

Global Restructuring & Insolvency Guide

Japan

Overview and Introduction

Japanese insolvency laws have undergone significant reform since 1996, particularly in the past decade. The changes addressed a number of problems under the old laws, including widespread complaints of debtor abuse, minimal court oversight of proceedings, overly strict requirements to commence proceedings and to confirm Reorganisation plans, difficulty in obtaining temporary restraining orders pending the commencement of proceedings, a lack of restrictions on secured creditors, and a lack of avoiding powers. This chapter will introduce the relevant legislation in the field of insolvency, out-of-court workouts, as well as ADR for business rehabilitations (“**Turnaround ADR**”).

Applicable Legislation

Four insolvency laws in Japan provide for court proceedings. Two of these are intended to facilitate the rehabilitation of the debtor and two are terminal proceedings that result in the liquidation and dissolution of a corporation or a “blank slate fresh start” for an individual.

The Corporate Reorganisation Law (the “**RL**”), which was introduced in 1952 and modelled on Chapter X of the US Bankruptcy Act of 1898, was reformed most recently in 2003. In order to facilitate effective rehabilitation, the RL includes significant restrictions on creditors’ rights, whether secured or unsecured, but requires the appointment of a reorganisation trustee to manage the corporation during the proceedings.

The Civil Rehabilitation Law (the “**CRL**”) was introduced in 2000 to replace the Composition Law, which was seen to have several shortcomings. An important feature of the CRL is its “debtor in possession” (“**DIP**”) system, in which the management of a debtor oversees its own reorganisation under court supervision. In addition, the CRL provides special treatment for an individual debtor’s housing loan.

Terminal proceedings may take place under the Bankruptcy Law, which was reformed most recently in 2005, or under the Special Liquidation chapter of the Companies Act, which was reformed in 2006. Bankruptcy proceedings provide only for the liquidation of a corporate or individual debtor’s assets. Special liquidation proceedings are intended to facilitate and streamline the liquidation of a corporation without a court-appointed trustee and this process has been utilised as a means of liquidating subsidiaries of a conglomerate company.

There are also a few out-of-court mechanisms that are available to financially troubled corporations in addition to the statutory proceedings. The most well-known mechanism is the Guidelines for the Out-of-Court Workout for Multi-Financial Institutions, under which a debtor corporation may apply directly to major banks to develop a reorganisation plan. Out-of-court mechanisms are also available when financially troubled corporations ask for help from government related corporations such as the Resolution and Collection Corporation (“**RCC**”).

Under either the statutory proceedings or the out-of-court mechanisms, financially troubled corporations can make use of several rehabilitation methods. For example, debt-to-equity swaps (“**DES**”), corporate recovery funds, DIP financing, restructuring advisory services, and turnaround managers are methods of revitalising a corporation alongside the restructuring of debt obligations.

Personal Bankruptcy

Individuals who face bankruptcy may avail themselves of two of the insolvency laws. In the event of bankruptcy, when an individual is unable to make debt payments when they become due, the

bankrupt individual may petition for proceedings under the Bankruptcy Law. In the case of consumer debt, individuals are often discharged of their debt. Bankrupt individuals with more substantial liabilities, such as corporate CEOs, will often be subject to full proceedings. In these cases, a trustee is appointed to oversee the liquidation of the bankrupt individual's assets so that the proceeds of the liquidation of their assets may be distributed to creditors on a *pro rata* basis according to the priority of the creditors' claims.

However, bankrupt individuals are allowed to exempt three months' family household expenses (currently JPY 990,000) from the bankruptcy estate that is to be distributed to creditors. Ultimately, liquidation with a modest cash exception or the discharge of consumer debt gives the debtor an opportunity for a "fresh start". Bankruptcy proceedings will be discussed in greater detail below in the context of corporate insolvency.

An individual debtor may also petition for the commencement of a proceeding under the CRL in order to avoid a proceeding under the Bankruptcy Law. The CRL proceeding allows an individual, with the help of a court-appointed rehabilitation supervisor, to propose a plan to creditors to discharge excessive debts in exchange for paying a portion of the debt from income for a fixed period of time. This option is available to individuals who are likely to have income on a regular basis and whose total amount of debt is JPY 50 million or less, excluding housing loans and other debts secured by a lien. A special rule exists to protect individual debtors who own houses, whereby a debtor who can pay both principal and interest may, in certain circumstances, reschedule the repayment terms of the housing loan.

