



The International Comparative Legal Guide to:

Corporate Recovery & Insolvency 2016

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Japan

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1 Overview

1.1 Where would you place your jurisdiction on the spectrum of debtor to creditor-friendly jurisdictions?

We think that Japan is a debtor-friendly jurisdiction in light of the following systems. Under Japanese insolvency and restructuring laws, the debtor is not obligated to file a petition for a bankruptcy or restructuring process in court even when it is insolvent (except in case of a liquidator of a stock company). The relevant laws provide for a voluntary filing for restructuring and insolvency processes. According to the report by the Japan Federation of Bar Associations in 2014, more than 96% of the natural persons who filed for bankruptcy proceedings received relief from debt obligations in the bankruptcy process. In addition, it is quite uncommon for a bankrupt person to be punished in connection with the bankruptcy process. However, there is an exception for cases where a person has committed fraudulent bankruptcy acts specified in the Bankruptcy Act. Also, there is a special bankruptcy process for an individual person or small/midsize company at many Japanese courts where a bankruptcy filing is permitted with a small deposit (e.g. JPY200,000) (Small Amount Trustee System). Under the Civil Rehabilitation Act (enforced in April 2000), it is possible for individuals and business enterprises to restructure their debts expeditiously.

Moreover, there are several private methods for restructuring debts owed to financial institutions without using a court process. Such procedures include, among others, the procedures conducted by the Small and Medium-sized Turnaround Support Committee and the procedures under Turnaround Alternative Dispute Resolution.

1.2 Does the legislative framework in your jurisdiction allow for informal work-outs, as well as formal restructuring and insolvency proceedings, and are each of these used in practice?

(a) Informal Work-outs

For the purpose of restructuring a company's debt, it is possible to reduce the amount of debt with the unanimous consent of all of the company's creditors under Japanese law. In addition, there are formal procedures established by law to obtain each creditor's consent. Such procedures include, among others, the procedures conducted by the Small and Medium-sized Turnaround Support Committee ("SMTSC") and the procedures under the Turnaround Alternative Dispute Resolution ("TADR"). These procedures are available to achieve a restructuring of a company's debts and conducted without court supervision.

The SMTSC and the TADR are used by companies in financial difficulty with creditors who are financial institutions. The debtor and the creditors conduct negotiations for debt restructuring with guidance from neutral special advisors. These procedures are not open to the public and serve as a kind of private restructuring process for financial institutions as creditors. A financial support plan (e.g. amendment of the conditions of repayment, release of debt and debt-for-equity swap) is decided with the unanimous acceptance of financial institution creditors.

(b) Formal Court Proceedings

The court procedures in Japan for companies facing financial difficulties are categorised into: (I) the rehabilitation process, consisting of (a) Civil Rehabilitation Proceedings, and (b) Corporate Reorganisation Proceedings; and (II) the liquidation process, consisting of (c) Bankruptcy Proceedings, and (d) Special Liquidation Proceedings.

The main characteristics of these procedures are as follows.

- (1) Civil Rehabilitation Proceedings ("Civil RP"): Debtor-in-possession proceedings with the purpose of reducing creditors' claims through a rehabilitation plan that is approved by the creditors' meeting and confirmed by the court in order to rehabilitate the debtors' business. (See question 3.5 as to the conditions for approval by a creditors' meeting.)
- (2) Corporate Reorganisation Proceedings ("Corporate RP"): Rehabilitation proceedings for stock companies which are mainly conducted by a trustee appointed by the court.
- (3) Bankruptcy Proceedings ("BP"): Liquidation proceedings conducted by a bankruptcy trustee appointed by the court.
- (4) Special Liquidation Proceedings ("SLP"): Debtor-in-possession liquidation proceedings for a stock company conducted by a liquidator. The directors of the company become its liquidators unless otherwise determined by the articles of incorporation or the shareholders' meeting. This procedure is aimed for the distribution of the liquidation company's assets by agreement among the debtor's creditors according to the rules under the Companies Act.

2 Key Issues to Consider When the Company is in Financial Difficulties

2.1 What duties and potential liabilities should the directors/managers have regard to when managing a company in financial difficulties? Is there a specific point at which a company must enter a restructuring or insolvency process?

