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# Insolvency 2021

Japan: Law & Practice
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Japan: Trends & Developments
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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, especially those that have developed economies and contrary to the anticipations borne by many market participants and practitioners as well as economists at the very early stage of the COVID-19 pandemic, the number of debtors petitioning for in-court insolvency protections in Japan have not spiked; rather, it has decreased, even during the pandemic. It is generally believed that the various debt support and rescue measures, directly and indirectly via commercial financial institutions, afforded and provided by the national and local governments to all sorts of enterprises, affected directly or indirectly through quarantine measures introduced because of the COVID-19 pandemic, have been preventing a rapid spike in insolvency cases.

### Figures for 2019–21

In terms of statistical analysis, according to a survey by Teikoku Databank, the number of in-court insolvencies in 2020 decreased by 6.5% from 2019, although on an industry-by-industry analysis, the number of in-court insolvencies, especially liquidation type proceedings, in business categories that are more affected by COVID-19, such as restaurants and other food and drink related businesses and hotels and other accommodation businesses, as well as smaller real estate businesses, transportation and communication businesses is found to be increasing (although the number of bankruptcy (*hasan,* "bankruptcy"), a type of in-court insolvency seeking liquidation, for restaurants and hotel accommodation businesses have decreased in the first half of 2021). In terms of analysis based on the size of debtors' businesses, small size bankruptcy cases (a debt of less than JYP50 million) account for almost 63% of in-court insolvency cases. Even in the first half of 2021, this trend is continuing. The number of in-court insolvencies in the first half of 2021 decreased by 21.8% compared to the same period in 2020.

Another notable but a little puzzling point in the recent trend is that special liquidation proceedings (*tokubetsu seisan tetsuduki*, "Special Liquidation"), another type of in-court insolvency seeking liquidation, have been increasing. As explained in **7.1 Types of Voluntary/Involuntary Proceedings**, Special Liquidation is typically selected when the parent company liquidates a subsidiary with the parent holding the majority of the claims. However, there are also several cases where Special Liquidation is selected when a debtor transfers its profitable business to a different entity (ie, a sponsor company) to restructure the business itself. While it is not apparent why the number of Special Liquidation is increasing, it can probably be assumed to be because businesses are looking for ways in which to restructure their business models, even at the expense of using special liquidation as a tool to achieve that goal.

### Support and Rescue Measures

As noted above, support and rescue measures afforded via public funds have been able to prolong numerous enterprises' corporate lives. However, providing additional debt support and extending payment due dates will not in and of themselves save enterprises from lost revenues and profits, and the support and rescue measures are starting to create new financial issues. According to the survey by Tokyo Shoko Research, Ltd in early August 2021, the number of companies which consider the debts they owe to be excessive has increased (among smaller and mid-sized companies, by more than 35%). In particular, among industries heavily affected by the pandemic, such as restaurants or hotel accommodation, nearly 80% of those companies consider the debt they owe to be

excessive. How to restructure those companies may become big issue post pandemic.

The Japanese government is considering legislative measures to introduce a new out-of-court workout scheme to facilitate business restructuring and new guidelines for out-of-court restructuring for smaller and mid-size companies. This is still under discussion, but it is noteworthy that allowing in-class cram-down via majority vote, as opposed to requiring the unanimous consent of involved creditors, in an out-of-court workout setting is also being discussed.

## 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 the civil rehabilitation proceeding (*minji saisei tetsuduki*, "civil rehab") and corporate reorganisation proceeding (*kaisha kosei tetsuduki*, "corporate reorganisation").

#### Out-of-Court Restructuring Processes

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

Formal, rule-based out-of-court restructuring processes are, in most cases, based on a statute allowing specific entities to set a rule for a process offered to debtors through which a debt adjustment or restructuring can be achieved on a consensus basis with the participating creditors. They do not, however, involve any court supervision or approval of the resultant workout plan, thus they are pure out-of-court processes.

#### Hybrid

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

#### Partnerships

For partnerships, available options are limited as corporate reorganisation is not available, for example, to partnerships, and bankruptcy would be applied to each of the partners rather than the

partnership itself (save for limited partnerships to which bankruptcy would be applicable).

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

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

## 2.3 Obligation to Commence Formal Insolvency Proceedings

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

## 2.4 Commencing Involuntary Proceedings

The commencement of proceedings is as follows.