Corporate Restructuring and Insolvency

Reorganisations, Restructurings and Work-Outs

Financially distressed corporations in Japan may seek reorganisation or rehabilitation with or without court assistance. Each of the court-based proceedings has unique features that might appeal to different types of debtors. For example, one corporation might opt for a Civil Rehabilitation proceeding in order to keep existing management during the proceeding, whereas another corporation might opt for a Corporate Reorganisation proceeding in order to bind secured creditors into the proceeding as well as to manage the corporation by a court-appointed reorganisation trustee. Alternatively, a company may wish to pursue an out-of-court work-out in order to deal with its financial troubles more quietly and privately under certain conditions.

Corporate Reorganisation Proceeding

This proceeding applies only to stock corporations. There are three types of applicants who can file for the commencement of a proceeding under the RL:

- A debtor;
- A creditor with an aggregate amount of claims that is at least 10% of the debtor's paid-in capital; and
- A shareholder with an aggregate amount of voting shares that is at least 10% of the total voting shares of the debtor corporation's paid-in capital.

The debtor may file a petition if payment of debts, when they become due, would significantly impair the debtor's business operations or if the debtor is in danger of bankruptcy. The creditor or the shareholder may also file a petition if the debtor is in danger of bankruptcy. The requirements of "bankruptcy" are defined under the Bankruptcy Law as being either when a debtor cannot pay its debts when they become due or when liabilities exceed the assets of the debtor (the balance-sheet test). When the court determines that one of these conditions has been met, the court issues a commencement order and appoints a reorganisation trustee. While the appointed trustee is usually a qualified lawyer, the RL allows the court to appoint a former management director as long as this person was not responsible for potential damage claims which might be pursued for any business failure caused by the debtor's management, major creditors do not object to such appointment and other requirements are met. Once appointed, the trustee manages the distressed corporation and makes and executes a reorganisation plan until the case is closed.

The RL provides several forms of assistance to the debtor. The first set of measures is aimed at protecting the debtor's assets in the period of time between the filing of a petition under the RL and the issuance of the commencement order.

- First, upon the filing by the debtor, a creditor or a shareholder, the court will often issue preservative injunctions. These injunctions typically prohibit the debtor from paying pre-injunction debts, disposing of the debtor's assets and borrowing money.
- Second, in addition to or instead of the above injunctions, the court will often issue an interim administration order to appoint an interim trustee and an examiner before a reorganisation trustee is appointed with the commencement order. The interim administration order restricts the interim trustee in the same way as the preservative injunctions.
- Third, because the above measures are directed only at the debtor's actions, the court may issue a "cease and desist order" that prevents or halts foreclosures or other proceedings against the debtor.
- Fourth, under special circumstances in which a cease and desist order is not sufficient, the court may issue a more powerful order against creditors, namely a "comprehensive prohibition order", to prohibit creditors from pursuing pre-injunction claims. This order may be made under the 2003 reform to the RL.

Once the court issues a commencement order, the RL provides a second set of measures to protect the debtor's assets during the Corporate Reorganisation proceeding. Most importantly, the debtor is prohibited from making any payments of debts that are owed before the time of the commencement order. All creditors must file a proof of claim to be examined and allowed before becoming eligible to receive any payment during the proceeding.

One of the most significant features of a Corporate Reorganisation proceeding is that secured claims are subject to the same restrictions as unsecured creditors. The court further limits the extent of secured claims to the value of the collateral (usually real estate), and when necessary for the debtor's Reorganisation, the court may extinguish the security claim by allowing the debtor to pay the value of the collateral to the court. The amount paid is either used for the purpose of the debtor's business with supplemental security for the secured creditor or paid to this creditor after the court confirms a Reorganisation plan.

In addition, the RL gives the trustee the power of avoidance in order to void certain sales of the debtor's assets that were made while the debtor was in a financially distressed condition. The purpose of this avoidance is to ensure that all creditors are treated equally while the debtor is in such condition. The power of avoidance allows the trustee to avoid obligations that arose out of transactions characterised as "fraudulent conveyance" or "preference".

