from third parties during the period between the commencement and the end of the TADR ("Pre-DIP financing"), the Pre-DIP financing can have repayment priority over the other creditors in the TADR, but only if all the creditors agree; the same goes for super-priority liens and thus is not a norm. In the event the TADR ends in failure and has to be transferred to in-court insolvency proceedings, the court is allowed, under a statutory provision, to "consider" granting repayment priority to the Pre-DIP financing.

A capital injection into the debtor by new sponsors can be set out in the TADR Plan.

3.4 Duties on Creditors

There are no specific rules regarding duties of the creditors during a TADR or other out-of-court workouts. As a general principle of the civil law, the principle of acting in good faith may apply to the creditors, and general tort doctrines can give rise to certain tortuous misstatements or fraud.

3.5 Out-of-Court Financial Restructuring or Workout

In terms of formal, rule-based out-of-court workouts, there is no way to bind dissenting creditors to a restructuring plan since that plan needs to be approved by the unanimous consent of all the creditors.

In contrast, pure consensual out-of-court workouts that involve syndicated loans or bonds could bind dissenting creditors. For lenders, there typically are contractual provisions permitting a majority or super-majority of lenders to bind dissenting lenders to changed credit agreement terms. For bondholders, there was an amendment to a statute to permit such majority voting in the bondholders' meeting with the court's authorisation pursuant to the Companies Act.

4. Secured Creditor Rights, Remedies and Priorities

4.1 Liens/Security

Typical liens/security interests on each type of asset in our jurisdiction would be as follows.

Real Estate

A mortgage (*teito ken*) or umbrella mortgage (*ne teito ken*); although a pledge (*shichi ken*) or umbrella pledge (*ne shichi ken*) is also possible.

Equity Shares, Movable Property, Intangible Property, Intellectual Property and Accounts

A pledge (*shichi ken*) or umbrella pledge (*ne shichi ken*), and security assignment (*joto tampo ken*) or umbrella security assignment (*ne joto tampo ken*) are the norm.

4.2 Rights and Remedies

In-Court Insolvency Proceedings

Secured creditors would still enjoy legal rights to enforce and foreclose on collateral in bankruptcy, special liquidation and civil rehab, whereas in corporate reorganisation, secured creditors, too, will be bound by the proceedings and therefore will not be able to enforce or foreclose outside the corporate reorganisation. However, even where secured creditors are allowed to enforce/

foreclose outside the proceedings, they may separately be subject to a court's discretionary stay order in certain circumstances.

When secured creditors are allowed to enforce/foreclose outside the insolvency proceedings, they would remain subject to contractual intercreditor covenants.

In a corporate reorganisation where secured creditors are bound by the proceedings, secured creditors would be in a class separate from unsecured creditors, and, therefore, would be able to veto the approval of the reorganisation plan, thus effectively blocking the conclusion of proceedings. Such ability would practically mean that they have practical rights to disrupt the proceedings in the process up to the creditors' vote as well. As for bankruptcy, special liquidation and civil rehab, secured creditors would only have indirect powers to influence the proceedings in their decision whether or not to enforce/foreclose their rights.

While there is no automatic stay in Japan, secured creditors would be stayed from enforcement and foreclosure actions in corporate reorganisation, as a result of a discretionary but comprehensive day-one stay order by a court, but in other insolvency proceedings, they typically would not be (until and unless a separate discretionary stay order is granted by the court).

Out-of-Court Workouts

There is no mandatory or forced stay/standstill under out-of-court workouts, so secured creditors would continue to have the ability to enforce/foreclose outside the process, unless the secured creditor itself agrees to be bound by a stay/standstill.

4.3 Special Procedural Protections and Rights

Under bankruptcy, special liquidation and civil rehab where secured creditors are not bound by the proceedings, there naturally is no special protection or rights offered to secured creditors. In terms of corporate reorganisation, in contrast, secured creditors would be in a different class with unsecured creditors, and therefore will be afforded an opportunity to block a reorganisation plan from being approved through its class vote; and the majority threshold for the class vote is different from the unsecured creditors' class (see **6.1 Statutory Process for a Financial Restructuring/Reorganisation**). Furthermore, in a corporate reorganisation, up to the value of the collateral, secured creditors must be protected in priority to unsecured creditors (although subject to cram-down rules and certain other haircut rules).

5. Unsecured Creditor Rights, Remedies and Priorities

5.1 Differing Rights and Priorities

Secured Creditors

A distinction is made between secured creditors who have a security interest in individual assets and those who only have a general priority over the debtor's assets. The former has priority in insolvency and restructuring proceedings with respect to the value of the assets in question, and in bankruptcy and civil rehab the secured creditors can exercise the security interest outside the proceedings to collect their claims, whereas in a corporate reorganisation, individual foreclosure on security interests is prohibited and, in principle, the secured creditors may receive repayments only based on an approved reorganisation plan. The latter is categorised as claims with general priorities.

If the asset value of a security interest is less than the amount of the claim, the secured creditors may participate in the proceedings as an unsecured creditor in respect of the deficient amount.

Unsecured Creditors

Bankruptcy

The hierarchy of payment priorities is as follows (in descending order of priority):

- common benefit claims (*Zaidan-saiken*);
- bankruptcy claims with general priorities;
- general bankruptcy claims;
- subordinated bankruptcy claims; and
- consensually subordinated bankruptcy claims.

Common benefit claims are paid outside bankruptcy at any time by the bankruptcy estate. See **5.5 Priority Claims in Restructuring and Insolvency Proceedings**.

Bankruptcy claims with general priorities, typically some labour and tax claims that arose prior to the commencement of bankruptcy, have priority over other general claims to receive distribution.

General bankruptcy claims are paid by distribution on a pro-rata basis.

Subordinated bankruptcy claims, typically interests and damages for default after commencement of the proceedings, are subordinated to general bankruptcy claims in terms of distribution. Consensually subordinated bankruptcy claims are subordinated to subordinated bankruptcy claims, as agreed between the debtor and a creditor before the commencement.

Civil rehab and corporate reorganisation

The hierarchy of payment priorities is as follows (in descending order of priority):

- common benefit claims (*Kyoueki-saiken*);
- claims with general priorities;
- general claims; and
- consensually subordinated claims.

Common benefit claims are paid outside civil rehab and corporate reorganisation proceedings, at any time. See **5.5 Priority Claims in Restructuring and Insolvency Proceedings**.

Claims with general priorities have payment priority over other general claims. While in corporate reorganisation claims with general priorities are paid pursuant to the reorganisation plan, these claims are repaid outside the proceedings at any time in a civil rehab.

General claims are paid pursuant to the restructuring plan.

Consensually subordinated claims are fairly and equitably differentiated from other claims in the restructuring plan, taking into account the agreed-upon subordination.