### Bankruptcy

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

### Civil Rehab

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

### Corporate Reorganisation

This can be initiated by:

- a creditor who holds claims that account for one-tenth or more of the amounts of the stated capital of the debtor; and/or
- a shareholder who holds one-tenth or more of the voting rights of all shareholders of the debtor, may file a petition to commence a Corporate Rehab by providing evidence to show the existence of:
  (a) the creditor's claim or shareholder's voting rights; and
  (b) facts establishing that there is a "threat" of insolvency.

### Special Liquidation

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

## 2.5 Requirement for Insolvency

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

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

## 2.6 Specific Statutory Restructuring and Insolvency Regimes

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

## 3. OUT-OF-COURT RESTRUCTURINGS AND CONSENSUAL WORKOUTS

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

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

- the Guidelines for Out-of-Court Workouts (Shiteki-seiri Guidelines);
- Turnaround ADR (Jigyo-saisei ADR); and
- SME Revitalization Support Councils (Chusyo-kigyo Saisei Shien Kyogikai).

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

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

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

### 3.2 Consensual Restructuring and Workout Processes

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

#### 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, hair-cuts, debt for equity swaps or debt for debt swaps, and submit it to the meditators for their review. The meditators scrutinise it from a fair and neutral standpoint and submit an investigation report on the TADR Plan to the creditors. Also, the debtor gives an explanation on the TADR Plan to the creditors after the second meeting and before the third meeting.

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

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

In the TADR Plan with a debt waiver by the creditors, the amounts to be waived are normally calculated on a pro-rata basis based on the non-secured amount of each creditors' claim; thus, contractual priority, security/lien priority, priority rights, and the relative positions of competing creditor classes would not be affected unless by unanimous consent of all relevant creditors. Also, if a debt waiver by the creditors is required in the TADR Plan, part or all of the shareholders' rights need to be extinguished (in general).

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

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

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

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

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

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

## 4. SECURED CREDITOR RIGHTS, REMEDIES AND PRIORITIES

### 4.1 Liens/Security

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

#### Real Estate

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

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

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

### 4.2 Rights and Remedies

#### In-Court Insolvency Proceedings

Secured creditors would still enjoy legal rights to enforce and foreclose on collateral in bankruptcy, special liquidation and civil rehab, whereas in corporate reorganisation, secured creditors, too, will be bound by the proceedings and therefore will not be able to enforce or foreclose outside of the corporate reorganisation. However, even where secured creditors are allowed to enforce/foreclose outside of the proceedings, they may separately be subject to a court's discretionary stay order in certain circumstances.

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

In 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 its decision whether or not to enforce/foreclose its rights.

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

#### Out-of-Court Workouts

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

### 4.3 Special Procedural Protections and Rights

Under bankruptcy, special liquidation and civil rehab where secured creditors are not bound

by the proceedings, there naturally is no special protection or rights offered to secured creditors. In terms of corporate reorganisation, in contrast, secured creditors would be in a different class with unsecured creditors, and therefore will be afforded an opportunity to block a reorganisation plan from being approved through its class vote; and the majority threshold for the class vote is different from the unsecured creditors' class (see **6.1 Statutory Process for a Financial Restructuring/Reorganisation**). Furthermore, in a corporate reorganisation, up to the value of the collateral, secured creditors must be protected in priority to unsecured creditors (although subject to clam-down rules and certain other haircut rules).

## 5. UNSECURED CREDITOR RIGHTS, REMEDIES AND PRIORITIES

### 5.1 Differing Rights and Priorities

#### Secured Creditors

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

The latter is categorised as claims with general priorities.

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

#### Unsecured Creditors

##### *Bankruptcy*

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

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

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

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

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

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

##### *Civil rehab and corporate reorganisation*

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

- common benefit claims (*Kyoueki-saiken*);

- claims with general priorities;
- general claims; and
- consensually subordinated claims.

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

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

General claims are paid pursuant to the restructuring plan.

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

## 5.2 Unsecured Trade Creditors

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

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

## 5.3 Rights and Remedies for Unsecured Creditors

An unsecured creditor who is 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, 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 are a part of the Plan.