Finally, the court may approve and issue an order for the assignment of all or part of the debtor's business if such assignment is necessary for the successful restructuring of the corporation before, on, or after the creditors' meeting for voting on the Reorganisation plan. The Reorganisation trustee asks the court to assign the part of the business that is necessary to reorganise the debtor before the creditors' meeting that is held for acceptance of the Reorganisation plan. While creditors are entitled to a hearing that may affect the court order, shareholders who hold more than one-third of voting shares can veto this assignment if the debtor is not in the condition of balance-sheet insolvency (liabilities exceed assets). The assignment of the business could be included in the Reorganisation plan that is accepted at the creditors' meeting and confirmed by the court. (The procedure for acceptance and confirmation is described below.) The Reorganisation trustee should change the confirmed Reorganisation plan if he intends to assign the business and the assignment was not included in the plan. Generally, the proceeding in regard to this change is similar to that of accepting and approving the original plan.

The RL also provides some protection for creditors' rights. One of the protections is for administrative claims including wages for the debtor's employees, fees for the Reorganisation trustee and costs for operating the corporation after the filing under the RL. These claims may be paid at any time without being based on the Reorganisation plan and are completely different from the Reorganisation claims,

either secured or unsecured, which should be repaid in accordance with the confirmed Reorganisation plan. The court may permit the payment of claims not under the Reorganisation plan that are essential to the continuation of business either by the creditor or the debtor, and the court may also permit the payment of small claims in order to reduce a large number of creditors, which facilitates the process of the proceedings. In addition, the RL allows creditors the right of set-off, by which a creditor may set off a debt that it owed to the debtor at the time of the commencement order against a claim that it has against the debtor; provided, however, that the RL prohibits the creditors' from setting-off under certain circumstances.

The goal of the proceedings under the RL is to formulate and implement a Reorganisation plan that revitalises the debtor corporation and provides reasonable repayment to creditors. A plan is usually submitted by the trustee; however, a recent trend is that numerous creditors have begun to submit their own plans to attempt to obtain more favourable repayment conditions. The plan must be confirmed by the court after the creditors' meeting that accepts the plan. Acceptance of the plan requires each of the following votes of approval (note that voting rights are allocated based on the amount of the claim, not the number of creditors or claims):

- More than half of the total voting rights for unsecured creditors;
- Two-thirds or more of the total voting rights for secured creditors if the plan provides for the extension of due dates of secured claims; and
- Three-quarters or more of the total voting rights for secured creditors if the plan provides for a "haircut" (debt forgiveness) or other adverse consequences for secured creditors (other than an extension of due dates).

The proceedings are terminated when the plan is performed in its entirety or when the court is convinced that it will be performed. Generally, secured claims have the highest repayment priority, followed by unsecured claims. The distribution rate for each secured claim is usually 100% without interest. Distribution rates for unsecured claims depend on the case in question. The reformed RL also establishes the concept of contractual subordinated claims, which allows the claims to be paid after completing payment for claims that are to be paid prior to the subordinated claims. Shareholders have no voting rights if the debtor's liabilities exceed the assets, which occurs in most cases. Shareholders have the lowest priority and usually cannot receive any distribution based on the Reorganisation plan.

Civil Rehabilitation Proceeding

A corporate or individual debtor or a creditor may petition for the commencement of an insolvency proceeding under the CRL. The debtor may file a petition if payment of debts when they become due would significantly impair the debtor's business operations or if the debtor is in danger of bankruptcy, while the creditor may file a petition if the debtor is in danger of bankruptcy, as described above in "Corporate Reorganisation Proceeding". When the court determines that one of these conditions has been met, the court will issue a commencement order.

The CRL proceeding uses a DIP system in which the debtor maintains its own management under the court's supervision. Depending on the situation, the court can appoint a supervisor or an examiner, and it can allow an official creditors' committee to participate in the proceedings. The Tokyo District Court usually appoints a supervisor but has rarely received a request to allow an official creditors' committee to be formed. The main reason for not receiving such a request may be that members of the committee are compensated from the debtor's property only for actual costs, such as transportation fees and/or meeting expenses, after being scrutinised by the court. This means that professional fees, such as attorneys' fees, would usually be paid by the committee members and not by the debtor. The court could appoint an interim trustee or a trustee to replace the management of the debtor in rare cases where the debtor's existing management is found to be inappropriate.

