The Legal 500 & The In-House Lawyer
Comparative Legal Guide
Japan: Restructuring & Insolvency

This country-specific Q&A provides an overview of the legal framework and key issues surrounding restructuring and insolvency in Japan.

This Q&A is part of the global guide to Restructuring & Insolvency.

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What forms of security can be granted over immovable and movable property? What formalities are required and what is the impact if such formalities are not complied with?

1.

Japanese law recognises a number of types of security interests, and the law of secured transactions is one of the most complex areas of the Japanese legal system. Many types of security interests are provided for by statute, but others have been created by the courts. Security can be taken over various types of assets, including both immovable and movable property. The main methods of taking security over immovable property include, inter alia:

- mortgages;
- revolving mortgages;
- pleges (shichiken);
- statutory liens (sakidori tokken);
- provisionally registered ownership transfers (kari toki tampo);
- mortgage by transfer (joto tampo); and
- retention of title (shoyuken ryuho).

Mortgage by transfer and retention of title are recognised by precedent, whereas the other forms of security are provided for by statutes. Statutory mortgages are the most commonly used type of security interests. Statutory mortgages must be made public through registration in order for the mortgagee to have priority over other creditors (either in the ordinary course of business or in a formal insolvency).
The types of security interests that can be taken over movable property include, inter alia:

- pledges (shichiken);
- statutory liens (sakidori tokken);
- repurchase arrangements (sai-baibai no yoyaku);
- security by transfer (joto tampo); and
- retention of title (shoyuken ryuho).

The formalities required for enforcing a security interest over movable property differ across the different types of security interests.

2. **What practical issues do secured creditors face in enforcing their security (e.g. timing issues, requirement for court involvement)?**

Security enforcement is generally governed by the Civil Execution Act. Although the specific steps for enforcing security differ across the different types of security interests and different types of assets, the process generally is controlled by the court. In the case of a mortgage over immovable property, for example, the court will hold a compulsory auction to convert the property into cash. However, in certain exceptional circumstances (in particular with respect to non-statutory security), secured creditors can exercise their security interests without the court's involvement.

It should be noted that once a corporate reorganisation procedure is commenced with respect to the debtor corporation, enforcement of security interests will be subject to certain limitations as contemplated in the Corporate Reorganisation Act. Commencement of other types of insolvency proceedings (i.e. bankruptcy, civil rehabilitation and special liquidation) does not automatically affect a secured creditor's right to enforce their security interests; provided, however, that in exceptional circumstances, the court can impose certain restrictions on the secured creditors' right to enforcement.

3. **What is the test for insolvency? Is there any obligation on directors or officers of the debtor to open insolvency procedures upon the debtor becoming distressed or insolvent? Are there any consequences for failure to do so?**

A petition for commencement of bankruptcy proceedings may be filed by a debtor, a director of a debtor company or a creditor in the following circumstances:

- where the debtor is characterised as being 'unable to pay its debts' – that is, where a debtor is generally and continuously unable to pay its debts as they become due; or
- in cases where the debtor is a company, where the debtor is characterised as 'insolvent' – that is, where the debtor's debts exceed its assets.

The court must order commencement of the proceedings if it is satisfied that one of the above circumstances (as applicable) exists.

There is no specific statute providing obligations on directors or officers of the debtor to open insolvency procedures. Directors and officers, however, owe general duties of care and loyalty to the company. It is theoretically possible that failure to open insolvency procedures may be a violation of such duties. In such situations, directors and officers are liable for damages of the company, creditors and shareholders.

- **What insolvency procedures are available in the jurisdiction? Does management continue to operate the business and/or is the debtor subject to supervision? What roles do the court and other stakeholders play? How long does the process usually take to complete?**

There are two options for court liquidation for insolvent companies: bankruptcy proceedings (hasan) and special liquidation proceedings (tokubetsu-seisan), the latter being more flexible than the former. Special liquidation proceedings allow a director or an officer of the company to be the liquidator to execute the liquidation, while bankruptcy proceedings require a court-appointed trustee to execute the liquidation.

