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JAPAN

Law and Practice

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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 number of debtors petitioning for in-court insolvency protection in Japan has drastically decreased in 2021. However, while the total amount of debt of those companies decreased slightly, cases involving a large amount of debt (a debt of more than JPY5 billion) have increased in 2021. It is expected that the number of companies which cease business operations may increase in 2022 (or in 2023 and beyond) due not only to the end of a variety of financial support measures, but also to the various indirect effects of the Russia-Ukraine war (such as increased cost of raw materials and disruptions in transportation and logistics), the rapid weakening of the yen, etc.

Figures for 2021–22

In terms of statistical analysis, according to a survey by Teikoku Databank, the number of in-court insolvencies in 2021 decreased by 23.0% from 2020. This is the third lowest number of in-court insolvencies ever recorded. The number of civil rehabilitation proceedings (*minji saisei tetsuduki*, “civil rehab”) was 195, and this is the lowest number since the civil rehabilitation law entered into force in 2000. Unlike in 2019, the number of in-court insolvencies has decreased in the retail and service industries, but the number of in-court insolvencies in the transportation industry has increased. In terms of analysis based on the size of debtors’ businesses, small size bankruptcy (*hasan*, “bankruptcy”) cases (a debt of less than JPY50 million) account for almost 56% of in-court insolvency cases. The number of special liquidation cases decreased in 2021, but the composition ratio of special liquidation cases among all in-court insolvency cases has increased.

While this trend has been continuing in the first half of 2022, we have seen signs of this downward trend slowly reversing, and we expect the number of in-court insolvency cases to increase, as the number of in-court insolvencies in the first half of 2022 decreased by 1.2% compared to the same period in 2021. Recently, the number of restructuring cases where petitions were filed for in-court insolvency protection after having obtained special loans under the pandemic has rapidly increased.

Support and Rescue Measures

As noted above, support and rescue measures which utilised public funds have been able to prolong numerous enterprises’ corporate lives. The amount of substantially interest-free loans that did not require collateral totalled approx. JPY55 trillion. However, the provision of such special loans ended on 30 September 2022. Recently, the Japanese government has changed its policy to improve SMEs’ earning capacity and to enhance restructuring and “re-challenge”. Regarding “re-challenge”, the management of most SMEs were required to provide personal guarantees for the repayment of those loans, although these personal guarantees were criticised as effectively preventing the management of such SMEs from restarting, reforming or reshaping of business operations, as well as leading to the restructuring of fiscally unhealthy companies. The Japanese government has announced its intention to implement measures to address this issue by 31 March 2023. However, according to a survey by Tokyo Shoko Research, Ltd in mid-August 2022, the ratio of companies which consider the debts they owe

to be excessive was 29.5%. In addition, 30% of the SMEs among these companies do not intend to restructure their businesses. Accordingly, how to restructure those companies may become a significant issue in the post-pandemic era.

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. These guidelines were prepared by representatives of financial institutions, SMEs, academics and specialists in response to the Action Plan of the Growth Strategy published by the Japanese government in 2021. As such, they are expected to be respected and referred to by the parties in cases of out-of-court restructuring of SMEs, although these guidelines are not legally binding. The notable points of the guidelines include requirements for deadlines for eliminating liabilities in excess of assets, etc, which are relatively less stringent than other types of out-of-court restructuring, and that debtors are eligible for subsidies for expert costs (up to JPY7 million) if the debtors satisfy the relevant requirements. No cram-down provisions are provided in these guidelines.

The Japanese government is considering presenting a bill in 2023 to introduce a new out-of-court workout scheme to facilitate business restructuring by allowing in-class cram-down in combination with court approval.

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 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 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 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 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 inter-creditor 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, 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 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 practi-

cally 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 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 ("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 ("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.

Note, however, 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 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 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 debt-

or 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, buy-back 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 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 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 ("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**.