Like the RL, the CRL provides several forms of assistance to the debtor. The first set of measures is aimed at protecting the debtor's assets in the period of time between the filing for commencement of the case under the CRL and the time of the commencement order. The court may issue one of several types of preservative injunctions and other orders, which are described in detail above. The

commencement order itself provides a second set of measures to protect the debtor's assets during the Civil Rehabilitation proceeding. Most importantly, the debtor is prohibited from making any payments on debts owed before the commencement order. All creditors must file a proof of claim to be examined and allowed before becoming eligible to receive any payments under the rehabilitation plan. Unlike the RL, however, the proceeding under the CRL does not bind secured creditors, and they may enforce their security rights without going through the Civil Rehabilitation proceeding.

The CRL also provides for a power of avoidance in order to void certain sales of the debtor's assets made while the debtor was in a financially distressed condition. However, this power is available only to a supervisor and not to the DIP (management of the corporation). The specifics of the avoidance power are essentially the same as those under the RL.

Finally, the court may approve the assignment of all or part of the debtor's business if it is necessary for the successful restructuring of the company. The proceeding is largely the same as that in the RL.

Like the RL, the CRL provides some protection for creditors' rights. Administrative claims similar to those under the RL, as well as priority claims (including statutory liens and certain tax claims), are paid at any time at the discretion of the debtor. Some creditors are entitled to execute the right of set-off. These provisions are discussed in greater detail in the context of the RL.

In principle, the CRL does not bind secured creditors, and they may enforce their security rights without going through the Civil Rehabilitation proceeding. However, as an exception, upon the request of the debtor, the court may extinguish the security rights if the collateral is indispensable for the continuation of the debtor's business and the debtor provides to the court the present value of the collateral (not the face amount of the claim). The purpose of this exception is to allow the debtor to keep indispensable collateral (such as a factory and/or raw materials) in order to ensure the continuation of the debtor's business.

A rehabilitation plan may be submitted by either the debtor or the creditors. The plan must set forth the terms amending the rights of creditors, including but not limited to, an extension of the due dates and a haircut of the amount of the claims.

The time period for completing the distribution under the rehabilitation plan is no more than 10 years following the confirmation of the plan.

The CRL provides for a "summary rehabilitation proceeding" or a "consensual rehabilitation proceeding" to avoid the time-consuming process of the full proceeding. A summary rehabilitation proceeding is a "quasi-prepackaged plan", which requires the consent of creditors holding at least 60% of the total amount of unsecured claims at the time of filing. This proceeding eliminates the examination of the proof of claims, the result of which is confirmation and allowance of the filed claims. However, the proceeding requires the acceptance of the plan at the creditors' meeting. A consensual rehabilitation proceeding is even quicker and simpler than a summary rehabilitation proceeding because it requires neither the creditors' meeting nor the examination of the claims. This proceeding, however, requires the unanimous consent of all creditors.

Out-of-Court Work-Out

In 2001, a committee consisting of several Japanese financial institutions introduced the Guidelines for the Out-of-Court Workout for Multi-Financial Institutions (the "**Guidelines**"). The Guidelines are intended to facilitate the rehabilitation of large corporations with significant debts to a number of banks while avoiding court-based proceedings, which may diminish the value of the debtor as well as consume time and money. Although many lenders are likely to be involved, the out-of-court work-out process is still tied to a traditional Japanese "main bank" system. A corporation typically would have a strong relationship with a single "main bank", to which the company would turn first for loans. The main bank traditionally took care of lending money, assigning capable persons to the borrower and intensively monitoring the borrower. Although this system has become less prevalent, mainly because the banks have become more sensitive about conflict issues and financial profitability, most corporations maintain a relationship with an existing main bank or a few major banks. Therefore, the workout process of the borrower focuses on these financial lenders, which are called major creditors. The current definition of "major creditors" also includes the debtor's principal trade creditors, as well as private equity funds and debt servicers.

In order to initiate an out-of-court work-out, the debtor corporation, together with a main bank, must present to its major creditors financial documents explaining the reason for financial distress as well as a debt restructuring plan (“**work-out plan**”). The main methods used under the work-out plan are the restructuring of creditors’ claims against the debtor through haircut agreements (debt forgiveness), extension of payment deadlines and modification of payment instalments. In addition, the Guidelines call for plans to eliminate negative net worth and net income losses within three years, to divest the interest of controlling shareholders and to force the retirement of the management. When the debtor and its main bank submit to the other major creditors the plan to be accepted, they issue a notice of “standstill” to all of the major creditors in order to freeze all activity between themselves and the debtor for up to three months from the time of submission. Unless all creditors consent to the proposed work-out plan before the end of this period, the out-of-court workout will terminate. If the plan is not accepted, the debtor retains the right to file a petition to initiate court-based proceedings such as bankruptcy, CRL or RL.

