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Insolvency

Japan

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practiceguides.chambers.com

2020

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Law and Practice

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1. Market Trends and Developments

1.1 The State of the Restructuring Market

Japan's financial and commercial markets, as well as the overall economy, was not immune to the impact of the global-spread of COVID-19 pandemic. At the time of writing, Japan has been one of the more fortunate regions/nations experiencing a less severe fatality-population ratio and in addition to other less severe medical statistics, however, it is obvious that many industries have taken a severe hit. Among those industries are the nation's food service, hotels and other accommodations, airlines and transportation, automotive and other mobility companies, automotive parts manufacturers, manufacturers of non-essential products, theatres and movie complexes, clothing and other apparel, and various retail shops and franchises.

In terms of statistical data concerning the number of in-court insolvencies and business suspensions, according to a survey by Teikoku Databank as of October 26th, the number of companies that suffered from a COVID-19-related insolvency (including bankruptcy, civil rehabilitation, special liquidation, and business suspension) was 645, which is a significant increase accounting for more than a ten-fold increase in terms of numbers (although there are a lot of different statistics).

As is well documented, prior to the COVID-19 pandemic, Japan was still recovering from the "lost decade" following the burst of its bubble economy, although the "Abe-nomics" initiated by the former Prime Minister Shinzo Abe and the much anticipated Tokyo Olympic games had shed a brighter light on the overall economy and Japan was hopeful that the economy would regain ground in many economic aspects. But with the pandemic hitting the economy hard, no one can yet determine the depth of the impact, and although we have not yet seen an explosion in the number of insolvency filings, that is believed to be the result of government debt support offered to many businesses (especially smaller- and mid-sized businesses) and commercial banks extending emergency loans to larger-sized businesses in the wake of the pandemic. Since debt support can only go so far, many market participants and practitioners expect that there will be a significant uptick in the number of restructuring cases (especially in-court insolvency proceedings) as the maturity date for the emergency loans approaches, which typically is a year from their being provided.

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 proceeding (similar to US Chapter 7), namely the bankruptcy proceeding (*hasan tetsuduki*, "Bankruptcy"); and special liquidation proceeding (*tokubetsu seisan tetsuduki*, "Special Liquidation") and the other being the restructuring-type insolvency proceeding (similar to US Chapter 11), namely the civil rehabilitation proceeding (*minji saisei tetsuduki*, "Civil Rehab") and corporate reorganisation proceeding (*kaisha kosei tetsuduki*, "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 by:

- 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:
  (a) the creditor's claim; and
  (b) 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
"Act on Special Measures for the Reorganization 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*);
- Turnaround ADR (*Jigyo-saisei ADR*); and
- SME Revitalization Support Councils (*Chusyo-kigyo Saisei Shien 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 de-listing.

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 workouts differs depending on which procedure is adopted, the following will explain the process and timeline of a Turnaround ADR (TADR), which is the newest and most commonly used procedure.

Filling 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 ("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 ("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, hair-cuts, 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 creditors' 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 Company 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 of the Corporate Reorganisation. However, even where secured creditors are allowed to enforce/foreclose outside of 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 of the insolvency proceedings, they would remain subject to contractual intercreditor covenants.

In Corporate Reorganisation where secured creditors are bound by the proceedings, secured creditors would be in a class separate from unsecured creditors, and therefore, will be able to veto the approval of the reorganisation plan, and thus effectively block the proceedings from concluding, and 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 its decision whether or not to enforce/foreclose its 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 of 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 Corporate Reorganisation, up to the value of the collateral, secured creditors must be protected in priority to unsecured creditors (although subject to clam-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 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 the proceeding for the Civil Rehab and Corporate Reorganisation 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 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 Civil Rehab and 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 opposing 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 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 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 ("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, 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 ("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 a 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 are 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, 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-fourths 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 an order to confirm ("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.