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Trends and Developments

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Usage of In-Court Restructuring Proceedings in Japan

According to Teikoku Databank, the number of in-court restructuring proceeding cases in calendar year 2021 drastically decreased by 23.0%, from 7,809 in the previous year to 6,015, which was the lowest level since 2000. The total amount of debt owed by those insolvent debtors subjected to insolvency proceedings in 2021 also decreased but only slightly by 1.5%, from approximately JPY1,181 billion in the previous year to approximately JPY1,163 billion. On the other hand, while the number of in-court restructuring cases from January to June 2022 decreased by 1.2% from 3,083 during the same period in the previous year to 3,045, the total amount of debt involved increased by 180.7% from JPY628 billion during the same period in the previous year to approximately JPY1,763 billion.

On an industry-by-industry analysis of the above restructuring cases in 2022 from January to June, 583 cases were debtors in the construction business, 382 were retailers and 208 were restaurant businesses. Retailers and restaurants were greatly affected by COVID-19, but due to financial support from the government and the stay-home requests being eased, the numbers of in-court restructuring cases for retailers and restaurants have decreased in 2021. Conversely, the number of in-court restructuring cases for transportation businesses, especially freight transport businesses, increased by 3.8% in 2021 (to 272 cases) due to soaring fuel costs and shortage of drivers.

Moreover, the number of in-court restructuring cases from April to September (which is Q1 and Q2 in typical Japanese financial practice) in 2022 increased by 6.3% compared to the same period in the previous year. The number of civil rehabilitation proceedings (*minji saisei tetsuduki*), which had recorded their lowest numbers for a consecutive few years, have also increased. On an industry-by-industry basis, in industries other than retail, the number of in-court restructuring cases have increased during the same period. In addition, a large number of SMEs are facing financial difficulties. Many SMEs could not pass on the increase in costs, such as raw materials, to sales price and filed a petition for commencing in-court restructuring proceedings. The number of such cases from April to September in 2022 doubled from the same period in the previous year. From statistical analysis, it is apparent that the downward trend in the past few years is reversing, and the number of in-court restructuring cases is expected to increase in the latter half of 2022. General observation is that the main causes of this trend are the government's ceasing of a variety of financial support measures provided during the pandemic (which resulted in the terms of the many special loans maturing), the indirect effects of the Russia-Ukraine War (such as increased cost of raw materials and disruptions in transportation and logistics causing revenues to be halted or decreased) and the rapid weakening of the yen, among other factors. This is in line with reports of a rapid increase in the number of restructuring cases with petitions filed for in-court restructuring protection after having obtained special loans under the COVID-19 pandemic.

The Increase of Insolvency Cases due to a Lack of Successors

Another notable trend is that the number of companies which ceased business (including by filling a petition for in-court restructuring proceedings) due to a lack of successors (mainly death or disease in founding family management) has increased and is becoming a serious issue for SMEs, which constitute 99% of companies in Japan; a lack of successors accounts for 30% of companies that ceased business, even though 60% of companies that ceased business made a profit. According to the Small and Medium Enterprise Agency, a governmental agency, 40% of management members who are in their seventies do not have successors, likewise 48.2% of management members who are in their sixties. But since it is expected that the population in Japan will continue to age at an accelerated rate, this type of insolvency may become a more important issue across Japanese society.

What is the Issue in Japan? No Change, With No Real Wish to Change?

Structural weakness of the Japanese economy shown by depreciation of the Japanese yen

The Japanese yen's rate against the USD breached ¥150 on 20 October 2022: this is the lowest rate for 32 years. Experts expect that this weak yen trend will not end while the US Federal Reserve continues to raise its interest rate to deal with the pressure of inflation, but the Bank of Japan has maintained and intends to maintain the ultra-low interest rate, even though many countries' central banks (not only the US) are raising interest rates.

There seems to be another reason: trade deficit. Japan recorded JPY11.01 trillion (USD73 billion) trade deficit in the first half of FY 2022. Due to the Russia-Ukraine War, energy prices have spiked drastically in 2022. This also contributes to the depreciation of the yen, since Japan has been heavily reliant on imports of most of its energy resources. The Japanese government also aims to restart and promote nuclear power generation, which has been suspended due to Fukushima Daiichi nuclear accident in 2011. However, several issues remain on restarting nuclear power generation, such as the consent of local governments where the nuclear power plants are located.