5.2 Unsecured Trade Creditors

There is no Japanese equivalent of a critical vendor regime and, in general, unsecured creditors' claims can only be repaid on a pro-rata basis, regardless of whether or not they are trade claims. However, in a civil rehab or corporate reorganisation, unsecured pre-petition claims that are required to be repaid for the continuation of the debtor's business are allowed to be repaid with the court's permission. It is practically expected that the court would give permission if the conditions below are met:

- the trade claim is a small amount;
- the continuation of the trade is essential for the continuation of the debtor's business activities;
- there is a high possibility that the other party to the trade will refuse to continue the trade if the debtor does not repay the trade claim, and it is difficult to find an alternative trade partner; and
- if the debtor repays such trade claim, the trade creditor commits to continue the trade on the same terms.

5.3 Rights and Remedies for Unsecured Creditors

An unsecured creditor who is opposed to bankruptcy may, as a party having a "legal interest" in the case, immediately appeal against the commencement order. In addition, the creditors who prefer "restructuring type proceedings" may file a petition for civil rehab or corporate reorganisation as a counter measure to bankruptcy.

After the proceedings are commenced appropriately, unsecured creditors have the right to participate in the proceeding by filing their claims and to vote on whether to give consent to a restructuring plan, and be repaid pursuant to the approved plan (in a civil rehab or corporate reorganisation) or can receive a distribution on a pro-rata basis if a bankruptcy estate is formed (in bankruptcy).

5.4 Pre-judgment Attachments

Once bankruptcy, civil rehab or a corporate reorganisation commence, existing pre-judgment attachments are automatically suspended or extinguished. Between the petition for commencement of these proceedings and the order to commence, pre-judgment attachments are not automatically suspended so a separate court order must be obtained to prohibit or suspend pre-judgment attachments.

5.5 Priority Claims in Restructuring and Insolvency Proceedings

In bankruptcy, civil rehab and corporate reorganisation, administration expenses, a part of employee wages and tax claims, as well as claims that arise during the proceedings for the common benefit of the creditors are categorised as "common benefit claims" which have payment priority senior to general claims.

Secured creditor claims have priority over common benefit claims, to the extent of the value of the relevant collateral. Hence, common benefit claims' priority over secured creditors is limited to the amount uncovered by such value.

6. Statutory Restructuring, Rehabilitation and Reorganisation Proceedings

6.1 Statutory Process for a Financial Restructuring/Reorganisation

General Overview

As described in **2.1 Overview of Laws and Statutory Regimes**, civil rehab and corporate reorganisation both have somewhat similar characteristics to those of US Chapter 11. In Japanese statutory reorganisation processes, the debtor typically takes the initiative to formulate a restructuring/reorganisation plan (the "Plan") under the court's supervision. The main processes to effectuate a Plan are:

- determining estates and claims;
- submission of a Plan;
- voting on the submitted Plan by the creditors' meeting; and
- the court's confirmation of the Plan.

Unjustifiable Purpose

As described in **2.5 Requirement for Insolvency**, "threat" of insolvency is required to commence proceedings thereunder; as a result, any petition that does not purport to address a restructuring of an insolvent company would not be justified (ie, would be denied). Also, where a petition is filed for other unjustifiable purposes or it is not filed in good faith, the court must dismiss with prejudice on the merits.

Determining Estates and Claims, Etc

Determining estates

The debtor would be responsible to investigate and evaluate its assets and property at the time the proceedings commence (the "Estate") and submit a report to the court.

Determination of claims

As a default rule, creditors' claims are calculated and recognised based on:

- the claim register and submission of proofs of claims by each relevant creditor; and
- approval or objection by the debtor.

Not all contingent claims would be entitled to receive repayments or holders thereof be enabled to vote, but conditional claims would receive repayments when the relevant condition is met. However, the debtor shall be discharged from all its liabilities for all rehabilitation claims (in a civil rehab)/reorganisation claims and secured reorganisation claims (in a corporate reorganisation) and, when an order to confirm a Plan ("Plan Confirmation Order") by the court becomes final and binding, such discharge would extend to any and all contingent claims which are not registered by creditors (save for few exceptions and certain tax claims), unless approved and a part of the Plan.

Submission of Plan

General timeline

There is no statutory deadline for a debtor to submit a Plan but, for example, the Tokyo District Court generally sets a deadline (via a court order) for the submission of a Plan, which is typically three months after the petition in a civil rehab and 11 months in a corporate reorganisation. As there is no concept of an exclusivity period, any creditor may also prepare and propose a Plan to the court within the period specified by the court. The deadline can also be extended by a separate court order and, in practice, especially in large and complicated cases, debtors often are granted such extension, where, for example, the status of a sponsor bid would justify an extension.

Components of the Plan

The fundamental components, in terms of legal rights of stakeholders, of a Plan are:

- treatment of claims (classification of claims and modifications of claims, discharge, etc);
- repayments (form of repayment, timing, etc); and
- treatment of existing shares (and issuance of new shares), etc.

Modifications of creditors' rights

The debtor can set clauses to modify creditors' rights in the Plan, such as reducing the amounts of claims, releasing claims, DES (Debt Equity Swap), extending the term for claims, etc. As a general rule, this modification of rights shall be equal between creditors. However, this shall not apply where any creditors who will suffer detriment have given consent or where equity will not be undermined even if the plan otherwise provides for small claims, etc, or any other difference in the treatment of creditors.

Class of Creditors

Civil rehab

As a general rule, there is only one class who can vote: holders of "rehabilitation claims" who submitted "proofs of claims".

Corporate reorganisation

Classes are separated for each type of creditor – secured claims, other general priority claims, general unsecured claims, consensually subordinated claims and shares – or the creditors who hold the types of rights specified by the court.

Voting

In reorganisation cases, no unanimous consent is required. Cram-down is available only in limited cases (see **6.4 Claims of Dissenting Creditors**).

Civil rehab

The threshold to approve the Plan is:

- the majority of voting right holders (in terms of headcount); and
- the majority in terms of claim amounts, ie, of the holders of claims that account for not less than half of the total amount of claims (basically, which equate to voting rights).

Corporate reorganisation

The threshold depends on each class and how the claims will be modified. In the general unsecured claim class, approval by the holders of claims that account for more than half of the total amount of claims (basically, which equate to voting rights) are required. In the secured claim class, (i) for a Plan which extends the terms of secured claims, approval by the holders of claims that account for not less than two thirds of the total amount of claims (basically, which equate to voting rights) or (ii) for a Plan which reduces and releases debts for secured claims or provides measures that may affect the rights of secured creditors other than extensions of terms, approval by the holders of claims that account for not less than three quarters of the total amount of claims (basically, which equate to voting rights) are required.

Plan Confirmation Order

Following a creditors' meeting that met the threshold requirement, the court makes a decision about whether or not to confirm a Plan. When legal requirements (such as the feasibility test, or the best interests of creditors test, see **6.12 Restructuring or Reorganisation Agreement**) are met, the court should issue a Plan Confirmation Order. A Plan shall be effective in the interests of and against the debtor, all creditors (unsecured creditors in civil rehab, unsecured and secured creditors in corporate reorganisation) and shareholders, etc, regardless of whether each specific creditor voted or not.