Because of the nature of bankruptcy as liquidation, the main role of a trustee and a liquidator is to realise and distribute the debtor's assets rather than to continue its business. However, a trustee may operate the debtor's business to the extent necessary and appropriate to sell the debtor's assets at maximum value.

Both a trustee and a liquidator are subject to court supervision. For example, the court may on its own motion or upon a petition by an interested party remove a trustee or a liquidator if it finds that he/she is not administering the debtor's assets appropriately. In addition, some activities of a trustee or a liquidator are subject to the court's approval. Such activities include (but are not limited to):

- the transfer of real property rights;
- the borrowing of money;

- the filing of an action; and
- the waiver of a right.

According to court statistics, more than 90% of bankruptcy proceedings are completed within one year and it is rare to take more than two years to complete. No statistics are available for special liquidation proceedings but the period within which to complete them is generally similar to that of bankruptcy proceedings. In 2016, there were 71,838 bankruptcy proceedings (including those for individuals) and 292 special liquidation proceedings initiated.

- **How do creditors and other stakeholders rank on an insolvency of a debtor? Do any stakeholders enjoy particular priority (e.g. employees, pension liabilities)? Could the claims of any class of creditor be subordinated (e.g. equitable subordination)?**

In bankruptcy proceedings, creditors' claims are ranked in the following order:

1. estate claims (e.g. fees for trustees, administrative expenses, tax claims which became due within one year before the commencements of bankruptcy proceedings, employee compensation for their work within three months before the commencements of bankruptcy proceedings);
2. superior bankruptcy claims (e.g. tax claims and employee compensation which are not estate claims);
3. ordinary bankruptcy claims; and
4. subordinated bankruptcy claims (e.g. interests after the commencement of bankruptcy proceedings).

In special liquidation proceedings, creditors' claims are ranked in two categories. Claims in the first category basically correspond to estate claims and superior claims in bankruptcy proceedings. Claims in the second category basically correspond to ordinary bankruptcy claims and

subordinated bankruptcy claims in bankruptcy proceedings. The first category is superior to the second category.

The priority of shareholders is the lowest both in bankruptcy proceedings and special liquidation proceedings. Japanese law does not have a rule of equitable subordination.

- **Can a debtor’s pre-insolvency transactions be challenged? If so, by whom, when and on what grounds? What is the effect of a successful challenge and how are the rights of third parties impacted?**

In bankruptcy proceedings, a debtor’s pre-insolvency transactions may be challenged by the trustees. The trustees must exercise this right through court proceedings within two years after the commencements of bankruptcy proceedings.

There are two elements to the grounds for such challenges. The first pertains to the timing of the transactions, and they need to be conducted after the debtor falls into financial crisis. The other is the harmfulness of the transactions to the debtors.

If such challenges are successful, the subject transactions basically become null and void. Bona fide third parties, however, may be protected from such challenges.

In special liquidation proceedings, such challenges are not available, but creditors may challenge transactions which are harmful to creditors based on the Civil Code. This challenge is not special to insolvency proceedings, and may apply to transactions in general.

- **What form of stay or moratorium applies in insolvency proceedings against the continuation of legal proceedings or the enforcement of creditors' claims? Does that stay or moratorium have extraterritorial effect? In what circumstances may creditors benefit from any exceptions to such stay or moratorium?**

Upon the commencement of bankruptcy proceedings, civil actions and civil execution proceedings with respect to bankruptcy claims are suspended, and bankruptcy creditors are prohibited from commencing new civil actions or civil execution proceedings. This moratorium does not have extraterritorial effect, but if any foreign creditors received payments, the "hotchpot rule" shall be applied to such creditors. The "hotchpot rule" prohibits a creditor who has received part payment in respect of its claim in a foreign insolvency proceeding from receiving a payment for the same claim in bankruptcy proceedings in Japan regarding the same debtor, so long as the payment to the other creditors of the same class is proportionately less than the payment the creditor has already received. Exercising security interests is not prohibited, and secured creditors may collect their claims regardless of the filing or commencement of bankruptcy proceedings. Civil actions brought by claim holders on the estate are not suspended and will not be prohibited.