Note, however, that in Civil Rehab, secured creditors are, as a general rule, outside of 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 takeover 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-a-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 the 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 of 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 debtors' property, etc, at the time the proceedings commence; and/or
  (b) the liabilities of the debtors' 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 to 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 are 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 courts' 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 typical Civil Rehab) or a trustee (in 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 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 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 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 nonexistence 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 setoff only until the expiration of the claims filing period, and when the time when 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 absent 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 requires a "threat" of insolvency to commence proceedings (see **2.5 Requirement for Insolvency**), the debtor acquires existing shares with no consideration and such 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. Please see **2.2 Types of Voluntary and Involuntary Restructurings, Reorganisations, Insolvencies and Receivership**.

Overview

Pros and cons of Special Liquidation are as follows:

Pros

- 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

- available only to stock companies; and
- Special Liquidation 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

- 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 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 Bankruptcy) or liquidator (in 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

Like Civil Rehab and Corporate Reorganisation (See **6.3 Roles of Creditors**), a creditor committee can be formulated with court approval in Bankruptcy. If actually formulated and it is found that there have been activities by the creditor committee that have contributed to the smooth progress of Bankruptcy, the court may permit the bankruptcy estate to reimburse the creditor committee. In contrast, there is no formal creditors committee in 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 this regard on the part of Japanese courts, but to date, there have been no cases where a court entered into a protocol or a similar arrangement with a foreign court.

8.3 Rules, Standards and Guidelines

With regard to the proceedings, it is considered to be 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 to be 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.

9. Trustees/Receivers/Statutory Officers

9.1 Types of Statutory Officers

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

In 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 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 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 coordinate 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, buy back of secured assets or filing of lawsuits.

A supervisor, in 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 also **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 Civil Rehab are almost the same as the trustee.

In Corporate Reorganisation, the provisional administrator administers the business and the assets of the debtor until commencement as well as investigates whether to commence the proceedings. The duties and powers of the trustee in Corporate Reorganisation are basically the same as those in 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 Civil Rehab (see also **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**. above. 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 advisors, 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 directly owes a duty of care to all the creditors and, if the trustee breaches his 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 Corp 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 ("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 debtors' 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, such disposition is subject to the Right of Avoidance if the following conditions are met:

- such 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 such disposition; and
- the buyer knew the debtor's intention at the time of such 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 such 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**.

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Trends and Developments

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Restructuring under and Post COVID-19

Introduction

Although, as of time of writing, Japan has been one of the more more fortunate regions in regards to fatalities related to COVID-19, there is yet to be an end to COVID-19's impact. No one can yet be sure of the full impact COVID-19 brought about to the nation's economy, much less its continued effect.

In the wake of the pandemic and increasing spread of COVID-19 within Japan (especially in Tokyo Metropolitan area), Japan's national government issued its state of emergency declaration on 7 April 2020, which remained in place until May 25th, allowing the nation's local prefectural governments to implement quarantine measures, such as to shut down or shorten business hours of restaurants, theatres, commercial complexes and other commercial establishments, and call for citizens to stay at home.

The declaration and measures actually taken were not an enforced "lockdown" as in other countries, but a "request for restraint (*Jisyuku Yosei*)" for people and businesses to cooperate on a voluntary basis. Nevertheless, many people and businesses in Japan have complied with the request and have continued to refrain from social activity and events, even after May 25th, when they were lifted. This phenomenon has caused "Corona Crisis" including diminishing demands in terms of consumption in numerous lines of businesses, as well as disruptions in supply and manufacturing chains, both of which have had a serious impact on the economic activities of companies.

The impact on industries

While the true extent of the impact is yet to be recognised, it is obvious that a lot of industries have taken a severe hit. Among those industries are: the nation's food service industry, hotel industry, airlines and transportation, automotive and other mobility companies, automotive parts manufacturers, manufacturers of non-essential products, theatres and movie complexes, clothing and other apparel, and various retail shops and franchises. As a result, a number of enterprises are facing financial difficulties at this stage. For example, according to the survey by Teikoku Databank conducted on November 5th, the number of insolvency cases (including bankruptcy, civil rehabilitation, special liquidation, and business suspension) resulting from COVID-19 totalled 683.