However, note that in civil rehab secured creditors are, as a general rule, outside the proceedings, so they would not be bound (see **4.3 Special Procedural Protections and Rights** and **6.3 Roles of Creditors**).

Challenge

An immediate appeal may be filed against a Plan Confirmation Order (or an order not to confirm) by creditors, or the debtor, etc.

6.2 Position of the Company

Civil Rehab

The norm is that the debtor, even after a proceeding is commenced, will continue to have the rights to carry out its business or administer or dispose of its property (the statute provides for an exception where the competent court could appoint a trustee to take over those rights), in which case the debtor's incumbent managers generally continue its operation; provided,

that the court and the supervisor (*Kantoku-iin*) appointed by the court will supervise the debtor. By way of example, the debtor will have the power and authority to borrow money even after the commencement of the proceedings, but the approval of the court or the supervisor may be required (depending on the court's ruling upon its appointment of the supervisor).

The debtor shall have the obligation, vis-à-vis creditors, to exercise the above rights and conduct rehabilitation proceedings in a manner "fair and sincere" to all creditors.

Corporate Reorganisation

Once the proceedings are commenced, the rights and authority to manage the debtor's business and to administer and dispose of the debtor's assets will be vested exclusively in a trustee or trustees (*Kanzai-nin*) who is/are appointed by the court. Prior to the appointment of the trustee (ie, prior to the commencement), the court and a provisional administrator (*Hozen Kanri-nin*) or the examiner (*Chosa-iin*) appointed by the court will supervise the debtor. Normally, the provisional administrator will be appointed as a trustee.

The trustee will be overseen by the court, and will need to obtain approvals from the court to conduct corporate actions and transactions, other than those that fall within the debtor's ordinary course of business. As with a civil rehab, the trustee, on behalf of the debtor, can borrow money even during the proceedings, but the approval of the court may be required. A trustee owes a duty of care and duty to provide information, and is restricted from transacting with the debtor on their own behalf and owes non-compete obligations.

However, there are some cases where an incumbent management is appointed by the court as a trustee, and such person continues to manage the business. In such case, the court appoints a third party as an examiner or a supervisor who oversees the debtor.

Stay

Unlike US Chapter 11, there is no "automatic stay" in Japan.

Pre-commencement

The court may issue a temporary restraining order that prohibits the disposition by the debtor of its property. By this order, the debtor is prohibited from making payments or disposing of collateral. To prohibit a compulsory execution, or to stay a foreclosure on a security interest, the debtor needs to obtain a separate "pre-commencement stay order".

Post-commencement

Payment of a pre-petition obligation is prohibited in general. In a civil rehab, since a security holder can exercise its right outside the proceedings, the debtor needs to obtain a "post-commencement stay order" to prohibit such action by a security holder. In a corporate rehab, a security holder is prohibited from exercising its security interest against secured property by virtue of statute as a result of the commencement.

6.3 Roles of Creditors

Class of Creditors

In civil rehab, general unsecured creditors and secured creditors are treated differently with regard to exercising rights, but there is only one class with regard to the vote. A secured creditor (*Betsujyo-kensya*) can exercise its "rights of separate satisfaction" even during a proceeding, but with regard to voting, such creditor may exercise its right as a general unsecured creditor

only for the part of its claim not covered by its collateral (ie, a part of the claim for which discharge will not be achieved via a foreclosure on the collateral). Conversely, in corporate reorganisation, general unsecured creditors and secured creditors are both prohibited from exercising rights during the proceeding, but they are put into separate classes for purposes of creditors' voting (as described in **4.2 Rights and Remedies**, **4.3 Special Procedural Protections and Rights** and **6.1 Statutory Process for a Financial Restructuring/Reorganisation**).

Creditors' Committee

The court may give approval to the participation of a committee consisting of creditors in the proceedings, when such a creditors' committee meets the requirements: such as the majority of creditors consent to the committee's participation, and it is found that a creditors' committee would properly represent the interests of creditors as a whole. However, formulation of a creditors' committee is a rarity in Japan as there are very few cases. If actually formulated, the creditors' committee will be authorised to state its opinions to the court, the debtor or a supervisor/examiner and will have certain monitoring rights.

Information Available to Creditors

Creditors can receive certain information during the proceedings, such as:

- a report by the debtor (or trustee) regarding:
  - (a) the debtor's property, etc, at the time the proceedings commence; and/or
  - (b) the liabilities of the debtor's directors/officers;
- the Plan; or
- a report by the supervisor/examiner required by the court, regarding the commencement of the proceedings or the Plan, etc.

In addition, creditors can examine and inspect documents submitted to the court by the debtor and peer creditors.

6.4 Claims of Dissenting Creditors

Cram-down is available, but only in limited cases. As a general rule, if the Plan is not approved by a certain class, that Plan will not be confirmed. However, the court may issue a Plan Confirmation Order by modifying the proposed Plan and specifying a clause to protect the rights of those whose consent has not been obtained, in the interests of those holders, when at least one class has consented to the proposed Plan. The contents of a clause to protect rights depends on the class to be protected.

A clause to protect a certain class can be included in the Plan in advance. In this case, creditors who belong to that class (as long as fully protected) cannot vote on the Plan.

6.5 Trading of Claims Against a Company

A creditor can trade its claims against the debtor. No disclosures and approvals by the court are required, but a successor needs to submit a notice to the court to be recognised. Civil law governs the transfer of claims and perfection thereof.

6.6 Use of a Restructuring Procedure to Reorganise a Corporate Group

As a general rule, a restructuring proceeding is conducted for each entity as a different case, even in the case of group companies. However, in practice, there will be administrative consolidation of those cases, so when several entities that constitute a "group" file petitions, they are usually treated as a "single" debtor in many administrative aspects, such as the appointment of the same trustee, one

stakeholders' meeting held on the same date, a unified reorganisation plan, etc, within the court's discretion.

6.7 Restrictions on a Company's Use of Its Assets

The norm is that the debtor will be permitted to use its assets for its business during a formal restructuring proceeding within the ordinary course of business. However, in some cases, for example, where common benefit claims which exceed the bar amount set by the court will be incurred by the continuance of the business operations (ie, usage of its assets), the court may require the debtor/trustee to seek approval of the court.

6.8 Asset Disposition and Related Procedures

Directors (as a DIP in a typical civil rehab) or a trustee (in a corporate reorganisation) operate(s) its business and execute(s) the sale of assets. However, approval from the supervisor/examiner or the court is required to sell its assets. (There are some exceptions: for example, if the sale is within the ordinary course of business, such approval is not required.) To transfer its business to a third party not based on a Plan, the debtor/trustee needs to obtain the court's approval. The court may grant approval only when it finds it necessary for the restructuring of the debtor's business.