The Guidelines also include provisions for tax advantages in order to facilitate the debtor’s revitalisation. The Guidelines provide that debtors evaluate the present value of assets in order to lessen their tax burden if the book value is excessive. In addition, when a creditor agrees to reduce the amount of its claims against the debtor, the debtor may set off the income from forgiveness of indebtedness against its carried forward loss so that the tax burden does not increase. Otherwise, cash that debtors could use to pay off their debts would instead be lost to pay taxes. The Guidelines include these provisions so that the Japanese tax agency can trust that the haircut agreements have been made in accordance with a formal framework and under appropriate circumstances.

Turnaround ADR

The Turnaround ADR concept was created under the Law on Special Measures for Industrial Revitalisation and Innovation. It refers to rehabilitation proceedings for businesses facing operational failure, through mutual consultations among the affected parties rather than through insolvency proceedings in court.

When the main bank directs the out-of-court workout proceedings under the Guidelines, the main bank has normally been required by the other (non-main) banks to accept a disproportionate, and not a *pro rata*, amount of debt forgiveness. In the past, when the “main bank” system prevailed, a corporation would have a long-term and significant relationship with a particular bank not only in terms of lending but also in terms of the holding of shares in the corporation and appointment of the corporation’s directors, etc. However, due to recent disruptions in the system, main banks no longer have a reason to assume an especially heavy obligation. Consequently, it has become more difficult to achieve consensus among financial institutions concerning the ratio of the amount of debt forgiveness under the out-of-court workout.

The Turnaround ADR is designed to overcome the shortcomings of the out-of-court work-out process and to secure the effectiveness of the out-of-court mechanism by entrusting a fair and neutral professional, instead of a main bank, with the responsibility of executing the restructuring proceeding.

The Turnaround ADR proceedings may be carried out only by ADR providers who are certified by the Minister of Justice and who have been approved and authorised by the Ministry of Economics, Trade and Industry (“**METI**”), which selects specialists with the requisite knowledge of business revitalisation, as defined by the Ministerial Ordinance Concerning Alternative Dispute Resolution on Business Rehabilitation. The following is an example of the proceedings practised by the Japanese Association of Turnaround Professionals (the “**JATP**”), which acquired the first special certification for ADR.

Preliminary Consultation Proceeding

When the JATP receives a request for business rehabilitation ADR, it assesses the overall assets and checks the revitalisation plan of the debtor to determine the eligibility of the debtor. The JATP implements the proceeding only for debtors that are genuinely in need and are likely to survive by using the proceeding.

Preparation of the Revitalisation Plan

When the JATP determines that a case has a genuine need for revitalisation and is likely to succeed, the JATP, together with the debtor, dispatches standstill notices to the debtor's financial creditors to request that they stop individual debt collection or seizure of collateral. Following this notice, a creditors' meeting will be arranged and the financial creditors will attend the meeting. The revitalisation plan of the debtor will be prepared and discussed at the meeting. When the revitalisation plan is prepared, it is vital to show that the plan is economically more advantageous to creditors than legal insolvency proceedings would be.

Process after Preparation of the Revitalisation Plan

Formulation of the plan requires the unanimous consent of all the creditors at the creditors' meeting. When the revitalisation plan receives a unanimous consent, the plan is approved and the debt forgiveness is implemented on the basis of the approved plan. If the consensus of all creditors cannot be obtained and the revitalisation plan is denied, the case can be transferred to a legal insolvency proceeding, either to a specific conciliation proceeding or a statutory insolvency proceeding.

A specific conciliation proceeding is managed by the court. The proceeding is the same as the turnaround ADR in that it requires the unanimous agreement of all creditors. However, since this proceeding takes place before the court, the creditors are more likely to be encouraged to agree to the plan than under the ADR processes. Civil conciliation proceedings also contain the "decision in lieu of conciliation" mechanism, in which the court can make necessary decisions to resolve the dispute. When a decision in lieu of conciliation is made, it becomes final unless a motion of objection is filed within two weeks.

If there is no possibility of formulating a revitalisation plan under the specific conciliation proceeding (i.e. unanimous consent cannot be reached), the case can be transferred to legal insolvency proceedings, e.g. a Civil Rehabilitation proceeding or a Corporate Reorganisation proceeding.