Other than energy costs, industrial structure changes also seem to be contributing to the soaring trade deficit. Japan recorded its first trade deficit in 2011 after a long-lasting trade surplus since 1981. After that, it recorded a trade deficit for seven of the ten years until 2020. Since many Japanese manufacturing companies have moved their production sites to overseas locations, the amount of imports for those products (or parts) have increased. In addition, due to the Russia-Ukraine War and inflation around the world, the price of raw materials has also increased. In 2022, as noted above, it is expected that Japan will record its highest trade deficit. In the past, the Japanese economy was able to make up for its imports by earning more money by exporting manufactured products. However, in recent years, it has been unable to cover the trade deficit due to the loss of competitiveness of Japanese companies.

As we can see above, it is believed that the depreciation of the yen is also caused by the structural weakness in the fundamentals of the Japanese economy. As the depreciation is being embedded in the fundamentals, the general wisdom would conclude that it will not be easy for the Japanese government to come up with a "quick" cure against this trend. It is also difficult for Japanese companies to strengthen

or change their industrial structure immediately (rather, they still seem to be at the "denial" stage when it comes to the need for change, as mentioned below). In the meantime, the depreciation of the yen is causing financial difficulties in Japanese companies and the Japanese economy is losing its capacities for reformations or going through structural reorganisations: as unfortunate as it is, the Japanese economy seems to be on the verge of falling into a vicious cycle.

Conservative tendency of Japanese companies (and society)

The attitude of management in Japanese domestic companies has long been recognised as conservative, especially when compared to management in Western countries. It has been reported that the outstanding amount of retained earnings exceeded JPY516 trillion as of 31 March 2021, which is the highest amount it has ever been. But this tendency of management to prefer to keep cash in hand may lead to the company being reluctant to use money for future investment or for making changes.

This tendency to avoid change is also applicable to Japanese politics. A large portion of voters are elderly people, who prefer not to implement measures that will drastically change the current treatment. This is known as the "silver democracy".

The background and issues with increasing insolvency cases due to lack of successors

Among SMEs passing to someone by succession, 90% are cases where the relatives of the founding family management/owner succeeded to the company. However, recently, cases are seen where even relatives are reluctant to succeed to a company, since they are sceptical about the future or stability of that business. In addition to that, they do not want to succeed to guaranty obligations which the current management/owner has provided to creditors. Traditionally, the management of most Japanese SMEs were required to provide personal guarantees for the repayment of those companies' debts, although the Japanese government has tried to change this custom.

In addition, for most SMEs, management assets and company assets (and debts secured by management providing personal guarantees) are often commingled. This also prevents employees or a third party from succeeding to a company.

It is necessary to prepare in advance to find a successor by achieving transparency of management and separating the company's and management's assets and liabilities. Succession cannot be achieved in the short term. However, many older owners do not have the motivation or additional energy to propose long-term management policies and to invest in the future during a long-lasting pandemic, and they cannot find and/or develop successors. Consequently, their companies will lose more profitability and productivity.

If SMEs that have a unique business (technology, product, etc) or SMEs that can make a profit cannot avoid ceasing business or insolvency proceedings because of a lack of successors, there will be significant social consequences. The Japanese government has tried to provide aid for these SMEs and there appears to be an increase in the number of successful successions.

Conclusion

As noted above, many Japanese companies have not been able to implement fundamental changes. In addition, even though it has been

pointed out that it is important to achieve sustainable economical growth by implementing fundamental development, the removal of industry barriers also has not been achieved. Rather, Japanese society prefers to just survive with as few drastic measures as possible, which attitude also has contributed to the fact that the economy has unconsciously or blindly created "zombie" companies.

The special loans supplied during the COVID-19 pandemic have supported many companies and people's daily livelihood but also contributed to the survival of and rapid increase in the number of "zombie" companies, in turn increasing the aggregate outstanding debts among companies. The ultra-low interest rate may also have contributed to the increase of "zombie" companies. In addition, during the pandemic there has been an increase in the number of cases whereby a debtor company has requested rescheduled payment terms for debts through the SME Vitalisation Councils mentioned below. However, rescheduling payment terms for debts may help a company in the short-term, but it will not be a fundamental solution in situations where companies were merely weathering the pandemic with no real change being implemented to their business operations.