#### Submission of Plan

##### *General timeline*

There is no statutory deadline for a debtor to submit a Plan, but for example, the Tokyo District Court generally sets a deadline (via a court order) for the submission of a Plan, which is typically three months after the petition in a civil rehab and 11 months in a corporate reorganisation. As there is no concept of an exclusivity period, any creditor may also prepare and propose a Plan

to the court within the period specified by the court. The deadline can also be extended by a separate court order and in practice, especially in large and complicated cases, debtors often are granted such extension, where, for example, the status of a sponsor bid would justify an extension.

*Components of the Plan*

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

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

*Modifications of creditors' rights*

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

### Class of Creditors

*Civil rehab*

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

*Corporate reorganisation*

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

### Voting

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

*Civil rehab*

The threshold to approve the Plan is:

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

*Corporate reorganisation*

The threshold depends on each class and how the claims will be modified.

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

### Plan Confirmation Order

Following a creditors' meeting that met the threshold requirement, the court makes a decision about whether or not to confirm a Plan. When legal requirements (such as the feasibility test, or the best interests of creditors test, see **6.12 Restructuring or Reorganisation**

**Agreement**) are met, the court should issue 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 of the proceedings, so they would not be bound (see **4.3 Special Procedural Protections and Rights** and **6.3 Roles of Creditors**).

### Challenge

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

## 6.2 Position of the Company

### Civil Rehab

The norm is that the debtor, even after a proceeding is commenced, will continue to have the rights to carry out its business or administer or dispose of its property (the statute provides for an exception where the competent court could appoint a trustee to takeover those rights), in which case the debtor's incumbent managers generally continue its operation; provided, that the court and the supervisor (*Kantoku-iin*) appointed by the court will supervise the debtor. By way of example, the debtor will have the power and authority to borrow money even after the commencement of the proceedings, but the approval of the court or the supervisor may be required (depending on the court's ruling upon its appointment of the supervisor).

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

### Corporate Reorganisation

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

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

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

### Stay

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

#### *Pre-commencement*

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

the debtor needs to obtain a separate "pre-commencement stay order".

*Post-commencement*

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

## 6.3 Roles of Creditors

### Class of Creditors

In civil rehab, general unsecured creditors and secured creditors are treated differently with regard to exercising rights, but there is only one class with regard to the vote. A secured creditor (*Betsujyo-kensya*) can exercise its "rights of separate satisfaction" even during a proceeding, but with regard to voting, such creditor may exercise its right as a general unsecured creditor only for the part of its claim not covered by its collateral (ie, a part of the claim for which discharge will not be achieved via a foreclosure on the collateral). Conversely, in corporate reorganisation, general unsecured creditors and secured creditors are both prohibited from exercising rights during the proceeding, but they are put into separate classes for purposes of creditors' voting (as described in **4.2 Rights and Remedies**, **4.3 Special Procedural Protections and Rights** and **6.1 Statutory Process for a Financial Restructuring/Reorganisation**).

### Creditors' Committee

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

### Information Available to Creditors

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

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

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

## 6.4 Claims of Dissenting Creditors

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

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

### 6.5 Trading of Claims against a Company

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

### 6.6 Use of a Restructuring Procedure to Reorganise a Corporate Group

As a general rule, a restructuring proceeding is conducted for each entity as a different case, even in the case of group companies.

However, in practice, there are administrative consolidation of those cases, so when several entities, that constitute a "group", file petitions, they are usually treated as a "single" debtor in many administrative aspects, such as the appointment of the same trustee, one stakeholders' meeting held on the same date, a unified reorganisation plan, etc, within the courts' discretion.

### 6.7 Restrictions on a Company's Use of Its Assets

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

### 6.8 Asset Disposition and Related Procedures

Directors (as a DIP in 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 approval).

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

### 6.11 Determining the Value of Claims and Creditors

Statutory proceedings are not available to be used specifically for such purpose, but disputes over the value of claims or who has economic interests in the company can and will be resolved as a part or result of the proceedings. With regard to determination of claims, see **6.1 Statutory Process for a Financial Restructuring/Reorganisation**.

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

### 6.12 Restructuring or Reorganisation Agreement

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

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

### 6.13 Non-debtor Parties

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

### 6.14 Rights of Set-Off

A creditor can set off its pre-petition obligation with a pre-petition claim against the debtor. However, a creditor can 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 absent a consensual agreement.