The approval itself does not clear claims or liens, and an agreement with a claim holder/security interest holder will be separately required for such purpose. There is no credit bid system in Japan. The creditor may be a stalking horse, but it is treated the same as other candidates. It is possible to effectuate pre-negotiated sales, etc, during a formal proceeding, but approval from the supervisor/examiner or the court will be required.

6.9 Secured Creditor Liens and Security Arrangements

In a civil rehab, security holders continue to be allowed to foreclose on their collateral and receive preferred payments from the proceeds, even after the proceedings commence. To clear security interests, a consensual agreement with a security holder or approval from the court to extinguish security interests is required. Security interests cannot be cleared simply by the adoption of the Plan.

In a corporate reorganisation, approval from the court to extinguish security interests is also available. However, a security holder may only receive repayments in accordance with the Plan and secured claims can be impaired based on the Plan. When a Plan Confirmation Order is issued, the debtor must be discharged from its liabilities for all claims, and security interests which exist on its property will be extinguished.

6.10 Priority New Money

DIP financing claims (arising after a proceeding commences and with approval from the supervisor/court) are treated as common benefit claims. It is also possible to secure them by the assets of the debtor (with the court's approval).

It is not possible to have priority over pre-existing secured creditors' liens (without their consent), meaning that in Japan, super priority/priming liens in US Chapter 11 are not available.

6.11 Determining the Value of Claims and Creditors

Statutory proceedings are not available to be used specifically for such purpose, but disputes over the value of claims or who has economic

interests in the company can and will be resolved as a part or result of the proceedings. With regard to determination of claims, see **6.1 Statutory Process for a Financial Restructuring/ Reorganisation**.

A creditor who holds a denied/disputed claim may file a petition for assessment with the court. This process is a mini-trial rather than a formal litigation, and the court shall make a judicial decision to assess the existence or non-existence of the denied/disputed claim after interrogating the denying/disputing parties. A person who objects to such court order may file an action to oppose.

6.12 Restructuring or Reorganisation Agreement

The Plan should be confirmed by the court, and the Plan should meet the feasibility test (whether the Plan is likely to be executed) and the best interests of creditors test (whether the Plan meets the common interests of creditors) in a civil rehab or the fair and equitable test (whether the content of the Plan is fair and equitable) in a corporate reorganisation, to be confirmed by the court.

In Japan, a restructuring or reorganisation agreement other than the Plan is not executed among the debtor, creditors and other parties, in general. The approved and confirmed Plan will bind the debtor and creditors (see **6.1 Statutory Process for a Financial Restructuring/ Reorganisation**).

6.13 Non-debtor Parties

A statutory proceeding does not release non-debtor parties from liabilities. A Plan will not affect any rights held by creditors against the debtor's guarantor or any other person who owes debts jointly with the debtor, and any security provided by persons other than the debtor in the interests of creditors.

6.14 Rights of Set-Off

A creditor can set off its pre-petition obligation with a pre-petition claim against the debtor. However, a creditor can set off only until the expiration of the claims filing period, and when the time that the obligations of both parties become due and suitable for set-off has arrived before the expiration of the claim filing period. As long as these conditions are met, set-off will not be suspended or stayed in the absence of a consensual agreement.

6.15 Failure to Observe the Terms of Agreements

If it has become obvious that the Plan is unlikely to be implemented, the court shall issue an order discontinuing the proceedings. The discontinuance of the proceedings may cause bankruptcy to commence. However, a discontinuance of the proceedings after the Plan has been confirmed will not affect any effects arising from the implementation of the Plan. For example, discharges from claims, changes of creditors' or shareholders' rights, or the issuance of new shares, etc, which were implemented based on the Plan will remain in effect. In general, however, in a statutory reorganisation proceeding, it is rare to include any obligations imposed on creditors as a part of the Plan.

6.16 Existing Equity Owners

Existing equity owners can receive a distribution from the debtor only when all creditors superior to the equity owners are paid in full. In practice, and because the statutes require a "threat" of insolvency to commence proceedings (see **2.5 Requirement for Insolvency**), the debtor acquires existing shares with no consideration and these existing shares will be cancelled

based on the Plan. New shares will be issued to a sponsor in exchange for new money.

7. Statutory Insolvency and Liquidation Proceedings

7.1 Types of Voluntary/Involuntary Proceedings

Insolvent companies may be liquidated voluntarily or involuntarily by bankruptcy or special liquidation. See **2.2 Types of Voluntary and Involuntary Restructurings, Reorganisations, Insolvencies and Receivership**.

Overview

The pros and cons of special liquidation are as follows.

Pros

The pros are:

- special liquidation does not require the same rigorous procedure as bankruptcy proceedings, so the process proceeds relatively quickly;
- a liquidator can be selected by the debtor; and
- compared to bankruptcy, special liquidation is generally viewed as allowing the debtor to avoid being labelled negatively.

Cons

The cons of special liquidation are:

- it is available only to stock companies; and
- it cannot proceed without the consent of two thirds or more of the creditors (based on the total amount of claims).

Due to the cons, special liquidation is normally used when there are only a handful of co-operative creditors, or when the parent company liquidates a subsidiary with the parent holding the majority of the claims.

Differences Between Bankruptcy and Special Liquidation

The differences are as follows.

- In both cases, the proceedings are commenced by filing a petition with the court. With respect to the requirements to commence, in bankruptcy the debtor must be insolvent, whereas in special liquidation it is sufficient that the debtor is suspected of being insolvent.
- In both cases, creditors' claims are recognised by the debtor by filing claims.
- In both cases, the schedule of the procedures including the creditors' meetings are decided by the court at the time of commencement. An inventory of assets and income and expenditure statements will be provided to creditors at the creditors' meeting.
- In bankruptcy, the debtor is prohibited from repaying the bankruptcy claims after commencement in general. In special liquidation, the debtor cannot repay the claims during the period the claims are being filed, but after that period the debtor can repay the claims on a pro-rata basis. Also, in both cases, commencement causes foreclosures or litigation against the debtor to cease. Furthermore, in both cases, after commencement, set-off by pre-commencement claims is prohibited in general. While the trustee is granted a right of avoidance (see **11.1 Historical Transactions**), the liquidator does not have such a power.
- At commencement, while the trustee is appointed by the court in bankruptcy, the liquidator who is designated by the debtor is appointed by the court. The trustee has

the power to terminate a contract that has not been performed by both parties, but the liquidator has no such power.
- In bankruptcy, distribution from the formed bankruptcy estate is made to the creditors on a pro-rata basis, whereas, in special liquidation, repayments are made pursuant to the approved agreement or individual settlement agreement with each creditor.

7.2 Distressed Disposals

The trustee (in a bankruptcy) or liquidator (in a special liquidation) have authority to dispose of the debtor's assets. Certain dispositions (eg, where the value is over JPY1 million) must be approved by the court. There is no general rule regarding granting "free and clear" title to a purchaser of the assets, thus it depends on the negotiations between the trustee or liquidator and the purchaser.