As in any jurisdiction, for enterprises facing financial difficulties, cash is king; thus, enterprises typically would initiate their efforts mainly in two fronts, both of which aim to procure cash at their disposal: controlling their payments (ie, cash-out) and obtaining financing usually from external sources (ie, cash-in). With these as a backdrop, this article purports to provide an overview of trends and cash flow measures for enterprises in Japan under COVID-19, divided into two categories (procurement of financing (cash-in aspect) and deferral and reduction of payments (cash-out aspect)) as well as to introduce characteristic issues arising in enterprises' restructuring efforts in the midst of the "With Corona" environment.

Measures Taken in Procurement of Cash

In the midst of an economic downturn, the nation's government (including the local prefectural governments) have been introducing a series of emergency financing measures, concurrently with measures to reduce cash payouts which we will touch upon later in this article, especially for small to mid-sized enterprises which face more difficulties in procuring financing from external sources.

COVID-19 does not discriminate by size, so there are a lot of larger companies, which are typically listed companies, being severely hit by the impact of COVID-19. However, banks and other financial institutions in Japan have been very cooperative in that they have been engaging in numerous and extensive discussions with companies facing financial difficulties.

Trends in larger companies' financing

According to TOKYO SHOKO RESEARCH, LTD, 171 listed companies have been able to raise large-scale emergency loans by June 8th, in order to stabilize their financial bases. The total amount of procured financing being JPY9.67 trillion. The highest amount was JPY1.25 trillion extended to Toyota Motor Corporation, as it secured bridge loans from several domestic banks in the face of the anticipated impact on its business of COVID-19. NISSAN MOTOR CORPORATION was also funded with debt at JPY712 billion. In addition, the government reportedly guaranteed JPY130 billion of Nissan's emergency loan of JPY180 billion from a government-affiliated bank in this May.

According to Teikoku Databank research published on 26 August 2020, the number of listed companies that disclosed they have entered into commitment line contracts from January to July 2020 were 5.2 times (136 companies) that of the previous year, the total contract amount being JPY1.1 trillion, and more than 60% of these were due to the COVID-19 pandemic.

Furthermore, mezzanine financing is actively used in situations where it is necessary to avoid a sharp increase in the amount of debt and beef up the capital. For example, ANA HOLDINGS INC, which had already secured more than JPY1 trillion of funds through commitment lines and by other means, announced in October that it would raise subordinated loans of JPY400 billion from a government-affiliated bank and Japanese megabanks.

Financing measures for SMEs

In contrast, for smaller-sized and mid-sized companies (SMEs), obtaining financing from banks and other financial institutions through regular commercial channels have been more difficult, as most had lower credit scores or ratings even prior to the pandemic, so the main financing methods for SMEs are emergency loan programs provided by governments and government-affiliated financial institutions. Below are some of the examples of such governmental or quasi-governmental initiatives introduced in the wake of the pandemic.

- If sales decline by 5% or more from the previous year, the real interest-free and unsecured special loan programs from Japan Finance Corporation, and Shoko Chukin Bank, Ltd, can be used.
- If sales decline by 5% or more from the previous year, the Safety-net guarantee program, which promotes loans from private banks by having a Credit Guarantee Association, guarantees that these loans can be used.

However, the total of the first and second supplementary national budgets for the COVID-19 measures has reached a record high of JPY57 trillion, most of which will be financed through the issuance of additional government bonds, and there is a concern that there will be an extraordinary tax raise, especially with the consumption tax, coming in the future to compensate for the governmental expenditures.

Priority of loans

One of the problems in obtaining new loans (emergency loans) such as those mentioned above, is ensuring the priority of such loans over existing loans. In particular, if a company (in some cases, whose financial difficulty may have existed prior to COVID-19) has already requested a moratorium on principal repayments to existing financial creditors, it would be reasonable for the financial institution providing new financing to request that they must be repaid in preference to other existing loans (ie, to ensure the funds provided by the new loans are not used to repay existing loans from other financial creditors).