### 6.15 Failure to Observe the Terms of Agreements

If it has become obvious that the Plan is unlikely to be implemented, the court shall issue an order discontinuing the proceedings. The discontinuance of the proceedings may cause bankruptcy to commence. However, a discontinuance of the proceedings after the Plan has been confirmed will not affect any effects arising from the implementation of the Plan. For example, discharges from claims, changes of creditors' or sharehold-

ers' rights, or the issuance of new shares, etc, which were implemented based on the Plan will remain in effect.

In general, however, in a statutory reorganisation proceeding, it is rare to include any obligations imposed on creditors as a part of the Plan.

### 6.16 Existing Equity Owners

Existing equity owners can receive a distribution from the debtor only when all creditors superior to the equity owners are paid in full.

In practice, and because the statutes requires a "threat" of insolvency to commence proceedings (see **2.5 Requirement for Insolvency**), the debtor acquires existing shares with no consideration and such existing shares will be cancelled based on the Plan. New shares will be issued to a sponsor in exchange for new money.

## 7. STATUTORY INSOLVENCY AND LIQUIDATION PROCEEDINGS

### 7.1 Types of Voluntary/Involuntary Proceedings

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

#### Overview

Pros and cons of special liquidation are as follows.

*Pros*

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

*Cons*

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

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

#### Differences between Bankruptcy and Special Liquidation

- In both cases, the proceedings are commenced by filing a petition with the court. With respect to the requirements to commence, in bankruptcy the debtor must be insolvent, whereas in special liquidation it is sufficient that the debtor is suspected of being insolvent.
- In both cases, creditors' claims are recognised by the debtor by filing claims.
- In both cases, the schedule of the procedures including the creditors' meetings are decided by the court at the time of commencement. An inventory of assets and income and expenditure statements will be provided to creditors at the creditors meeting.
- In bankruptcy, the debtor is prohibited from repaying the bankruptcy claims after commencement in general. In special liquidation, the debtor cannot repay the claims during the period the claims being filed, but after that period the debtor can repay the claims on a pro-rata basis. Also, in both cases, commencement causes foreclosures or litigation against the debtor to cease. Furthermore, in

both cases, after commencement, set-off by pre-commencement claims is prohibited in general. While the trustee is granted a right of avoidance (see **11.1 Historical Transactions**), the liquidator does not have such a power.
- At commencement, while the trustee is appointed by the court in bankruptcy, the liquidator who is designated by the debtor is appointed by the court. The trustee has the power to terminate a contract that has not been performed by both parties, but the liquidator has no such power.
- In bankruptcy, distribution from the formed bankruptcy estate is made to the creditors on a pro-rata basis. Whereas, in special liquidation, repayments are made pursuant to the approved agreement or individual settlement agreement with each creditor.

### 7.2 Distressed Disposals

The trustee (in 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 creditor committee can be formulated with court approval in bankruptcy. If actually formulated and it is found that there have been activities by the creditor committee that have contributed to the smooth progress of bankruptcy, the court may permit the bankruptcy estate to reimburse the creditor committee. In contrast, there is no formal creditors committee in 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 a similar arrangement with a foreign court.

### 8.3 Rules, Standards and Guidelines

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

### 8.4 Foreign Creditors

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

### 8.5 Recognition and Enforcement of Foreign Judgments

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

- the foreign judgement 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 judgement". An execution judgment will be made without investigating or adjudicating the merits of the case.

## 9. TRUSTEES/RECEIVERS/STATUTORY OFFICERS

### 9.1 Types of Statutory Officers

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

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

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

### 9.2 Statutory Roles, Rights and Responsibilities of Officers

A trustee in a bankruptcy is a person or entity who has the right to manage and dispose of the

property belonging to the bankruptcy estate. It owes a duty of care in its management. Specifically, the trustee has a duty to properly maintain and increase the bankruptcy estate for the benefit of the creditors. In addition, the trustee, as the successor of the debtor's rights and obligations, has a duty to properly organise and co-ordinate legal relations with interested parties. The trustee reports to the court and has to obtain approval from the court with respect to certain activities, such as disposition of high value assets, 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 investigates 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 advisors, etc, if necessary.

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

## 10. DUTIES AND PERSONAL LIABILITY OF DIRECTORS AND OFFICERS OF FINANCIALLY TROUBLED COMPANIES

### 10.1 Duties of Directors

In general, officers and directors owe a duty of care and a duty of loyalty to the company under the Companies Act, and if a breach of these duties is the cause of the company's financial predicament, they may be personally liable to the company for damages.