There is no credit bid system in Japan. Creditors, regardless of whether they are secured or unsecured, may participate in a bid for the debtor's assets. The creditors may be a stalking horse, but are treated the same as other candidates.

As long as the court approves the disposition, it is possible to effectuate the pre-negotiated sales transactions following the commencement of Bankruptcy.

7.3 Organisation of Creditors or Committees

As in civil rehab and corporate reorganisation (see **6.3 Roles of Creditors**), a creditors' committee can be formulated with court approval in bankruptcy. If actually formulated and it is found that there have been activities by the creditors' committee that have contributed to the smooth progress of bankruptcy, the court may permit the bankruptcy estate to reimburse the creditors' committee. In contrast, there is no formal creditors' committee in a special liquidation.

8. International/Cross-Border Issues and Processes

8.1 Recognition or Relief in Connection With Overseas Proceedings

Japan has adopted a recognition regime as a domestication of the UNCITRAL's model recognition proceeding. As a result, a trustee, etc, who has a right to administer and dispose of a debtor's property in a foreign insolvency proceeding may file a petition with a Tokyo District Court for recognition of such foreign insolvency proceeding. If the requirements are met (eg, the debtor has a business office, etc, in the country where such foreign insolvency proceeding is petitioned) and a decision to commence such foreign insolvency proceeding is made, the court shall issue an order of recognition. The court shall dismiss with prejudice on the merits a petition in cases where:

- it is obvious that the effect of the foreign insolvency proceeding does not extend to the debtor's property in Japan; or
- it is contrary to public policy in Japan to issue a disposition of assistance for the foreign insolvency proceeding, etc.

The court may:

- issue an order to stay other court proceedings (eg, a proceeding for compulsory execution); or
- issue a disposition prohibiting a disposition of property, a disposition prohibiting payment, etc.

8.2 Co-ordination in Cross-Border Cases

There seems to be a lot of interest in cross-border co-ordination on the part of Japanese courts, but, to date, there have been no cases where a court entered into a protocol or similar arrangement with a foreign court.

8.3 Rules, Standards and Guidelines

With regard to the proceedings, it is considered appropriate to apply the laws of the country where the debtor's restructuring proceedings commenced. If there is more than one country where a petition to commence insolvency proceedings is filed, it is considered appropriate to apply the laws of the country where the debtor's principal business office is located.

8.4 Foreign Creditors

Foreign creditors have the same status as Japanese creditors, respectively, with respect to bankruptcy, civil rehab and corporate reorganisation, in general.

8.5 Recognition and Enforcement of Foreign Judgments

If a foreign judgment satisfies all of the requirements below, Japanese courts will recognise the judgment without further determining the merits of the case:

- the foreign judgment is a final and binding judgment rendered by a foreign court;
- the jurisdiction of the foreign court is recognised pursuant to laws, treaties, etc;
- the defeated defendant had been properly served;
- the content of the judgment and the litigation proceedings are not contrary to public policy in Japan; and
- a guarantee of reciprocity is in place between the foreign jurisdiction and Japan.

To enforce the foreign judgment in Japan, a creditor needs to file a petition to seek an "execution judgment". An execution judgment will be made without investigating or adjudicating the merits of the case.

9. Trustees/Receivers/Statutory Officers

9.1 Types of Statutory Officers

In a bankruptcy, a trustee (*Hasan-kanzai-nin*) is appointed by the court.

In a civil rehab, the debtor continues its business and the process under supervision by a supervisor appointed by the court (see **6.2 Position of the Company**). However, in exceptional cases where the court finds it particularly necessary to rehabilitate the debtor's business, it may appoint a trustee, rather than allow the debtor to continue to have the rights and authority to operate.

In a corporate reorganisation, the main statutory officers involved are the trustee, the provisional administrator and an examiner appointed by the court. In normal practice, the trustee consists of a legal trustee appointed from among attorneys and a business trustee appointed from the debtor or new sponsor (if already selected). For further details, see **6.2 Position of the Company**.

9.2 Statutory Roles, Rights and Responsibilities of Officers

A trustee in a bankruptcy is a person or entity who has the right to manage and dispose of the property belonging to the bankruptcy estate. It owes a duty of care in its management. Specifically, the trustee has a duty to properly maintain and increase the bankruptcy estate for the benefit of the creditors. In addition, the

trustee, as the successor of the debtor's rights and obligations, has a duty to properly organise and co-ordinate legal relations with interested parties. The trustee reports to the court and has to obtain approval from the court with respect to certain activities, such as disposition of high-value assets, buyback of secured assets or filing of lawsuits.

A supervisor, in a civil rehab, receives reports from the debtor on the execution of business and the proceedings, and gives its consent to the debtor's important activities that are similar to matters approved by the trustee (see **6.2 Position of the Company**). The supervisor is also responsible for ensuring that the court and the creditors make appropriate decisions by reporting its findings and providing an opinion to the court.

The roles, rights and responsibilities of a trustee in a civil rehab are almost the same as the trustee.

In a corporate reorganisation, the provisional administrator administers the business and the assets of the debtor until commencement as well as investigating whether to commence the proceedings. The duties and powers of the trustee in a corporate reorganisation are basically the same as those in a bankruptcy, and the examiner's roles, rights and responsibilities, where the court appoints incumbent management as a trustee in corporate reorganisation, are almost the same as the supervisor in a civil rehab (see **6.2 Position of the Company**).

9.3 Selection of Officers

At the commencement of each proceeding, the court appoints statutory officers (explained in **9.1 Types of Statutory Officers**). Once appointed, these officers cannot be removed or replaced without a court decision, in general.

Although the management of the debtor loses its authority to operate the debtor once a trustee is appointed, as it is necessary for the trustee to continue to operate the business during restructuring, the trustee appoints a business trustee or runs the debtor with the consultation and co-operation of the directors and employees of the debtor.

The statutory officers are selected from among attorneys who have extensive experience in insolvency and restructuring. They can contract accountants, financial advisers, etc, if necessary.

In all practical senses, virtually no creditor would be appointed as a statutory officer, unless a creditor also becomes a sponsor, in which case it could be appointed as a business trustee, especially in a corporate reorganisation.

10. Duties and Personal Liability of Directors and Officers of Financially Troubled Companies

10.1 Duties of Directors

In general, officers and directors owe a duty of care and a duty of loyalty to the company under the Companies Act, and if a breach of these duties is the cause of the company's financial predicament, they may be personally liable to the company for damages. Once bankruptcy and corporate reorganisation are commenced, the incumbent officers and directors lose their rights to carry out the debtor's business and such rights are vested in the trustee. Hence, the trustee owes a duty of care towards all creditors (see **9.2 Statutory Roles, Rights and Responsibilities of Officers**) and officers and directors (including

those who have already resigned) do not owe any obligation directly to the creditors but owe a duty to provide information to the trustee.

In civil rehab, the debtor, as debtor in possession, is obliged to carry out rehabilitation proceedings in a manner "fair and sincere" towards all creditors, and the officers and directors of the debtor are required to take into account such duty in the course of fulfilling their duty of care to the debtor.