Directors of stock companies who continue to trade while the stock company has financial difficulties should note the following issues concerning their potential liability:

- (1) if a director neglects his/her duties, he/she will be liable to such company for damages arising as a result of such neglect. If a director acts with wilful intent or with gross negligence in neglecting such duties, such director is liable to third parties for damages arising as a result of such neglect;
- (2) if a director commits an act of malfeasance, there is a possibility that such director will be criminally liable for breach of trust stipulated in the Criminal Code or aggravated breach of trust stipulated in the Companies Act; and
- (3) there are specific procedures for pursuing director's liability in an expedited process in Civil RP, Corporate RP, BP and SLP. A petition for an assessment of director's liability can be filed in such proceedings asserting damages to the company by an illegal act by a director.

Under Japanese law, it is possible for a stock company to file a petition for restructuring or insolvency court proceedings when its financial conditions meet certain conditions stipulated under the laws. However, filing such a petition is not mandatory except when a liquidator of a stock company which is going through a liquidation process under the Companies Act finds that the company may be insolvent. In such a case, the liquidator is obligated to file a petition for a special liquidation process supervised by the court.

2.2 Which other stakeholders may influence the company's situation? Are there any restrictions on the action that they can take against the company?

A creditor may file a petition to commence BP at court by providing *prima facie* evidence to show (i) the existence of the creditor's claim, and (ii) the fact constituting the grounds for commencement of BP for the debtor. A creditor may file a petition to commence Civil RP in court by providing *prima facie* evidence to show the existence of (i) the creditor's claim, and (ii) the risk that facts constituting grounds to commence BP of the debtor will occur.

In addition, as to a stock company: (i) a creditor who holds claims that account for one-tenth or more of the amount of the stated capital of the stock company; and (ii) a shareholder who holds one-tenth or more of the voting rights of all shareholders of the stock company, may file a petition to commence Corporate RP at court by providing *prima facie* evidence to show the existence of (i) the creditor's claim, and (ii) the risk that facts constituting grounds to commence BP of the debtor will occur.

A creditor, liquidator, company auditor or shareholder may file a petition in court to commence SLP.

2.3 In what circumstances are transactions entered into by a company in financial difficulties at risk of challenge? What remedies are available?

The trustee in Corporate RP or BP ("Trustee") or the supervisor in Civil RP ("Supervisor") may exercise the right of avoidance against certain acts as listed below. Note that there is no right of avoidance under Special Liquidation Proceedings.

- (1) **Fraudulent Act**
 - (a) An act conducted by the debtor that is detrimental to its creditors while the debtor has knowledge that it is detrimental (this does not apply where the person who has benefited from such act did not know that the act was detrimental to the debtor's creditors).
 - (b) An act conducted by a debtor that is detrimental to its creditors after suspension of payments or the filing of a petition for commencement of any of the court procedures (collectively, a "Suspension of Payments") took place (this does not apply where the person who has benefited from such act did not know that a Suspension of Payments had taken place or that the act was detrimental to the debtor's creditors).

- (c) An act to extinguish debt in exchange for giving property if the value of property exceeds the amount of the debt extinguished and such act satisfies either of conditions (a) and (b) above. Such act may be avoided only for the portion of the property which exceeds the value of the cancelled debt.
- (d) Any gratuitous act conducted by the debtor within six months prior to, or after, a Suspension of Payments.

(2) Disposal of Assets with the Intention to Conceal the Proceeds

An act of disposal of property (in exchange for reasonable value) from another party in which both of the following conditions apply: The act creates an actual risk that the debtor may conceal or otherwise dispose of the property in a manner which is detrimental to creditors ("Concealment") by changing real property to cash or any other manner.

The debtor had the intention of conducting a Concealment and the other party knew of this intention.

(3) Preferential Act concerning Provision of Security or Extinguishment of Debt

An act to provide security or extinguish debt after the debtor becomes unable to pay its debts, or a petition for commencement of any of the Court Procedures has been filed.

An act to provide security or extinguish debt within 30 days prior to the date when the debtor becomes unable to pay its debts if such act is not based upon the debtor's legal obligation.

(These do not apply where the creditor did not know the relevant fact as mentioned above.)