Upon the commencement of special liquidation proceedings, civil execution proceedings are suspended and creditors are prohibited to commence new civil execution proceedings. However, civil actions are not suspended and will not be prohibited. This moratorium does not have extraterritorial effect and the "hotchpot rule" is not provided for special liquidation proceedings. Exercising a security interests is not prohibited, and secured creditors may collect their claims regardless of the filing or commencement of special liquidation proceedings.

What restructuring and rescue procedures are available in the jurisdiction, what are the entry requirements and how is a restructuring plan approved and implemented? Does management continue to operate the business and/or is the debtor subject to supervision? What roles do the court and other stakeholders play?

There are two types of restructuring procedures in Japan: civil rehabilitation proceedings (minji-saisei) and corporate reorganisation proceedings (kaisha-kosei).

a. Civil Rehabilitation Proceedings

The entry requirement for the civil rehabilitation proceedings is that (i) there is a risk that the debtor will not be able to pay its debts as they become due or that a debtor's debts exceed its assets or (ii) the debtor is unable to pay its debts already due without causing significant hindrance to the continuation of its business.

In civil rehabilitation proceedings, the board of the debtor company remains in control and has the power to manage the company's business. However, the court may require the debtor to obtain permission of the court in order to conduct certain types of activities, including (but not limited to): (i) disposing property, (ii) accepting the transfer of property, (iii) borrowing money, (iv) filing an action, (v) settling a dispute or entering into an arbitration agreement, and (vi) waiving a legal right. In practice, the court appoints a supervisor in most cases and grants him or her the authority to give such permission to the debtor on its behalf in respect of the debtor's activities.

The debtor must propose and submit to the court a rehabilitation plan within the period specified by the court. A registered creditor also has the right to propose and submit a rehabilitation plan. The rehabilitation plan must be approved at a creditors meeting by a majority in number of creditors present and voting at the meeting and a majority by value of all creditors who hold voting rights. If approved, the court authorises the rehabilitation plan, which will bind the company and the creditors.

b. Corporate Reorganisation Proceedings

The entry requirement for corporate reorganisation proceedings is that (i) there is a risk that the debtor will not be able to pay its debts as they become due or that a debtor's debts exceed its assets or (ii) the debtor is unable to pay its debts already due without causing significant hindrance

to the continuation of its business.

In corporate reorganisation proceedings, a trustee must be appointed for the corporate debtor. The trustee has control and possession of the debtor's business and its assets. The trustee is appointed by the court and is usually an attorney who has expertise in insolvency cases. However, a trustee can also be a business person who is deemed to be a fit person to operate the debtor's business.

There have been an increasing number of cases in which the court appoints trustees from the current management. Such proceedings are called debtor in possession-type ('DIP-type') reorganisation proceedings, as opposed to traditional 'administration-type' proceedings. In those cases, the court usually also appoints a supervisor, who monitors management's activities. Thus, the proceedings look similar to civil rehabilitation proceedings.

The trustee must propose and submit to the court a reorganisation plan within the period specified by the court. The debtor company, a registered creditor or a stockholder may also propose and submit a reorganisation plan. The reorganisation plan must be submitted to and approved at a stakeholders meeting. If approved, the court authorises the rehabilitation plan, which will bind the stakeholders. Different classes of stakeholders (e.g. unsecured creditors, secured creditors and shareholders) vote separately, and approval must be obtained from each class. The Corporate Reorganisation Act sets forth different thresholds for different classes (for example, for unsecured creditors the requisite majority is a majority by value).

- **Can a debtor in restructuring proceedings obtain new financing and are any special priorities afforded to such financing (if available)?**

In both civil rehabilitation proceedings and corporate reorganisation proceedings, the debtor's or the trustee's right to borrow new money is subject to the court's permission. The court will grant permission if the debtor shows that new funding is necessary to continue trading and maximise the value of the company's business. The lender can collect its claim outside these proceedings as a common benefit claim. This places the new lender in a better position than prior unsecured creditors, but the new money funding will not have priority over secured creditors in respect of their secured assets.

- **Can a restructuring proceeding release claims against non-debtor parties (e.g. guarantees granted by parent entities, claims against directors of the debtor), and, if so, in what circumstances?**

No, claims against non-debtor parties cannot be released under either civil rehabilitation proceedings or corporate reorganisation proceedings.