There are no specific rules related to directors' personal liabilities for the debtor's pre-insolvency obligations, unless they do not personally guarantee such obligations. Also, there are no specific penalties for the directors of the debtor for filing insolvency proceedings itself in Japan.

10.2 Direct Fiduciary Breach Claims

In bankruptcy and corporate reorganisation, the trustee owes a duty of care to all the creditors directly and, if the trustee breaches its duty of care and causes damage to the creditor, the creditor may make a direct claim against the trustee for the damage.

In civil rehab, the directors do not owe any obligation to the creditors directly but owe a duty of care to the debtor. Hence, if they breach such a duty and cause damage to the debtor, the debtor may assert claims against the directors for the damage.

11. Transfers/Transactions That May Be Set Aside

11.1 Historical Transactions

Only the trustee (in bankruptcy and corporate reorganisation) or the supervisor (in civil rehab) has the power to avoid acts taken by the debtor before these proceedings commence which are deemed to impair equality among the creditors and/or which are against the concept of the proceedings (the "right of avoidance").

The following explanation is based on an example of bankruptcy which is common among other proceedings.

Avoidance of Acts Prejudicial to Creditors

The acts subject to this right of avoidance are acts reducing the liable assets. In order to avoid such acts, it must be done intentionally by a party to the transaction, or the act must be done after the debtor's suspension of payments, etc. The main examples of such acts are as follows:

- selling real estate at a very low price;
- guaranteeing the debt of someone without any guarantee charge; and
- gifts, waivers of claims, etc, made by the debtor during the six months prior to the debtor's suspension of payments or after such suspension.

Avoidance of an Act of Disposing of the Debtor's Property With Reasonable Value From the Counterparty

Even if the debtor received reasonable consideration from the buyer of the property, the disposition is subject to the right of avoidance if the following conditions are met:

- the disposition creates an actual threat that the debtor will conceal the property more easily;
- the debtor had the intention to conceal or dispose of the consideration at the time of the disposition; and
- the buyer knew the debtor's intention at the time of the disposition.

Avoidance of Provision of Security, etc, to Specific Creditors

The acts subject to this right of avoidance are granting a security interest or repayment of an existing debt made with respect to an existing debt after insolvency or a petition to commence bankruptcy. The main examples of these acts are as follows:

- after the petition to commence bankruptcy, upon the request of a creditor knowing the petition, the debtor grants the creditor a security interest on the debtor's property to secure the creditor's claim; and
- after the debtor becomes insolvent, a creditor knowing the debtor's insolvency demands that the debtor repay the creditor's claim and the debtor does so.

11.2 Look-Back Period

As a general rule, the right of avoidance is exercisable for two years after the insolvency proceedings commence or 20 years after the act to be avoided was done. However, the right of avoidance requiring an act was conducted after payments were suspended or while knowing that payments were suspended is exercisable only when the act was conducted within one year before the petition for commencement.

11.3 Claims to Set Aside or Annul Transactions

See **11.1 Historical Transactions**.

Trends and Developments

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Nishimura & Asahi (Gaikokuho Kyodo Jigyo) (N&A) is one of the largest law firms in Japan, with approximately 850 lawyers (22% of whom are qualified in jurisdictions other than Japan), providing a full range of legal services both in Japan and overseas. N&A provides expeditious and high-quality legal services, particularly for cross-border cases that require an ability to resolve complicated international issues, and projects that require a high level of expertise to traverse multiple jurisdictions and various practice areas requiring specialised professionals. N&A has one of the largest restructuring/insolvency teams in Japan, with approximately 50 attorneys. The group provides a first-class service for all types of restructuring/insolvency proceedings, whether in court or out of court. The firm's strengths include the ability to employ the most suitable team for each case, collaborating with the firm's attorneys from other practice areas, or providing attorneys on site in non-Japan jurisdictions via 15 overseas offices (including associate/affiliate/representative offices).

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Dawn of the Rise in Insolvency

Even at just a glance, the figures for in-court insolvencies (when counting both liquidation and restructuring-type proceedings) paint a stark contrast between this year and the last. According to the Teikoku Databank (TDB), while the number of in-court insolvencies dipped in 2021, they jumped 6% year on year in 2022 (6,376 cases), and in the first half of 2023 there has been a steeper increase of 31.6% (4,006 cases) compared to the previous six months. The amount of debt involved also increased by 48.8% from the previous period, reaching JPY906.8 billion in 2023, due to a series of large bankruptcies (ie, liquidations) since March 2023. In fact, especially when it comes to business turnarounds, the number of in-court insolvencies is only the tip of the iceberg. Many Japanese firms prefer out-of-court workouts to avoid the stigma of in-court proceedings, implying that the number of companies undergoing early restructuring has been increasing at a faster rate than the number of in-court insolvencies.

Trends by Cause and Industry

Excessive debt from COVID-19 loans

The Japanese government rolled out interest-free/collateral-free loans, named "Zero-Zero loans", as a main part of the financial support measures during the COVID-19 pandemic. With these measures being 100% government-backed, there is a general concern that over JPY56 trillion was poured into companies without adequate screening by private financial institutions who acted on the front end of these measures. While it was a short-term lifeboat for businesses, it inadvertently created numerous "zombie companies". TDB stats reveal the number of zombie companies (defined by the Bank for International Settlements as those with an interest coverage ratio (ICR) below 1 for three years and established over 10 years ago) increased significantly from 14.6% in pre-COVID times (2019) to 18.8% in 2021.

The government has begun to turn over a new leaf, though. Before, the government had been fervently working to rescue (or prolong) the lives of SMEs and maintain employment through low-interest loan programmes and rescheduling. Nonetheless, the government now fears that the increase in over-indebted companies will harm the reallocation of labour and capital and the overall productivity of the economy, thus dampening post-COVID economic recovery. In June 2023, the government announced its vision to establish a new workout scheme (detailed below at "Hybrid workout scheme"), supposedly aimed at facilitating the smooth exit of low-profit companies from the market as part of the government's "New Capitalism" action plan.

At present, there is no clear outlook on whether this new scheme will act as a catalyst in restoring the market's purification function. On the other hand, in reality, interest payments on the Zero-Zero loans, which have been effectively exempted since 2023, have begun, and the repayment of the principal is becoming full-fledged, leading to the already ongoing weeding out of zombie companies. The number of in-court insolvencies with Zero-Zero loans in the first half of 2023 has reached an all-time high on a semi-annual basis, and this trend is expected to continue.

The double whammy: rising costs and a weak yen

The significant changes in the external environment did not end with the pandemic. Soaring prices (especially energy prices) globally brought about by the invasion of Ukraine has pushed up production costs and the extraordinary depreciation of the yen since 2022 added fuel to the fire. The construction

and transportation industries have been most affected by this double whammy: according to TDB, the number of in-court insolvencies in 2022 in the construction industry, where material prices continue to soar, rose 12.9% year-on-year, while the transportation industry, where gasoline prices continue to rise, recorded a 22.5% increase over the same period.