Once bankruptcy and corporate reorganisation are commenced, the incumbent officers and directors lose their rights to carry out the debtor's business and such rights are vested in the trustee. Hence, the trustee owes a duty of care towards all creditors (see **9.2 Statutory Roles, Rights and Responsibilities of Officers**) and officers and directors (including those who have already resigned) do not owe any obligation directly to the creditors but owe a duty to provide information to the trustee.

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

There are no specific rules related to directors' personal liabilities for the debtor's pre-insolvency obligations, unless they do not personally guarantee such obligations.

Also, there are no specific penalties for the directors of the debtor for filing insolvency proceedings itself in Japan.

### 10.2 Direct Fiduciary Breach Claims

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

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

## 11. TRANSFERS/ TRANSACTIONS THAT MAY BE SET ASIDE

### 11.1 Historical Transactions

Only the trustee (in bankruptcy and 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 debtors' suspension of payments or after such suspension.

#### Avoidance of an Act of Disposing of the Debtor's Property with Reasonable Value from the Counterparty

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

- such disposition creates an actual threat that the debtor will conceal the property more easily;

- the debtor had the intention to conceal or dispose of the consideration at the time of such disposition; and
- the buyer knew the debtor's intention at the time of such disposition.

### Avoidance of Provision of Security, etc, to Specific Creditors

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

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

## 11.2 Look-Back Period

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

## 11.3 Claims to Set Aside or Annul Transactions

See **11.1 Historical Transactions**.

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# Trends and Developments

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## Introduction

The most important yet common challenge in a business turnaround is in achieving improvements in the subject enterprise's profit and loss and balance sheet via operational and financial restructuring. In other words, in typical cases, by recovering sales and reducing costs, turnaround efforts aim to generate sufficient profits to service the debts and/or by reducing the debts to the level serviceable with the profits generated by the restructured business.

### *COVID-19*

When it comes to business enterprises in financial difficulties during or because of the COVID-19 pandemic, however, challenges are not necessarily the same. For example, in business industries that centres around environments or spaces in which customers engage in closer contacts, such as restaurants and hotels, the new challenge from the pandemic has been to come up with funds – from their already depleted financial pockets – to purchase or otherwise finance instalments of measures to reduce the risk of COVID-19 infection, that not necessarily lead to improvements in profits – rather, they are mostly necessities to regain, in most cases only partially, revenues that were severely reduced by the direct or indirect impact of the pandemic.

When compounded with the uncertainties arising from the seemingly-ever-mutating COVID-19 strains and the human nature's battle against it, it has been more than difficult for the businesses to come up with valid business plans, let alone quickly recover sales completely to the prior levels or even to the level sufficient to raise profits to service the business' debts.

### *Rescue measures*

In Japan, too, when the COVID-19 risk became apparent, the national and local governments started to initiate certain rescue measures financed by public funds; such measures included deferments of tax payments and social insurance premiums, and provisions of new loans to save businesses severely affected by the pandemic. But those measures are, absent true exemptions of debts, merely prolonging of financial dire.

Coupled with the fact that under Japanese insolvency statutes, as a general rule, tax and social insurance premiums will not be exempted or discharged, all those accrued sums of unpaid taxes and social insurance premiums create a unique problem: there is not much advantage in filing for a traditional insolvency proceeding. Besides, with COVID-19 providing an easy-to-blame-culprit in many cases, it is difficult to persuade business managers to file for insolvency protection.

With these backdrops in mind, this article will first describe the current bankruptcy situation in Japan, and then introduce support systems aiming to either:

- reform existing businesses to generate new values; or
- take on challenges to enter into new business, as long-term measures (profit improvement measures).

In addition, in terms of short-term measures, ie, improvements in short-term cash flow, this article will introduce the loan programme developed

by The Development Bank of Japan (DBJ) and The Shoko Chukin Bank (SCB).

### Usage of In-Court Insolvency Proceedings in Japan

According to Teikoku Databank, the number of in-court insolvency proceeding cases in calendar year 2020 decreased by 6.5%, from 8,354 in the previous year to 7,809, which was the second lowest level since 2000. In addition, the total amount of debts owed by those insolvent debtors subjected to insolvency proceedings in 2020 decreased by 16.4%, from approximately JPY1,414 billion in the previous year to approximately JPY1,181 billion, which was the lowest since 2000. Moreover, the number of in-court insolvency cases from January to June 2021 decreased by 21.8% from the same period in the previous year to 3,083, and the total amount of debt decreased by 0.6% from the same period in the previous year to approximately JPY632 billion. From statistical analysis, it can be drawn that, with the financial support of the government as a backdrop, traditional in-court insolvency proceedings have not succeeded in metabolising the economy.