- **Is it common for creditor committees to be formed in restructuring proceedings and what powers or responsibilities to they have? Are they permitted to retain advisers and, if so, how are they funded?**

It is not common for creditor committees to be formed in Japan. In both civil rehabilitation proceedings and corporate reorganisation proceedings, the court may approve the participation of a creditors committee in the proceedings if (i) the number of committee members is not less than 3 and not more than 10, (ii) it is found that the majority of creditors consent to the committee's participation in the proceedings, and (iii) it is found that the committee will properly represent the interest of creditors as a whole.

Once the participation of the creditors committee is approved, the committee may (i) state its opinions to the court, the debtor, the trustee, or the supervisor in the proceedings, (ii) request the court to order that the debtor or the trustee make a report with regard to the status of the administration of the debtor's business and property and other necessary matters, (iii) petition for the convocation of a creditors meeting.

The creditors committee may retain advisors. The necessary expenses for the creditors' committee including advisors' fees may be reimbursed from the debtor's assets if the court finds that the creditors committee has carried out activities that contribute to ensuring the rehabilitation or the reorganization of the debtor.

- **How are existing contracts treated in restructuring and insolvency processes? Are the parties obliged to continue to perform their obligations? Will termination, retention of title and set-off provisions in these contracts remain enforceable? Is there any an ability for either party to disclaim the contract?**

The debtor may cancel a bilateral contract having obligations that neither the debtor nor the counterparty has yet completely performed. Even though existing contracts with the debtor often contain a termination clause providing that the filing of restructuring or insolvency proceedings is a cause of termination, such termination clauses are often regarded as void.

Where a creditor owes a debt to the debtor at the time of commencement of restructuring or insolvency proceedings, the creditor can set-off its claim against the debtor's claim under some circumstances.

- **What conditions apply to the sale of assets/the entire business in a restructuring or insolvency process? Does the purchaser acquire the assets “free and clear” of claims and liabilities? Can security be released without creditor consent? Is credit bidding permitted? Are pre-packaged sales possible?**

  In both types of proceedings, business and asset sales are possible during the rehabilitation process whether those are pre-packaged or not, but are subject to the consent of the court and/or the supervisor in some cases. Whether the purchaser can acquire the assets ‘free and clear’ of claims and liabilities depends on the agreement between the debtor or the trustee and the purchaser. In principle, security cannot be released without the creditor’s consent, though the debtor or the trustee may request the court to grant permission for extinguishment of a security interest on assets of the debtor if such extinguishment is essential for the debtor’s rehabilitation. Credit bidding is not permitted.

- **What duties and liabilities should directors and officers be mindful of when managing a distressed debtor? What are the consequences of breach of duty? Is there any scope for other parties (e.g. director, partner, shareholder, lender) to incur liability for the debts of an insolvent debtor?**

  There is no specific provision of law that places enhanced duties on directors of a distressed debtor. However, directors owe obligations under general provisions of the Companies Act, such as the duty of diligence and duty of loyalty. Thus, directors could, for example, be held liable for damages to the company or creditors if they have acted in breach of their duty of diligence. In addition, certain acts (such as a gratuitous act) by an insolvent company are vulnerable to being set aside.

In addition, if a director or officer has engaged in fraudulent conduct before filing of a company's bankruptcy proceedings, he/she may be held liable for such a conduct under criminal law and/or tort law.

Under Japanese law, parties other than the debtor are not liable for the debts of an insolvent debtor except under limited circumstances where, for example, they have expressly guaranteed such debts.

- **Do restructuring or insolvency proceedings have the effect of releasing directors and other stakeholders from liability for previous actions and decisions?**

Generally, commencement or completion of insolvency proceedings does not have the effect of releasing directors and other stakeholders from liability for their previous actions and decisions. As such, if a director of a company causes damages to a third party (e.g. a creditor) in breach of their obligations owed to such a party, he/she may be held liable for such damages regardless of commencement or completion of any restructuring or insolvency proceedings.