While inflation is a global trend, Japan is in a pickle of its own. Unlike the West, which has experienced mild inflation with economic growth, Japan has been mired in deflation for over two decades and had fallen into "too cheap Japan". It started to rise from 2022, but even so, according to the IMF World Economic Outlook Database (April 2023 Edition), the inflation rate in Japan was at 2.5% in 2022 and 2.73% in April 2023 (estimate), not as radical as in the US or UK that are experiencing higher inflation rates.

Still, no one believes that this inflation will bring about a virtuous cycle in the economy. That is because the current inflation is not due to an increase in demand, but rather cost-push inflation caused by external factors such as the pandemic and the invasion of Ukraine. Therefore, there are concerns that rising prices will lead to a decline in consumer confidence, resulting in stagflation. In particular, the Japanese mentality is fixated on "Good, Fast and Cheap", as epitomised by the popular dish *gyudon* (beef bowl). Japanese consumers are extremely averse to price changes, and managers cannot decide to raise prices for fear of being alienated by consumers. Thus, even with inflation in the 2% range, it poses a serious problem for Japanese companies, which have difficulty passing on the increase in prices. In fact, many companies, especially B2C companies, have resorted to "subtle" price increases where a product's price remains the same but its contents/quantity is subtly decreased, but such tactic naturally has its limitations.

To counteract the decline in consumption, the government is pushing for wage increases. Thanks in part to tax cuts and subsidies, a survey by the Nikkei Shimbun indicated that the average wage increase rate in 2023 was 3.89%, the highest in 31 years. That said, this surge in wage hikes has led to higher labour costs, which in turn further deteriorates Japanese companies' profitability.

Hot Topics

ESG – a real issue

Not a day goes by without hearing the term ESG, and its significance is seen across all aspects of society. Restructuring and insolvency is no exception. Particularly in Japanese society as of late, the importance of Social and Governance has become more pronounced. In September 2022, the Japanese government announced the "Guidelines for Respecting Human Rights in Responsible Supply Chains". While the concept is not different from that already established in "OECD Due Diligence Guidance for Responsible Business Conduct", it suggests the growing presence of human rights due diligence (HRDD) in Japan. For many Japanese companies sourcing and producing overseas, HRDD is no longer a lofty principle but a management matter that can determine the fate of their overseas expansion or withdrawal. Moreover, human rights violations are not occurring only outside Japan. Within the country, there is increasing awareness of the social appropriateness of continuing to do business with companies that have committed serious human rights abuses, and the impact of relationships with such companies on corporate value.

The other issue is one of governance. The expansion of social disparity and the SNS society has brought about the "Whitening Society" where "no fault is justified" globally as well as in Japan. Under such circumstances, governance-related misconduct is now also more likely to become the Achilles' heel of companies. Furthermore, in rescuing such a company, it is increasingly necessary to take into account not only its profitability, but also the social responsibility to ensure public acceptance of its continued existence.

Labour shortage and insolvencies

It is a well-known fact that Japan's super-aging society will cause a severe shortage of human resources in the Japanese labour market in the medium to long term. In certain industries, however, labour shortages are already triggering insolvencies. In the construction industry, the aging and retirement of skilled craftsmen and qualified construction managers is becoming a serious issue for companies, especially in regions outside metropolitan areas, to sustain their business operations.

In the transport industry, the risk of logistics disruption due to a shortage of drivers (the "2024 problem") is looming. This comes from tightening regulations on overtime hours for truck drivers, starting in 2024. To begin with, the shortage of truck drivers stems not only from aging, but also from the fundamental problems facing the Japanese transportation business (including drivers' low income/long working hours). Nevertheless, the government has strengthened only overwork regulations for drivers. As a result, there is concern that this will lead to a reduction in overtime pay (in effect, a reduction in salary) and, in turn, a further decline in the number of truck drivers. Unfortunately, a not-so-small number of transportation companies (mostly SMEs) have already given up on continuing their businesses, unable to cope with the shortage of drivers combined with the rise in gasoline prices.

The restaurant industry, which is experiencing rapid demand growth as all restrictions that were brought about by the COVID-19 pandemic are gone, is no exception. Some have gone bankrupt without recovering profitability, unable to secure enough business days due to a lack of manpower.

Structural problems – what are the obstacles?

Simply put, there are only three ways to cure a labour shortage:

(i) increase the domestic workforce,
(ii) invite workers from abroad, or
(iii) switch to a business model that does not require labour.

With regard to (i), the government has decided to take "extraordinary measures against declining birthrates", such as increasing child benefits. Even so, the effects will not be seen for decades (this supportive measure is very important, though).

For (ii), a new status of residence "Specified Skilled Worker" has launched for industries struggling to secure domestic labour. In June 2023, the government decided to expand the number of fields for Specified Skilled Workers in which permanent residency and family accompaniment are possible from the current two to 11: the expanded fields include, among others, construction, vehicle maintenance, agriculture, accommodation service and restaurant industry. In another response to (ii), it is expected that more companies will step forward to hire foreign nationals, as it will also enable them to secure a labour force in the mid

to long term. Yet, in a country where immigration is not yet exactly welcomed with open arms (people expect immigrants to be able to speak Japanese, for example), visa issues are not the only obstacle to the retention of foreign workers. In June 2023, the government presented a roadmap for addressing the various issues that foreign nationals face when settling in Japan. On the other hand, conservatives within the ruling party were quick to react to this, expressing concern that it was effectively an immigration policy. With the elderly, who are averse to change, making up (and will continue to make up) a majority of the electorate, it remains to be seen how seriously the government will be able to tackle this issue.

In addressing (iii), the topic often was, and in a sense still is, digital transformation (DX) of businesses. Was DX a passing fad? No. The more SMEs face difficulties in attracting human resources, the greater the need to engage in DX. However, according to a survey by the Organization for Small & Medium Enterprises and Regional Innovation, over 70% of SMEs said they were not working on DX, indicating that, unlike large companies, SMEs have not made much progress in DX even during the COVID-19 pandemic. In addition, the biggest challenge to DX efforts is cited as "lack of personnel for DX", resulting in a causal loop.

It is clear that various issues related to human resources are casting a shadow on Japan's economic growth. From the perspective of restructuring and insolvency, Japan may have to face these challenges for the next couple of decades.

The Establishment and Amendments

Regulation on personal guarantee (kojin-hosyo)

Remarkably, the practice of requiring SME owners to provide joint and several guarantees for corporate loans is still deep-rooted in Japan, impeding entrepreneurship, cessation/restarts of business and business succession. Following the Management Guarantee Guidelines (*Keieisya-hosho* Guidelines) established in 2014 and subsequent complementary guidelines focusing on business shutdown and business succession, financial institutions have voluntarily worked to alter their lending practices, but, even so, according to a survey by the Small and Medium Enterprise Agency, around 70% of new loans made by private financial institutions in FY2021 relied on guaranteed loans.