Corporate Insolvencies

Proceedings under the Bankruptcy Law are the normal mechanism for liquidation and dissolution, and special liquidation proceedings are usually used either for corporations that are subsidiaries of a conglomerate company or for corporations whose majority creditors are amicable, even in a financially troubled situation. Alternatively, a corporation may use several out-of-court mechanisms to revitalise its business.

Court-Based Liquidation Proceedings

Bankruptcy Law

A debtor or its creditor may petition the court to initiate a proceeding under the Bankruptcy Law if the debtor is unable to make payments when debts become due or if the debtor's liabilities exceed its assets. If either of these conditions is met, the court will issue a commencement order and appoint a trustee to manage the bankruptcy estate, which consists of all assets that belong to the debtor at the time of the commencement order. Eventually, the bankruptcy estate is liquidated into cash, which will be distributed to claim-holders in order of priority.

The bankrupt corporation may petition for a preservative injunction to protect the bankruptcy estate between the time of the filing and the issuance of the commencement order. The injunction prohibits the disposition of the debtor's assets and the collection and payment of pre-injunction debts. The bankrupt may also petition for other forms of interim protection such as cease and desist orders, comprehensive prohibition orders, interim administration orders and injunctions in preparation for avoidance actions.

All unsecured creditors must file proofs of unsecured claims with the court, and the proofs of claims are examined by the trustee and other creditors at a claim examination hearing. All claims allowed at the claim examination hearing have the effect of a final judgment. The Bankruptcy Law requires that a first creditors' meeting be held on the same day as the claim examination hearing. In practice, however, the Tokyo District court typically approves the omission of this meeting. A second creditors'

meeting is usually held within three months of the commencement order so that the trustee may report the status of the debtor's estate following the examination of claims.

Creditors' claims are classified into several categories for repayment. Administrative expenses receive the highest priority and consist of administrative costs and expenses, certain taxes and salaries and severance pay accrued within three months prior to the commencement order. Priority bankruptcy claims receive second priority and include claims such as other unpaid salaries, bonuses and severance pay. Third priority is given to ordinary unsecured bankruptcy claims, which include trade claims and other claims without priority. Subordinated bankruptcy claims receive fourth priority and include interest, default interest and other penalties that accrue after the order of bankruptcy commencement. The lowest priority is given to contractual subordinated bankruptcy claims.

Certain types of claims receive different treatment from the order of priority stated above. First, creditors with security interests have the right to exclude their claims from the proceeding and generally will not be affected by such proceeding. Secured creditors may receive payments on the security interest and they may initiate foreclosure procedures to obtain the value of the collateral. However, the trustee may ask the court to extinguish a security interest and sell an asset free and clear from any security interest if it is in the creditors' general interest. The purpose of this extinguishment of security interest is to sell the collateral at a value much higher than that of the secured claim so that the residual value may be included in the bankruptcy estate that is distributed to unsecured creditors. Second, the power of avoidance gives the trustee the right to avoid transactions that were made for the purpose of fraudulent conveyance or preference after the debtor fell into financial difficulty. Third, the right of set-off allows a creditor to set off a debt owed to the debtor at the time of the commencement order against a claim payable by the debtor.

Special Liquidation Law

A corporation may also opt for special liquidation under the reformed Companies Act. The corporation first initiates a regular liquidation proceeding by passing a resolution for the dissolution of the corporation at a shareholders' meeting. The corporation must then appoint a liquidator (usually former management), who is responsible for giving public notice and requesting that creditors report their claims. If the liquidator finds that the corporation is insolvent (balance-sheet insolvency), he must then file a petition for special liquidation with the court. Alternatively, the court may issue a commencement order for a special liquidation proceeding if there are circumstances that would pose significant problems for the debtor's liquidation or the corporation is in danger of balance-sheet insolvency. As with other insolvency proceedings, the court may also issue a preservative injunction to protect the debtor's assets before the court is able to issue the commencement order.