However, in Japan, there is no legal framework to ensure the priority of DIP financing in out-of-court proceedings (except Turnaround ADR). Instead, there are statutory frameworks ensuring the priority of DIP financing provided under in-court proceedings such as civil rehabilitation proceedings and corporate reorganisation proceedings (even in which case, there is no priming priority regime in terms of collateral under Japanese insolvency rules). As such, a debtor is often required by banks providing new financing to provide a new collateral unencumbered by any existing security interest or arrange for a consensual super-priority through negotiations and agreements with holders of existing security interests. In other words, if a company has few unencumbered collateral, or if it takes too much time to reach a deal to allow a consensual super-priority among existing financial creditors, it is difficult to secure emergency financings.

Measures against Cash-Out

In terms of the cash-out aspect, the nation's governments have taken measures to relax tax burdens and payments in terms of social security insurance and pension premiums. Also, there have been certain grants and subsidies for rent and lay-offs provided to companies that meet certain criteria by the governments.

Postponement of payment of taxes and social security premiums

Under the new governmental initiative allowing postponements of tax obligations, if the business income decrease by approximately 20% or more compared to the same period of the previous year and it is difficult to pay taxes, a company may defer the payment of taxes up to a year (or pay in instalments over an extended period of up to a year), with no late payment penalty applied and no collateral required. Similarly, social security insurance and pension premiums are now being allowed to be withheld for a year, or paid in instalments over an extended period of up to a year. However, these payment deferrals are mere "stopgap" measures for companies whose business incomes are slowly recovering, and could lead to future financial difficulties, because these companies will have to pay two years' worth of taxes and social insurance premiums the following year.

In addition, the accumulation of unpaid taxes and social insurance premiums could become practical obstacles for companies in choosing in-court insolvency protections, since tax and other public charges should be paid in priority to other general claims when companies file these proceedings.

Postponement and reduction of rent payment

Some prefectural governments are providing subsidies to support rent payments by businesses affected by COVID-19 under their own support programs, and the national government has started its rent support subsidy program (*Yachin-Shien Kyufukin*) for SMEs and individual entrepreneurs in July. In particular, those whose sales are down by 50% or more in a single month, or 30% or more in a three-month period, compared to the same period last year will be eligible to receive the one-time subsidy, each at the amount calculated in accordance with a certain formula and in one lump sum (as opposed to monthly) up to JPY6 million for SMEs and JPY3 million for individual entrepreneurs.

Other than these subsidies, businesses that rent offices or stores can only resort to a negotiation-based resolution in order to control its rent payments. Having stated the above, however, tenants/lessees may require the lessor to defer or reduce the rent payments via the following procedure made available under a statute protecting the rights of tenants/lessees. Under Article 32 of the Act on Land and Building Leases, if the rent becomes unreasonable due to "changes in economic circumstances," and if the two parties were not able to reach an agreement outside of court, the tenant/lessee may file for civil mediation with a competent court for a request to defer or reduce rent payments.

With the economic downturn affecting many businesses, practically speaking, certain types of building owners may have no choice but to comply with the request for rent reduction because the lessor is unlikely to find a new lessee immediately after the existing lessee goes out of business. This can be true especially for those leases that involve buildings that cannot be used for many other purposes, such as hotels, hospitals and other medical establishments, schools and other educational purposes, where a recovery in demand cannot be easily expected or is not foreseen, and therefore it could be prudent for the lessor to re-set the rent commensurate with the current economic circumstances in order to ensure profitability in the medium to long term, rather than to risk the current tenant/lessee to go bankrupt.