(4) Perfection

An act of perfection to assert the establishment, transfer or modification of a right against a third party (including a provisional registration) may be avoided if (a) the perfection action occurs after a Suspension of Payments, (b) the perfection action occurs 15 or more days after the date of establishment, transfer or modification of the right, and (c) the perfection action was attempted with a knowledge of the Suspension of Payments.

The Trustee and Supervisor may exercise the right of avoidance in court. Depending on the type of voidable action (as described above), the right of avoidance would allow them to petition the court for a court judgment for restoration of the estate of the debtor (e.g. return of property or payment or cancellation of mortgage which may be avoided under the applicable law).

3 Restructuring Options

3.1 Is it possible to implement an informal work-out in your jurisdiction?

Under Japanese law, it is possible to implement an informal work-out in addition to restructuring or insolvency court proceedings.

3.2 What formal rescue procedures are available in your jurisdiction to restructure the liabilities of distressed companies? Are debt-for-equity swaps and pre-packaged sales possible?

As explained in question 2.1 above, a company with financial difficulties may utilise Civil RP or Corporate RP in order to restructure the liabilities.

A debt-for-equity swap (Debt-Equity Swap or "DES") is permitted as one of the restructuring schemes. DES reduces debt and provides debtors with an opportunity to obtain capital gains and income from the equity after the rehabilitation of the company.

A “pre-packaged sale” is also possible. It refers to a type of procedure where a debtor selects its potential sponsor before the commencement of Civil RP or Corporate RP. By such arrangement, it is possible to avoid the impairment of the debtor’s business due to announcement of insolvency procedure by publication of the existence of the sponsor after Restructuring Proceedings is commenced.

3.3 What are the criteria for entry into each restructuring procedure?

As a common practice in Japan, when a company has financial difficulties, an informal work-out is conducted with creditors that are financial institutions without involving other types of creditors, such as trade creditors. In such cases, it is possible for the company to continue to conduct its business during the work-out process whereby the company can avoid the damages to its business which would be caused if the company goes through Civil RP or Corporate RP.

On the other hand, in the case of Civil RP and Corporate RP, all types of creditors are involved. The grounds for commencement of these procedures are (a) when there is a risk that grounds for commencement of BP will occur to a debtor (see question 4.2), and (b) when it is extremely difficult for a debtor to continue its business if the debtor pays its debts that are due.

3.4 Who manages each process? Is there any court involvement?

In the case of an informal work-out, the executive directors of the company continue to manage the company. Such directors also control the informal work-out process with assistance from legal counsel specialised in insolvency cases.

In case of Civil RP, the executive directors of the company continue to manage the company and control the Civil RP under the supervision of the court. On the other hand, as a basic rule in Corporate RP, a trustee appointed by the court takes over the positions of the executive directors and control the management of the company and the process of the Corporate RP.

3.5 How are creditors and/or shareholders able to influence each restructuring process? Are there any restrictions on the action that they can take (including the enforcement of security)? Can they be crammed down?

In an informal work-out, creditors that are financial institutions participate in the process. In certain cases, business entities who are major trade creditors also participate in the process. In order to achieve a successful work-out, unanimous consent of all creditors is necessary.

In Civil RP or Corporate RP, if the proposed rehabilitation plan is approved at a creditors’ meeting, the court will examine the pertinent conditions required by law and approve the rehabilitation plan. Upon the approval of the rehabilitation plan, the reduction of debts will become effective and the debtor shall pay the debts according to the plan.

The requirements for approval of a proposed reorganisation plan by the creditors meeting are as follows:

(1) Civil RP

(a) Consent of the majority (by number of creditors who exercise a vote), and (b) consent of creditors who hold claims in an amount not less than one half (½) of the total amount of claims owed by the debtor.

(2) Corporate PR

Approval of both (a) the unsecured claim creditors’ group, and (b) the secured claim creditors’ group are necessary as per the conditions below.

- (a) unsecured claims: consent of the persons who hold more than half of the total amount of unsecured claims; and
- (b) secured claims: conditions for approval varies according to the content of the proposal as set forth below.
 - (i) A proposed reorganisation plan which provides for the extension of the terms of secured claims: consent of the secured creditors who hold secured claims that are not less than two thirds (⅔) of the total amount of the secured claims.
 - (ii) A proposed reorganisation plan which provides for the reduction and release of debts for secured claims or provides for measures that may affect the rights of secured creditors other than the extension of terms: consent of secured creditors who hold secured claims that are not less than three quarters (¾) of the total amount of the secured claims.
 - (iii) A proposed reorganisation plan which aims for the discontinuation of the entire business of the reorganisation company: consent of secured creditors who hold secured claims that are not less than nine tenths (9/10) of the total amount of the secured claims.