Against this backdrop, the Financial Services Agency (FSA) once again took steps to further strengthen supervision of business customs. FSA has made it mandatory for financial institutions to explain the need for personal guarantees and the possibility of future cancellation to the business owners concerned when they enter into a joint and several guarantee agreement with them, starting in April 2023. In addition, financial institutions are obliged to report to the FSA the number of cases in which they provided the above explanations. While this does not directly regulate or even restrict personal guarantees, it is hoped to have a significant enough chilling effect. So far, the impact seems to be going in the right direction: more than ten regional banks have decided not to require personal guarantees in principle from April 2023. It is expected that, this time around, lending will be based on an assessment of the nature of the business and its growth potential, rather than on the assets of the individual.

Amendment to the collateral legislation

In December 2022, the Ministry of Justice published an interim draft on the amendment of collateral legislation, a part of the Civil Code. The main purpose of this proposed revision is to promote lending without relying on real estate collateral or personal guarantees, especially given the shrinking ABL market in Japan. The amendment, when officially put into effect, will newly stipulate the creation, disposal/transfer, registration, execution, and treatment in insolvency proceedings for non-possessory collateral over movable property and collateral over receivables. These types of collateral have so far only existed in case law, where they have developed independently. This proposed amendment will codify these case law principles comprehensively.

The government is purporting to introduce other legislation in connection with security collateral: this focuses on the establishment of a new type of security interest over the value of a business. This is envisioned as a type of all-asset collateral that would focus on business cash flows rather than the aggregate sum of individual assets. The design of this new security interest will have a significant impact on the restructuring or business turnaround practices, both in-court and out-of-court, by considering what happens if the debtor in question had already collateralised its entire business: how and with which asset should such debtor endeavour to restructure itself? Although the full details of the purported legislation are still largely unknown, it is essential to watch out for several points: the execution/enforcement process, procedures of business transfer/split, treatment in insolvency proceedings, and the matter of priority especially vis-à-vis both pre-DIP financing and DIP financing.

Hybrid workout scheme

Background

In October 2022, the government revealed the outline of a new workout scheme incorporating cram-down (technically in-class cram-down, described below). This aims to provide a means of early and swift business reorganisation, including debt restructuring, for companies burdened with excessive debt, which has increased dramatically due to COVID-19. Coincidentally, 2022 marked the first time that a large-scale restructuring case that had been proceeding under the existing "Turnaround ADR" process (which is a rules-based out-of-court workout process that requires unanimous consent of all creditors that are involved in the workout) was "converted" into the expedited civil rehabilitation proceeding (*kani-saisei-tetuduki*) due to an apparent failure to obtain the consents of minority creditors. It has been pointed out that the reason why unanimous out-of-court workouts have developed well so far in Japan is that the lenders of financial claims have been limited to homogeneous and highly sympathetic Japanese commercial banks. The government's concern is that, as the creditor pool becomes more diverse and global, the unanimous consent approach in the closed world may no longer work, thus calling for a new regime where an in-class cram-down would be possible even in an out-of-court workout setting.

Overview of the process

The procedure of the new workout scheme is a hybrid model: adding court sanction of the restructuring plan after the existing out-of-court workout process. The threshold for creditor approval is a special majority vote (eg, more than two thirds, but it is to be seen what threshold the new regime would require), which, with court sanction, can bind dissenting creditors to the restructuring plan. This innovative new work-

out scheme is theoretically interesting as it can involve an ideological controversy as to whether it is a constitutional violation for a creditor to have their claim reduced or discharged without their consent in an out-of-court proceeding. Government officials have said that there will be protective measures to ensure the new regime's constitutionality.

Scope of claims

First, the claims subject to the procedure are defined as "claims other than those that need to be paid for running its business"; while the meaning of this definition is yet to be clarified, commercial/trade claims may turn out to be untouchable under this workout scheme. On the other hand, from the standpoint of the creditor equality principle, debtors cannot arbitrarily select claims to target; debtors are not allowed to kick out a creditor unlikely to agree and a commercially reasonable ground should be required when drawing a line on which creditor to target. In short, there is still a lot to learn.

Supervisory organisations

Second, the procedure is presided over by an organisation designated by the Minister of Economy, Trade, and Industry (METI), and such organisation is purported to consist of insolvency practitioners and experts; however, no other details have been clarified at this stage. One of the issues facing the existing "Turnaround ADR" process has been that the fees, which are the source of remuneration for the process-mediators (*tetsuduki jissisya*), are relatively high and too burdensome, especially for SMEs in distress. Thus, the composition (number of persons and degree of involvement) of supervisory bodies is an important issue in terms of widespread use by SMEs. On the contrary, in Japan, creditors are considered to have less control over the in-court insolvency proceedings than in the US and Europe (one reason being the lack of a system to reimburse creditors-side professional fees as a procedural expense), and from the perspective of ensuring the fairness of procedures, supervision by a third party is essential in some respects.

In-class cram-down

Third, no classification of creditors is envisioned, and approval of the restructuring plan requires the approval of a special majority of creditors as a whole. Both secured and unsecured creditors will seem to fall into one class. In Japan, although cross-class cram-down exists in the Corporate Reorganisation Law, it is rarely used and the division of creditors into multiple classes is less familiar. Therefore, in order to avoid over-complicating the procedure, in-class cram-down is purported to be adopted in the new workout scheme. Meanwhile, the interests of secured and unsecured creditors differ (and in most cases conflict), and, therefore, court sanction needs to serve as adequate protection, for example, to ensure that a large number of secured creditors do not unduly prejudice the interests of a small number of non-secured creditors (and vice versa). How a court can make sure these concerns are appropriately addressed throughout the process until which point the matter will be brought before the court remains to be seen, as the details regarding the court's involvement under the newly purported workout scheme are not yet known; again, in short, there is still a lot to learn.

Conclusion

The post-pandemic normalisation and revitalisation of human traffic and economic activity may have a positive effect on the Japanese economy as a whole. As far as large-size companies are concerned, the Business Conditions Index for the first half of 2023 shows

improvement in both the manufacturing and non-manufacturing sectors. As mentioned at the outset, however, the number of insolvencies is rising remarkably. This disparity is clearly not solely attributable to normal economic metabolism. If long-accumulated structural problems in Japanese society are eroding the profitability/competitiveness of SMEs, drastic reforms that go beyond post-COVID-19 need to be urgently put into action.

The hybrid workout scheme with in-class cram-down would present companies with new options for business reorganisation. However, this new workout scheme will most likely have to include a feature where the debtor company that utilises this workout publicly discloses information (such as the name of the company and the contents of the restructuring plan) when the company is to obtain the final court sanction to make it binding even on the dissenting creditors. To what extent debtor companies will actually utilise this new workout scheme, even if and when officially introduced, may therefore depend on whether business managers and consumers in Japan can embrace failure and grant second chances unfettered by insolvency stigma to distressed debtors.

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