On an industry-by-industry analysis, of the in-court insolvency cases from January to June 2021, 530 cases were debtors in construction business, 397 were retailers, and 301 were restaurant businesses. Obviously, retailers and restaurants were greatly affected by consumers' general tendency to stay home to avoid infections (at the very least partially resulted from government's declaration of state of emergency), as well as by requests from the government for shorter business hours as quarantine measures against the spread of COVID-19. Conversely, construction businesses were greatly affected not only by the disappearance of new openings and renovation work due to the closures and bankruptcies of restaurants, hotels and retail stores, but also by the soaring prices of materials and the difficulty of procuring materials due to the lumber shortage.

It can be gathered from the statistics that companies that adopted bankruptcy procedures were centred in industries that involve people having close contacts with others as integral part of their business model. The fact that the stock prices of listed companies are relatively strong in Japan, due to the significant amount of money flowing into the stock markets as a result of, at the very least partially, the ultra-lax money policies brought on by the various jurisdictions' central banks in response to the economic halts following the pandemic, a K-shaped recovery tendency is clearly starting to be realised – that is, the dichotomy between industries affected by COVID-19 and industries not affected by COVID-19.

### Support Programmes to Reform Existing Businesses and to Venture into New Businesses to Generate New Value

While the outlook for an end to the COVID-19 pandemic is uncertain, business enterprises more often than not do not have the luxury to merely sit and wait until the pandemic is finally contained. It is necessary for them to seek, however uphill of a battle it is to do, ways to regain the lost revenue and improve on the depleted levels of profits. In many instances, the root cause of a businesses' financial troubles is not necessarily COVID-19 – COVID-19 is in many cases the direct cause rather than root cause, functioning as accelerant for underlying problems already incubating in many business enterprises in Japan, such as the shrinking market size, a declining production rate due to an aging population, delays in digitalisation, etc.

The government needs to take action to not only recover the pre-pandemic state of economy, but also needs to reshape the Japan's overall society and actually reform its economy. Among the

measures being proposed, a specific method includes developing programmes and initiatives that will help build a new society.

### *Overview*

Rather than merely grieving over the pandemic, or simply trying to the regain the pre-pandemic state of economy and society, the national government of Japan is looking to capitalise on the opportunity brought about by the spread of COVID-19 and cease the opportunity to undertake structural changes and diffuse a "New Normal", ideally resulting in Japan's economy becoming competitive, revitalised. To this end, in June 2021, the government gave effect to an amendment to the Act on Strengthening Industrial Competitiveness, Etc in order to provide support and assistance for corporate transformations, in anticipation of private sector's efforts toward adopting the "New Normal", taking a long-term perspective. The Law aims to cultivate sources of growth post-COVID-19, by:

- converting to a green society;
- responding to digitalisation;
- business restructuring for a "New Normal"; and
- strengthening the foundations of small and medium-sized enterprises (SMEs).

Under the amended law, while it is said that corporate transformation is important in response to growing global interest in global warming, as represented by the Paris Agreement, a shift to a green society is also being requested. In addition, in order to realise a green society, it is necessary to reduce the movement of people, and in order to reduce unnecessary work, utilise a wide range of human resources, efficiently utilise digital data, and promote innovation, with digitalisation of business enterprises and society as a necessary backdrop.

However, in Japan, the initiatives to digitalise has been slow due to persistent customs and norms resulting in red-tape and general reluctance to change. The importance placed on face-to-face encounters in both social and business settings certainly does not help, so the government is asking the private sector to take initiatives towards digitalisation.

### *Specifics*

With the Amendment, low-interest loans using Fiscal Investment and Loan Programs (FILP) have been implemented. In Japan, there is a measure called a "loss carry-forward deduction" that offsets deficits in the current term with surpluses from the next fiscal year onward to reduce the burden of corporate tax, and the maximum amount of deductions for medium-sized and large companies, other than SMEs, was limited to 50%. For medium-sized and large companies that worked on management reforms during the COVID-19 pandemic, the deduction limit for losses in FY2020 and FY2021 has been increased to 100% for periods of up to five fiscal years after those companies are back in the black.