Also, as mentioned above, there has been a rapid increase in the number of restructuring cases with petitions filed for in-court restructuring protection after having obtained special loans and in the number of companies considered to have excessive debts. It has recently been pointed out that "zombie" companies in Japan constitute over 10% of active companies. Under the "silver democracy", Congress and company management cannot draw a long-term plan or implement fundamental development.

However, leaving "zombie" companies without any measures would result in a significant burden on the Japanese economy. It is important to transform industrial structure by promoting the replacement of old industries and businesses with new ones and to have a strategy to achieve structural restructuring.

Possible Measures to Achieve Transformation and Restructuring

Lastly, an introduction to potential restructuring and insolvency-related measures, which are currently under discussion, to deal with these issues.

Development of environment to enhance restructuring and "revitalisation"

As mentioned above, the Japanese financial tradition of requiring the management of SMEs to provide personal guarantees has long been criticised, as it makes it difficult for management to "re-start" or "revitalise", given the very negative perception of "insolvency", and it is one of the obstacles to SME succession.

The Japanese government has tried to change this custom. For example, the Shoko Chukin Bank, which is a government-affiliated financial institution, has expanded cases where loans are provided without personal guarantees. Also, the "Grand Design and Action Plan for a New Form of Capitalism", which the Japanese government published in 2022, also states that a new guarantee system and financing practices will be established which do not demand management's personal guarantees.

In addition, the Japanese government intends to legislate for a new collateral system ("*Jigyo-Tanpo-Ken*" or "*Jigyo-Seicho-Tanpo-Ken*") whereby the business value of the entire enterprise itself is the subject matter of a security interest. Not

requiring personal guarantees where this new collateral is implemented is under discussion.

It is too early to say whether this custom will become obsolete, but the proposed changes may or are hoped to bring about changes in how businesses (especially SMEs) will be financed and, in turn, in how to achieve restructurings of SMEs.

SME Vitalisation Councils

The Japanese government published the “SMEs Vitalisation Package” on 4 March 2022, its aim being to improve profitability and to enhance business restructuring and revitalisation. Based on this package and policy, the SME Vitalisation Councils (*Chusho-kigyo Kasseika Kyogikai*) were established by merging the “SME Revitalisation Support Councils” (fair and neutral public institutions established in each prefecture) and the Support Centre to Improve Business Management (*Keiei Kaizen Shien* Centre). The SME Vitalisation Councils provide various types of support to SMEs:

- to improve profitability as a precautionary approach;
- in restructuring SMEs, by providing the Councils Scheme (*Kyogikai* Scheme) and the Restructuring of SMEs Support Scheme (*Chusho-kigyo Saisei Shien* Scheme);
- for “revitalisation”;
- to establish a business improvement plan in the early stages of restructuring; and
- to establish a business improvement plan of a debtor company which utilises the Guidelines for the Restructuring of Small and Medium Enterprises (*Chusho-kigyo no Jigyo-saisei-tou ni-kansuru* Guidelines).

The Ministry of Economy, Trade and Industry also published the “SMEs Vitalisation Package NEXT” on 8 September 2022, to implement additional measures such as strengthening the SME Vitalisation Councils.

As mentioned above, 90% of SMEs are Japanese companies. The SME Vitalisation Councils and their predecessor organisation have provided a variety of restructuring support for SMEs and developed their capabilities and experiences regarding co-ordinating interests between several financial institutions and debtors. In addition, since the SME Vitalisation Councils are located in each prefecture, it may be more convenient for SMEs to ask for advice. By effectively utilising the SME Vitalisation Councils and these schemes, it is hoped that as many restructuring of SMEs as possible will be successfully conducted and that regional vitalisation will also be enhanced.