Reduction of labour costs

Another obvious avenue in terms of controlling cash payouts would be reductions and/or deferrals in labour costs. During the emergency declaration, following which companies decided to temporarily close or shorten business hours, the issue of whether they were required to pay leave allowance to workers arose. Article 26 of the Labour Standards Act stipulates that if an absence from work is based on "reasons attributable to the employer", the employer must pay the worker an allowance equal to at least 60% of their average wage; employers are not obliged to pay the allowance if the absence is due to "force majeure". For leave to be considered a leave of absence due to force majeure, it is necessary that it is impossible to continue working remotely because of the nature of the business (not taking into account security systems or equipment availability at the workplace).

As a response, companies may receive the Employment Adjustment Subsidy (*Koyo Chosei Joseikin*) from the government equivalent to up to 100% of that leave allowance that they actually pay employees, and as of September 2020, the number of applications reached to 1.46 million.

Layoffs

With demand and sales still only partially returning to pre-COVID-19 levels for many of the businesses in Japan, there is a growing need for layoffs in the medium to long term. Nevertheless, in Japan, a cut-down on the workforce is not easily achieved as the labour law generally offers an abundance of protections against a termination of employment; in particular, the legality of a dismissal is judged taking into account the following four factors under Japanese labour law:

- the need to reduce the number of employees;
- efforts by the employer to avoid dismissals;
- reasonable selection of employees to be dismissed; and
- following proper dismissal procedures, and these apply even when a business/employer is on the verge of insolvency or is facing a severe deterioration of its financials.

As a result, speedy or rapid adjustments in employment or changes to a company's employment strategy flexibly in line with the surrounding economic environment is not easily achieved in Japan, and many companies would be left with the only viable/practical option being to downsize their workforce through temporary transfers (Syukko) and voluntary retirement programs with severance packages being offered to those accepting the early termination.

Until now, fixed-term employees (eg, contract workers, part-time employees) have been used in Japan as adjustments to help cope with the unstable economy. In October, however, the Supreme Court issued three judgments regarding the principle of equal pay for equal work (*Doitsu-rodo Doitsu-chingin Gensoku*) and overall, the difference between permanent employees and fixed-term employees is expected to decrease in the future.

Moratorium on debt repayment

On 6 March 2020, the Financial Services Agency (*Kinyu-cho*) requested that banks and other financial institutions respond promptly and flexibly to debtors' requests for changes in the terms of existing debts, including deferring repayments of principal and interest. Following this, banks and other finan-

cial institutions have responded co-operatively to the debtors' requests because of COVID-19, and it seems that a considerable number of companies have already deferred their existing debts. However, it is nearing a year since the recession caused by COVID-19 began, and many companies that have overcome their current financial difficulties because of repayment deferrals will go through a phase of developing rehabilitation plans to submit to their financial creditors.

New procedures and operations for financial adjustment

SME Revitalization Support Councils (*Chusyo-kigyo Saisei Shien Kyogikai*) have launched new support proceedings for SMEs whose sales in the last month have decreased by 5% or more compared to the same period in the previous year or two, as follows:

- the Councils collectively request the deferral of principal repayments to financial creditors on behalf of the debtor;
- the Councils assist the debtor in drafting a special one-year restructuring plan, encourage consensus-building among financial creditors to agree to the plans, and help the debtor obtain new loans from governmental and private banks as bridge loans, if necessary; and
- after the plan is approved, the Councils continuously check and advise debtor's concerning cash flow.

On 1 April 2020, Department 20 and Department 8 (Insolvency/Restructuring departments) of the Tokyo District Court began a new special conciliation (*Tokutei-Chotei*) operation, as follows:

- The target companies are those that have converted from formal and rule-based out-of-court workouts (eg, when some creditors do not agree to their rehabilitation plans) or those that have already held Creditors Meetings for financial creditors and have property assessment reports evaluated by certified public accountants or rehabilitation plans based on them.
- In the special conciliation, the Conciliation Commissioners (*Chotei-Iin*) appointed by the court examine the debtor's property assessment report and the process of sponsor selection. The cost of the procedure is determined by the difficulty and length of the examination, and it is capped at the cost of the civil rehabilitation proceedings.
- According to Article 17 of the Civil Conciliation Act, if agreement is unlikely to be reached among the parties, the court may issue a necessary order to resolve the case. The order has the same effect as a successful conciliation if no parties object within a certain period of time, and the court announced positive use should be made as necessary.