#### *Simplified rehabilitation*

In connection with insolvency regimes, measures to facilitate a conversion and transition from Turnaround ADR to "simplified rehabilitation" (*kan-i saisei*). Turnaround ADR is not a in-court insolvency procedure, but one of the formalised out-of-court workout processes available to be utilised by troubling debtors in Japan. By utilising the Turnaround ADR framework, which is formalised via sets of rules and processes published by a self-regulated organisation pursuant to the statute, business enterprises that have excessive debt (mainly financial debt) intent on revitalising their businesses via the co-operation of creditors and the involvement of a fair and neutral third party (usually a procedure administrator) designated by the self-regulated organi-

sation certified by the Minister of Economy, Trade and Industry.

A simplified rehabilitation procedure is an in-court insolvency procedure in Japan. Where a holder of a filed rehabilitation claim who holds a claim that accounts for three fifths or more of the value, as determined by the court, of total claims held by holders of filed rehabilitation claims has, in writing, consented to a pre-proposed rehabilitation plan submitted by the rehabilitation debtor, etc, and also consented to not initiating procedures to investigate and determine rehabilitation claims, the court can immediately grant an order to convene a creditors meeting aimed at adopting a resolution on a proposed rehabilitation plan without investigating and determining rehabilitation claims.

To provide a more complete picture, for the avoidance of doubt, the court is required under the statute to dismiss a petition for simplified rehabilitation when certain findings were made: eg, it finds that a resolution regarding the rehabilitation plan is contrary to the common interests of the rehabilitation creditors (*saikensya-no-ippannorieki*), so there are safeguards to make sure creditors' interest is undermined by adoption of a simplified process.

*Facilitating the adoption of simplified rehabilitation*

Under the amendment, adoption of simplified rehabilitation has now been further facilitated by the fact that, where more than three fifths of the total number of creditors involved in a Turnaround ADR process had agreed with the restructuring business plan, the debtor pursuing restructuring may request the third party procedure administrator to petition to the Order of the Ministry of Economy, Trade and Industry to receive a confirmation that the reduction of debts as stipulated in the plan is indispensable for corporate rehabilitation according to the standards set out and publicised by the Ministry.

In addition, where the debtor subsequently files a petition for a simplified rehabilitation proceeding, the court is statutorily required, in making its ruling on whether or not to admit to commence the simplified rehabilitation proceeding through determinations of factors such as the subsequent approval of the rehabilitation plan (based on the restructuring business plan in the preceded Turnaround ADR process with respect to which more than three fifths of the total number of creditors involved agreed) will be contrary to the common interests of the rehabilitation creditors, etc, to take into its consideration the fact that the impairments of debts as described in the restructuring business plan had been confirmed by the Ministry as indispensable for rehabilitation of the business.

The legislative intent is, by allowing the courts to more broadly commence simplified rehabilitation proceedings, to promote predictability – in terms of what will ensue if the Turnaround ADR fails to reach unanimous consent of the creditors involved – and to thereby enhance the likelihood of the creditors consenting to the plan without transitioning to in-court insolvency proceeding.

*Out-of-court workout processes*

Furthermore, important revisions have also been made on another formalised out-of-court workout process: to further promote and enhance chances for small-to-mid-sized enterprises (SMEs) to successfully restructure and revitalise, the rules concerning the workout process sponsored by the SME Revitalization Support Councils (fair and neutral public institutions established in each prefecture according and pursuant to the Act on Strengthening Industrial Competitiveness for the purposes of supporting SMEs efforts toward their restructuring and/or revitalisation). The following statutory provi-

sions that were applicable only to Turnaround ADR processes are now made applicable (available) to the workout processes sponsored by the SME Revitalization Support Councils under the Amendment.

*Confirming and declaring funds*

A debtor seeking to achieve business restructuring through a Turnaround ADR process may request that the procedure administrator confirm and declare that the borrowing of funds by the debtor during a period from the start of the Turnaround ADR process up to its termination conforms to both of the following:

- it is in conformity with the standards specified by Order of the Ministry of Economy, Trade and Industry as being indispensable for the continuation of the business affairs of the debtor; and
- the debtor has obtained consents of all the creditors that are involved in the Turnaround ADR process to treat the repayments of such borrowing preferentially over the repayments of other claims that those creditors have against the debtor.