When the court issues a commencement order, the liquidator usually becomes the special liquidator. Alternatively, it is common for the corporation to hire a qualified lawyer as special liquidator. The special liquidator is responsible for gathering the debtor's estate and formulating a distribution plan for the distribution of the estate. Claims are treated with the same priority as in a bankruptcy proceeding but typically with more flexibility. The distribution plan should provide for the restructuring of debts, including debt forgiveness and instalment payments. If the plan is not accepted at a creditors' meeting by a creditors holding more than half of the amount of claims, the special liquidation proceeding shifts to a bankruptcy proceeding. The special liquidation proceeding is commonly used for the dissolution of an insolvent subsidiary of a conglomerate corporation that is reorganising the companies within the group companies. The advantage for a conglomerate is favourable tax treatment in the special liquidation of its subsidiary. Moreover, the conglomerate is not bothered by a court-appointed trustee who is unfamiliar with the corporation's business.

Out-of-Court Mechanisms

Several other out-of-court mechanisms are available for the revitalisation of insolvent corporations. First, the use of DES is an option that has been more widely used since 2002, when relevant laws were reformed to allow banks to own more than 5% of a company's outstanding stock. Under this mechanism, banks may convert the debt owed by the debtor corporation to equity based on the present value of the debt. Banks can enjoy the upside of the stock value if the insolvent corporation successfully revitalises itself and its value continues to rise. On the other hand, it is possible for private equity funds to minimise the risk to banks by purchasing the stock swapped from the debt.

Second, “corporate recovery” private equity funds will often target financially distressed corporations directly instead of purchasing shares from a bank. After acquiring a corporation’s loan claims and implementing the DES to become a shareholder, the private equity fund will overhaul the business so that the fund may sell the corporation privately or publicly for a profit.

Third, DIP financing is usually necessary for a financially troubled corporation to maintain business operations, especially at an early stage of corporate revitalisation. The Development Bank of Japan is the most active provider of DIP financing, and several other commercial banks and finance companies have also established DIP lending businesses. DIP financing claims are treated with equal priority to administrative expenses during subsequent statutory insolvency proceedings.

Fourth, restructuring advisory services are available to help financially distressed corporations to restructure their businesses and resolve excessive debts. Although banks formerly performed these services as part of the “main bank” system, currently independent firms provide these advisory services under more transparent procedures.

Fifth, experienced turnaround managers may be brought in to oversee the reorganisation of viable but loss-making businesses. Although the number of qualified turnaround managers is still limited in Japan, there are several cases in which Japanese companies have sought the assistance of subsidiaries of US-based turnaround firms.

The Japanese government created two corporations several years ago to revitalise the economy by removing non-performing loans and reorganising businesses. The Industry Revival Corporation (“**IRC**”), which was intended as a short-term endeavour and was only in existence from 2003 to 2007, used a number of the mechanisms listed above to revive struggling corporations. The Resolution and Collection Corporation (“**RCC**”), which was originally established to purchase sub-performing loans from financial institutions and to collect these debts, has taken over the IRC’s role. It primarily uses DES or a similar approach, such as a private equity fund, in order to revitalise companies in a sustainable way that does not require government funding.

Conclusions and Additional Observations

Japan’s insolvency laws provide corporations and individuals with numerous statutory proceedings and out-of-court mechanisms for rehabilitation and liquidation. Troubled corporations may use the RL, the CRL, the Guidelines or the Turnaround ADR to restructure their obligations to creditors, and they may use the Bankruptcy Law and the Special Liquidation chapter under the Companies Act for the dissolution and liquidation of the company. Several other mechanisms are available to revitalise financially distressed corporations, including assistance from government-capitalised corporations, private equity funds and independent services. Heavily indebted individuals may also make use of the CRL and the Bankruptcy law, which provide a fair and reasonable way to rehabilitate or make a “fresh start”.

Moreover, Japanese insolvency law no longer suffers from territoriality. The Law on Recognition of and Assistance in Foreign Insolvency Proceedings (“**LRAF**”) and the Law to Amend a Portion of Civil Rehabilitation Law, etc. (“**LACR**”) came into force in 2001 on the basis of the UNCITRAL Model Law on Cross-Border Insolvency. The LRAF allows a foreign debtor to file a petition with a Japanese court for recognition of and assistance with a foreign insolvency proceeding. Once a recognition order has been issued, any of several assistance orders may be issued as the case may require for the protection of the foreign debtor’s assets in Japan. In addition, the LACR made changes to the CRL, the RL and the Bankruptcy Law to introduce a set of rules for cross-border insolvency.

Japan’s insolvency laws have been well adapted to the necessities of the Japanese business environment and well aligned with international standards for insolvency proceedings.

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