- **Will a local court recognise concurrent foreign restructuring or insolvency proceedings over a local debtor? What is the process and test for achieving such recognition? Has the UNCITRAL Model Law on Cross Border Insolvency been adopted or is it under consideration in your country?**

A local court in Japan may recognise foreign restructuring or insolvency proceedings. The process is initiated by a debtor's filing to the Tokyo District Court, which has exclusive jurisdiction on such recognition proceedings. The test for recognition is based mainly on the necessity of

such recognition. For example, if foreign restructuring or insolvency proceedings are obviously ineffective over assets in Japan, such recognition would be denied.

- **Can debtors incorporated elsewhere enter into restructuring or insolvency proceedings in the jurisdiction?**

  As long as it has an office or asset in Japan, a debtor incorporated outside Japan can enter into restructuring or insolvency proceedings in Japan.

- **How are groups of companies treated on the restructuring or insolvency of one of more members of that group? Is there scope for cooperation between office holders?**

  In general, there are no specific legal provisions on how to treat group companies in restructuring or insolvency proceedings. However, as a practical matter, group companies will usually file these proceedings at the same time because they have to resolve guarantee claims with respect to bank loans, typically in situations where the parent company has guaranteed its subsidiary’s bank loans.

  There are no specific legal provisions on cooperation between office holders. However, in general, the court will usually appoint the same trustee if group companies have a parent-subsidiary relationship. If the relationship is other than parent-subsidiary, and a subsidiary is extremely large or there are potential conflict issues among the group companies, the court sometimes will appoint different trustees. Nevertheless, the same court will have jurisdiction over the group companies in most cases, which makes it easy to proceed with several restructuring or insolvency proceedings at the same time and to construct a cooperative relationship

between the trustees.

- **Is it a debtor or creditor friendly jurisdiction?**

  With respect to restructuring proceedings, the creditor cannot take the initiative, nor has the right, to control the proceedings both institutionally and factually in Japan. For instance, in general, the debtor in civil rehabilitation proceedings or the trustee in corporate rehabilitation proceedings has the right to control almost the entire restructuring proceedings. As a result, we believe that Japan is a debtor friendly jurisdiction.

- **Do sociopolitical factors give additional influence to certain stakeholders in restructurings or insolvencies in the jurisdiction (e.g. pressure around employees or pensions)? What role does the state play in relation to a distressed business (e.g. availability of state support)?**

  The national government may pressure certain stakeholders in restructurings or insolvencies if there is the possibility of significant social impact or unemployment issues. The national government creates or joins corporate reconstruction funds aimed at supporting restructurings, such as the Enterprise Turnaround Initiative Corporation of Japan ('ETIC', now the Regional Economy Vitalization Corporation of Japan), and these funds support certain restructurings taking into consideration the value of the business, social impact and the like.

  For instance, in 2010, ETIC decided to support Japan Airlines Co., Ltd. ('JAL') in creating restructuring plans and providing enough financing to pay unsecured debts from commercial transactions, except financial debts, before filing for corporate reorganisation proceedings. JAL was the largest

airline in Japan with about 110 subsidiaries and 48,000 employees in its group, so the national government wanted to avoid significant social impact and unemployment issues. Owing to ETIC's support, JAL was reorganised and re-listed on the Tokyo Stock Exchange in 2012.

In comparison, prefectural governments are unlikely to have additional influence over stakeholders. Each prefectural government has a restructuring support system for distressed medium-sized companies, although this system is consigned by the national government.

- **What are the greatest barriers to efficient and effective restructurings and insolvencies in the jurisdiction? Are there any proposals for reform to counter any such barriers?**

First, in Japan, restructuring plans in out-of-court workouts must be approved by all creditors, and this rule sometimes makes it difficult to achieve successful restructuring plans. Therefore, some practitioners and scholars have proposed to change this rule in several ways, through new legislation or amendments to existing laws.

Second, if the restructuring plan is not approved by the creditors, the priority of new bank loans in out-of-court workouts cannot be confirmed and is subject to the court's approval thereafter during restructuring or insolvency proceedings. This sometimes makes it difficult for debtors without enough collateral to obtain new bank loans. Therefore, there have been discussions to change this rule as well so that court approval would not be required.