(Notes: (a) “Cramdown” is permitted by the law. Even if one creditor group disapproves of the reorganisation plan, the court may approve the reorganisation plan by creating new provisions to the plan which protect the interest of the creditor group who disapproved of the plan; and (b) in exceptional cases where a Corporate PR is used for a company which is not insolvent, consent of the shareholders who hold the majority of shares is also required.)

In Civil RP, secured creditors can enforce their security interests outside of the proceedings. However, upon petition by the debtor, the court may cancel the security interests in exchange for the payment of the fair value of the subject property which is essential for continuance of the debtor’s business even if the amount of the creditor’s claim exceeds such fair value of the subject property. It is a common practice for a debtor in Civil RP to negotiate and enter into an agreement with its key creditor who has security over the core property of the debtor’s business (e.g. its factory) whereby the creditor shall refrain from enforcing the security in exchange for instalment payments of the fair value of the property agreed to between the parties.

In Corporate RP, secured creditors cannot enforce their security outside of the proceedings. Their claims may be paid pursuant to the reorganisation plan with priority. However, if the subject property is clearly unnecessary for the reorganisation of the debtor’s business, a secured creditor can enforce its security outside of the proceedings after obtaining court approval.

3.6 What impact does each restructuring procedure have on existing contracts? Are the parties obliged to perform outstanding obligations? Will termination and set-off provisions be upheld?

In principle, even if Civil RP or Corporate RP have commenced, contracts between the company and others will not be terminated merely because of the commencement of proceedings.

If a debtor is a party to an executory contract at the commencement of Civil RP or Corporate RP, the debtor may choose (i) to reject the contract in which case it is terminated and the counterparty may seek damages as a priority creditor, or (ii) to assume the contract in which case the company must perform its obligations and may demand performance by the other party. When a debtor chooses to assume a contract, further claims by the counterparty shall take priority over other creditors.

Under Japanese law, it is necessary for the debts of two parties to become due in order to be eligible for set off. In Civil RP and Corporate RP, creditors can exercise the right of set off subject to the exceptions under the relevant law. The exceptions for set off

are (i) where the person has acquired another person's claim after the commencement of such proceedings, (ii) where the person has acquired a claim after the company became unable to pay debts, the company suspended payments, or the petition for commencement of such proceedings was filed, and the person knew, at the time of acquisition of the claim, of such fact. In addition, creditors can exercise the right of set off only within the period for the filing of their claims specified by the court.

3.7 How is each restructuring process funded?

The expenses for the restructuring process are paid by the debtor. In case of Civil RP and Corporate RP, (a) the debtor pays the expenses for the process to the court before the process is started, and (b) court approval (or the consent of the supervisor) is required in order for the company to borrow funds to finance the proceedings.

4 Insolvency Procedures

4.1 What is/are the key insolvency procedure(s) available to wind up a company?

As explained in question 1.2 above, BP and SLP are available to wind up an insolvent company.

4.2 On what grounds can a company be placed into each winding up procedure?

The grounds for commencement of BP are (a) the debtor is unable to pay its debts, or (b) the debtor is insolvent. In addition, when a debtor has suspended payments, the debtor is presumed to be unable to pay its debts.

In case of SLP, the grounds for commencement of the procedures are: (a) implementation of ordinary liquidation procedures would be extremely difficult due to certain circumstances which apply to the company; or (b) the company is suspected of being insolvent.

4.3 Who manages each winding up process? Is there any court involvement?

In BP, a trustee appointed by the court has the power to manage and dispose of the assets of the company and manage the BP under the supervision of the court. In most cases of SLP, the executive director of the company may become the liquidator and manage the process under the supervision of the court.

4.4 How are the creditors and/or shareholders able to influence each winding up process? Are there any restrictions on the action that they can take (including the enforcement of security)?