If and when the Turnaround ADR process transitions to rehabilitation proceedings (*minji saisei tetsuduki*) or reorganisation proceedings (*kaisha kosei tetuduki*), the court is required to make its ruling on whether or not it is permissible to preferentially pay claims in relation to its borrowing of the funds in the proposed rehabilitation plan (*saisei keikaku*) or reorganisation plan (*kosei keikaku*), as applicable, taking into its consideration, such confirmation/declaration under the preceded Turnaround ADR process.

*Confirming claims*

A debtor seeking to achieve business restructuring through a Turnaround ADR process may request that the procedure administrator confirm that the claims arising from any causes during the period up to the termination of Turnaround ADR process ("post-commencement claims") conform to both of the following:

- the post-commencement claims are small in amount; and
- there would be significant hindrance to the continuation of the operations of the debtor's business, unless the post-commencement claims are paid promptly when due.

In addition, if and when the Turnaround ADR process transitions to rehabilitation proceedings or reorganisation proceedings, the court is required to make its ruling on whether or not it is permissible to preferentially pay such post-commencement claims over other claims in accordance with the proposed rehabilitation plan or reorganisation plan, as applicable, taking into its consideration, the confirmation/declaration under the preceded Turnaround ADR process.

Under the Amendment, with these provisions becoming applicable to the out-of-court workout process sponsored by a SME Rehabilitation Support Council, if a debtor's process transitions to rehabilitation procedures or reorganisation procedures, the probability of pre-DIP financing loans being able to be granted preferential status in terms of its payment priority has increased, and trade creditors being afforded priority has increased.

### Loan System by DBJ and SCB

The Development Bank of Japan (DBJ), a government-affiliated financial institution, has been engaged in crisis response operations since October 2008 as a designated financial institution of the government. In March 2020, "cases related to the COVID-19 infection" were certified as a crisis. According to the news release dated 9 September 2021, the total amount of loans by DBJ to debtors in cases related to the pandemic was JPY2,361 billion as of the end of August

2021, and among them the aggregate of those loan amounts extended to medium-sized and large companies was JPY2,340 billion.

Shoko Chukin Bank (SCB) has been focusing on the extension of credits in the face of the pandemic as part of its crisis response operations. As of the end of August 2021, the total number of crisis response operations (resulting in extension of credit or provision of credit support) was 255,592 cases (JPY14,878 billion), of which 34,984 cases (JPY2,427 billion yen) were related to the pandemic. Of the cases related to the pandemic, 34,901 cases (JPY2,376 billion) were for small and medium-sized enterprises.

### *Types of loans*

These crisis response loans provided by DBJ and SCB include crisis response loans (senior loans) and "equity-cushion" subordinated loans. The "equity-cushion" subordinated loans were introduced for the following reasons. While the end of the pandemic is unclear, businesses cannot expect to make repayments from their residual profits, so they need to take steps to recapitalise instead of accessing financing from banks. However, in such a situation, it is difficult to expect a capital increase from their respective/existing sponsors (although there may be a capital increase from the private sector, diluting existing shares is a hurdle in the case of an advantageous issuance of shares). Therefore, "equity-cushion" subordinated loans were introduced.

On the ground that debts related to "equity-cushion" subordinated loans are subordinated to all debts (excluding those that are ranked equally or lower), should the relevant debtor initiates an in-court insolvency proceeding, "equity-cushion" subordinated loans can be regarded by financial institutions as the equivalent of equity capital rather than debt, and financial stability will be achieved (this will make it easier to receive other loans from commercial banks in the private sector).

Regarding "equity-cushion" subordinated loans, although there are unique merits which are different from crisis response loans as described above, it is still necessary to make payments in the future, so in practice, it is important that businesses are able to develop a repayment plan (business plan) to service those loans.

## Closing Remarks

Japanese society is experiencing a lot of unprecedented and unforeseeable changes and uncertainties with the emergence of the COVID-19 pandemic, with a "New Normal" emerging, for example, "working-from-home" becoming the norm, fewer face-to-face encounters, or distance learning for schools and on-the-job training. In order to achieve success in any business turnaround in such uncertain circumstances, debtors need to be especially proactive and bolder in their thinking and business decisions. However, it still remains the same in that of the most importance is the strong will of the debtors to restructure for survival, and to have an unwavering commitment to achieving a turnaround.

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