Although a lot of litigations and other proceedings have been delayed in the Tokyo District Court due to COVID-19, this new type of special conciliation is expected to be used frequently not far in the future (and quite possibly in the coming months) because it has the features of a non-public insolvency/restructuring procedure involving a court as an independent third party.

Practical Issues in Restructuring under and Post COVID-19

Difficulty in forecasting earnings

The first issue is that it is difficult to predict sales under and after COVID-19. In some cases, sales may return to the same level as before COVID-19 in the short term, while for others, depending on the industry, demand may continue to be weak in the medium term.

There are two uncertainties here: one, that the end of the pandemic cannot be predicted, and two, that the extent and ways in which the "new-normal" lifestyle and values brought about by the pandemic are changing our behaviour and demands.

In Japan, for example, the declaration of emergency led to a surge in remote working, but with the lifting of the declaration, people are gradually returning to their offices. This is due to the unique site-based approach and employment environment (including labour laws) in this country, which is strongly connected with systems of time-management, personnel evaluation, and promotion that assumes employees work in their workplaces. However, it is also true that the convenience and usefulness of remote working will not completely disappear. As a result, it is not easy to predict the extent to which the demand for residential and office space in the downtown area will change after COVID-19.

With such uncertainties, companies may develop interim rehabilitation plans for several years if it is difficult to forecast their profit in the short term.

Shortage of prospective sponsors

The second issue is that there is a concern about the shortage of prospective sponsors. Private equity and other investment funds may become cautious about investing for reasons such as the difficulty in forecasting corporate earnings, the inability to assess appropriate valuations, and the invisibility in terms of exiting their investments. At the same time, companies in the same industry, which are experiencing a similar economic environment to the target company, will be reluctant to acquire other companies as strategic buyers because of the lack of surplus cash or the uncertainties they themselves are facing.

When no sponsor can be found, there will be cases where revitalisation methods such as (super) long-term rescheduling, hair-cuts, debt for equity swaps (DES) or debt for debt swaps (DDS) against existing entities will be adopted instead of the "secondary corporation method" (transferring the going business to a new entity or sponsor and liquidating the original entity), which has been frequently used in Japan.

Necessity of progress in digital transformation (DX)

In Japan, where the population is expected to decline for the next few decades, the major challenge, even in corporate rehabilitation, is to promote the development of remote work and other DX systems, to secure capable human resources and increase business value. In addition, the popularization of working from home, job-based employment, side and secondary jobs, and non-employment working, brought about by the development of DX, will have an impact on the traditional Japanese-style employment system, which has been based on the "employment for life" premise, as well as on achieving a work-life balance and improvements in operational efficiency (eg, going paperless and abolishing seals), which is also expected to be encouraged.

The "Basic Policies for Economic and Fiscal Management and Reform 2020" approved by the Cabinet on 17 July 2020, states that "DX progress will be the driving force for "new-normal" lifestyles." In the report, the government set this year as an intensive reform period to strengthen and accelerate DX development towards the realisation of "Society 5.0" by thoroughly examining and analysing the delays and challenges of digitalisation. One of the centrepiece policies of the Suga Yoshihide government which was newly formed on 16 September 2020, is the establishment of the Digital Agency to accelerate seamless sharing of information in administrative affairs.

In this way, as professionals working in Japan, it is hoped that aggressive digital investment, both public and private, will contribute to the recovery of business performance and the overall Japanese economy, which have been affected by COVID-19.

Nishimura & Asahi is one of the largest law firms in Japan, with approximately 650 lawyers (10% 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 processionals. N&A has one of the largest restructuring/insolvency teams in Japan, with approximately 60 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 12 overseas offices (including associate/affiliate offices).

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