In BP, the trustee will distribute the remaining cash to the creditors on a *pro rata* basis after the liquidation of the assets of the debtor and payment of the claims with priorities. Therefore, the creditors and the shareholders are not able to influence the BP.

In SLP, a liquidation agreement may be proposed in a creditors' meeting. The requirements for approval of a liquidation agreement by the creditors' meeting is: (i) consent of the majority of creditors (by the number of creditors who exercise a vote); and (ii) consent of the creditors who hold claims that are not less than two thirds (⅔) of the total amount of unsecured claims owed by the debtor. If the liquidation agreement is approved at the creditors' meeting, the court will examine the pertinent conditions required by law and approve

the agreement. According to the approved liquidation agreement, the reduction of debts, payment of debts and liquidation of the company will be implemented. In SLP, it is also possible and common for a company to enter into separate settlement agreements with each of the creditors with court approval instead of holding a creditors' meeting.

In BP and SLP, secured creditors can enforce their securities outside of the proceedings.

4.5 What impact does each winding up procedure have on existing contracts? Are the parties obliged to perform outstanding obligations? Will termination and set-off provisions be upheld?

In principle, even if a winding up procedure has commenced, contracts between the company and others will not be terminated merely because such procedure has commenced. However, the Civil Code provides for automatic termination of (a) an agent's authority in case of bankruptcy of the agent, and (b) a mandate contract in case of bankruptcy of the engaged party or the engaging party.

If a debtor is a party to an executory contract at the commencement of BP, the debtor may choose (i) to reject the contract in which case it is terminated and the counterparty may seek damages as a priority creditor, or (ii) to assume the contract in which case the company must perform its obligations and may demand performance by the other party. When a debtor chooses to assume a contract, further claims by the counterparty shall take priority over other creditors.

In SLP, there are no such rules which enable the company to assume or reject the contracts.

If a contract provides that (i) the contract shall be automatically terminated, and (ii) the monetary obligations of both parties shall be automatically set off upon commencement of BP or SLP, such clauses are effective.

4.6 What is the ranking of claims in each procedure, including the costs of the procedure?

(1) BP

(a) The following types of claims are paid with priority outside of BP. Namely, these creditors are not subject to the restrictions under BP and the debtor has to pay the debt when it is due.

(x) Common benefit claims:

(i) Expenses for court proceedings performed for the common interest of creditors.

(ii) Expenses for the administration and disposition of the debtor's business and assets after the commencement of proceedings.

(y) Claims with general priority.

(z) Claims with priority under other laws. For example, a tax claim or a claim to wages.

(b) Creditors may execute claims secured by security interests outside of the procedure.

(c) Claims with general priority other than those stated in (1) (a) above have preferential status within the procedure for dividend distribution.

(d) Claims other than those above will be paid on a *pro rata* basis.

(2) SLP

(a) Claims as stated in (1)(a) above are paid with priority outside of the procedure.

(b) Creditors may execute claims secured by security interests outside of the procedure.

(c) Claims other than those above will be paid on a *pro rata* basis.

4.7 Is it possible for the company to be revived in the future?

A stock company shall be dissolved upon the commencement of BP under the Companies Act. SLP are applicable to a stock company which has been dissolved and insolvent. Upon the completion of BP or SLP, the stock company ceases to exist. There is no legal system which makes it possible for such a company to revive in the future.

5 Tax

5.1 Does a restructuring or insolvency procedure give rise to tax liabilities?

After the commencement of each procedure, a debtor will incur tax liability for corporate income tax and consumption tax regarding the acts conducted by the company. It should be noted that if a debtor is released of its debt to a creditor, the debtor will be subject to tax liability for deemed income equal to the amount of forgiven debt. Therefore, if the debtor has no deductible expenses applicable to such income, the debtor may be subject to additional corporate income tax.

Tax claims which arise after the commencement of each procedure are recognised as follows:

- (a) Civil RP, Corporate RP, and SLP: Claims with general priority.
- (b) BP: Subordinate claim which is paid only after full payment of ordinary claims which exist at the time of the commencement of proceedings. The creditor usually may not receive any dividends for such subordinate claim. However, tax claims which fall within the scope of expenses regarding management, realisation and distribution of a bankruptcy estate are regarded as priority claims and are paid outside the procedure.