The Guidelines for the Restructuring of Small and Medium Enterprises

The Guidelines for the Restructuring of Small and Medium Enterprises were published and became effective on 15 April 2022. Please see **1.1 Market Trends and Changes** in the Japan Law & Practice chapter in this guide for details. One notable point is that the guidelines also include the outline for out-of-court workout for a company that decides to cease its business operations. The purpose of this part of the guidelines is to allow a company’s business to cease smoothly; the other parts of the guidelines are aimed at allowing businesses’ management to re-start and revitalisation. By promoting the guidelines, the government also hopes that those managing SMEs will be able to make easier decisions to improve their business management and conduct business restructuring in the early stages through consultation with financial institutions. Although it is still not clear how or to what extent this out-of-court workout scheme

to cease business can or will support restructuring of "zombie" companies (since the scheme has rarely been used in the six months since its launch), it may contribute to the structural reorganisation necessary for Japan if many debtors can achieve smooth business closure through the guidelines.

New out-of-court workout scheme with in-class cram-down

It has also been reported that the Japanese government is considering drafting new legislation in 2023 to introduce a new out-of-court workout scheme to facilitate business restructuring by allowing in-class cram-down. The details of the new scheme have not yet been revealed, but it has been reported that the new scheme intends to allow a debtor company's out-of-court restructuring with the combination of a majority vote among creditors and a court sanction. On the other hand, there are also counter-arguments against majority rule in the out-of-court workout. The main point of such counter-arguments is: if a creditor is forced to waive its claim (even if it is partially) based on the majority vote, it should be recognised as an infringement of its constitutional property rights. The design of such new legislation must result in a fair system and not allow "zombie" companies to survive. Therefore, it is still uncertain whether this law will be enacted in the short term.

However, recently in Japan, many restructuring companies prefer the out-of-court workout rather than in-court restructuring. Even if there seems to be high uncertainty of success, debtors try to obtain the consent of financial creditors through the out-of-court workout. The main reasons why debtors prefer the out-of-court workout are to prevent damage to business, which may be caused by the negative stigma in-court restructuring proceedings still have in Japan, and to maintain employment opportunities and the local economy, etc, in contrast to the in-court restructuring, which may change the debtor company drastically (although this is not always true). In 2022, there was in fact a large in-court restructuring case where the debtor (Marelli Holdings) first tried to achieve its restructuring through the Turnaround ADR Procedures (one of the out-of-court procedures in Japan) but failed because of the opposition of a few financial institutions, and filed for simplified civil rehabilitation proceedings (*Kanni Saisei Tetsuduki*).

Thus, the new out-of-court workout scheme with in-class cram-down may be utilised, especially to prevent damage to business value or to enhance restructuring (and in Japanese society where relevant parties are relatively reluctant to drastic changes). Especially since it takes time (and it is sometimes too burdensome) to co-ordinate various interests between financial institutions in the current workout scheme that requires unanimous consent (as a general rule), this new scheme may support restructuring of companies, for example, in a case where only a few (or even one) creditor(s) (which own only a small amount of the claim) oppose the restructuring plan but most of the creditors have agreed to support it, in a case where a rapid restructuring is required but there is uncertainty whether unanimous consent will be obtained, etc. Given that many companies have excessive debts due to the COVID-19 pandemic, rapid restructuring may contribute to structural reorganisation in Japan, rather than just leaving "zombie" companies.

Closing Remarks

Japan is already a super-aged society and people still seem to be reluctant to bring about fundamental changes. Unfortunately, Japan has been losing industrial and economic com-

petitiveness and its economy has started to be structurally weakened. To improve and redevelop the economy, it needs to implement drastic reforms. The Japanese government has started to provide several initiatives. For example, by improving added value, providing DX subsidies and support for reskilling, accelerating the structural improvement of companies, allowing changes in employment systems (for example, guidelines for independent workers (ie, gig workers), and changing membership-type employment to job-based employment). Also, as outlined in this chapter, several initiatives related to restructuring have been introduced or are planned. However, the most important thing is a strong commitment by companies as well as Japanese citizens as a whole to embrace social and organisational restructure for fundamental survival, and to have an unwavering determination to achieve such structural improvements.

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