6 Employees

6.1 What is the effect of each restructuring or insolvency procedure on employees?

In rehabilitation procedures such as Civil RP and Corporate RP, employment relationships will not be directly affected by the commencement of the procedures. However, employees are often dismissed according to a restructuring plan approved within the procedures. In liquidation procedures such as BP and SLP, all employees will be dismissed eventually because the company will continue to exist only for a short time for the purposes of the liquidation proceedings.

In each procedure, employees will be reimbursed for their rights to wages with priority.

7 Cross-Border Issues

7.1 Can companies incorporated elsewhere restructure or enter into insolvency proceedings in your jurisdiction?

A foreign company incorporated in a country other than Japan may file a petition for commencement of BP or Civil RP at Japanese court if such company has a business office, other office or property in

Japan. A foreign company may also file a petition for commencement of Corporate RP if it has a business office in Japan.

7.2 Is there scope for a restructuring or insolvency process commenced elsewhere to be recognised in your jurisdiction?

According to the Act on Recognition of and Assistance for Foreign Insolvency Proceedings, the power and authority of a foreign trustee in foreign insolvency proceedings may be recognised in Japan through the recognition process in the Tokyo District Court (“TDC”).

If a debtor has a domicile, residence, business office or other office in the country where the foreign insolvency proceedings are petitioned against the debtor, a foreign trustee or the debtor (only if there is no trustee) may file a petition with the TDC for recognition of the foreign insolvency proceedings.

If such a petition meets the requirements prescribed in the law, the court will issue an order for the recognition of foreign insolvency proceedings. The court may dismiss the petition if there are grounds for dismissal which include, among others, the following: (a) it is obvious that the effect of the foreign insolvency proceedings does not extend to the debtor’s property in Japan; (b) it is contrary to public policy in Japan to render a disposition of assistance for the foreign insolvency proceedings pursuant to the Act on Recognition of and Assistance for Foreign Insolvency Proceedings; or (c) it is obviously unnecessary to render a disposition of assistance for the foreign insolvency proceedings.

The court may, when it finds it necessary in order to achieve the purpose of recognition and assistance, give an order such as (i) an order to stay other court procedures, (ii) an order prohibiting the disposition of property, as well as prohibiting payments and other dispositions, (iii) an order to stay procedures to exercise security interests, (iv) an order prohibiting compulsory execution, (v) an order permitting the disposition of property by the debtor, and (vi) an administration order to appoint a “recognised trustee” who has an exclusive power to administer the business and assets of the debtor within Japan. A recognised trustee may move the assets of the debtor out of Japan after obtaining court approval. Such approval may be given by the court if the court recognises that there is no risk that the interests of creditors in Japan would be harmed.

7.3 Do companies incorporated in your jurisdiction restructure or enter into insolvency proceedings in other jurisdictions? Is this common practice?

We understand that it is quite uncommon for a company incorporated in Japan to enter into restructuring or insolvency proceedings in other jurisdictions. However, it is common practice for Japanese companies to apply for recognition of Japanese insolvency proceedings in a foreign court in order to deal with assets existing in a foreign country or contracts with a foreign party.

8 Groups

8.1 How are groups of companies treated on the insolvency of one or more members? Is there scope for co-operation between officeholders?

Even in case of a group of companies, restructuring or insolvency proceedings are conducted for each company as a separate court case. However, it is common practice that the same person is appointed as trustee or supervisor so that such court cases for a group of companies may proceed simultaneously and efficiently.

9 Reform

9.1 Are there any proposals for reform of the corporate rescue and insolvency regime in your jurisdiction?

Japan experienced a long-term depression in 1990s after the “bubble economy” of the 1980s. During this long-term depression, one of the most important problems facing Japan was the restructuring and liquidation of many companies facing financial difficulties. In order to cope with the situation, the Japanese government implemented

fundamental reform of the insolvency laws. As the first step of such reformation, in April 2000, the Civil Rehabilitation Act came into force. In April 2003, a fundamental amendment to the Corporate Reorganisation Act was implemented. Then, the Bankruptcy Act was materially amended in January 2005. The Special Liquidation Process was also fundamentally amended when the Companies Act was newly enacted in May 2006. Because these fundamental reforms took place in relatively recent years, it is not expected for Japan to enact new reform of its corporate restructuring and insolvency regime in the near future.



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