A Practical Guide to Japanese Insolvency Procedures

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ADDITIONAL INFORMATION

This article is intended as a basic overview of insolvency laws and procedures in Japan as of September 2011. Please seek formal legal advice regarding a particular transaction or investment. If you have questions regarding insolvency proceedings in Japan or investing in distressed assets, please contact:

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OVERVIEW OF JAPANESE PRACTICE

In many ways, Japan's insolvency laws are similar to those of the United States—they provide a rational mechanism for distributing the value of any company that is being reorganized or liquidated. Due to an established court system, creditors can expect insolvency cases to produce consistent results for similarly situated creditors, whether foreign or domestic. However, compared to U.S. norms, there are significant differences in practice, procedure and cultural expectations.

These differences stem, in part, from local cultural expectations regarding Japanese business organizations and capital markets creditors. More so than their U.S. counterparts, Japanese corporations are often viewed as serving the interests of their employees, suppliers and customers rather than emphasizing shareholder returns. In addition, historically, bank lenders in Japan built a much closer relationship with their borrowers than might be typical in the United States, especially when acting as a borrower's primary bank or "main bank." With that closer relationship (at least in the context of insolvency cases) came a sense of responsibility on the part of the main bank, and a corresponding willingness on the part of the main bank to accept results supportive of a restructuring effort. Although lending practices in Japan have evolved significantly over the past decade, it is rare, even today, for a Japanese financial institution to aggressively prosecute its rights to the detriment of a debtor's other constituents. Against this backdrop, the following key differences in Japanese practice (as compared to those of the U.S.) can be better understood:

- The reorganization process in Japan relies heavily on court-appointed professionals (trustees, examiners, supervisors and others) to drive the restructuring process.
- Due to less onerous notice and disclosure obligations, these professionals have greater autonomy than do court-appointed professionals in the United States.
- The professionals are likely to operate with a primary goal of ensuring that the business continues as a going concern, so as to preserve jobs if at all possible.[1]
- As a practical matter, cases are often advanced via private communications between court-appointed professionals, rather than via formal motions and court hearings. Indeed, the professionals themselves are routinely permitted *ex parte* communications with the court for purposes of shaping the direction of a case.
- Court hearings tend to be rare. For instance, although a trustee requires court approval before taking several types of actions, the laws do not condition that approval on the trustee having first provided creditors with notice and an opportunity to object.
- Likewise, a trustee has very few public disclosure requirements in respect of the debtor's financial well-being. For instance, the laws do not require U.S.-style monthly operating reports to creditors, nor do they require a disclosure statement in support of a plan of reorganization.[2]

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1 A reorganization case in the U.S. can also be expected to focus on preservation of the business as a going concern. However, a case in the U.S. is likely to focus more critically on corporate restructuring in addition to financial restructuring. Corporate restructuring can shed unprofitable business lines in a process that may, itself, translate into a loss of jobs.

2 As a technical matter, debtors and trustees in Japan have monthly reporting obligations to the court. The applicable reports, however, are not as detailed as the monthly operating reports required in the U.S. In addition, the reports, or portions thereof, are often provided solely to the court on a confidential basis and not available to creditors.

- There is no official creditors' committee appointed to protect creditor interests.[3]
- As a result of the factors discussed above, a court-supervised restructuring process in Japan tends to be far less transparent than in the United States.[4]

The risk of creditor interests being treated unfairly, at least in domestic (not cross-border) cases, is mitigated by what can best be described as a "culture of consensus." Among other things, Japanese courts impose significant pressure on a trustee to informally obtain majority consent for key proposals before filing the same and, at a minimum, before the court needs to rule on the same. This system has the potential to work well in conjunction with the cultural assumptions noted previously. A trustee, or a debtor subject to supervision, takes on the role of diligently working to implement a restructuring for the benefit of all constituents (i.e., to preserve the company, jobs, supplier relationships, etc., if at all possible). In turn, significant financial creditors are given a back-channel voice regarding the formulation of a restructuring plan and can be expected to take positions supportive of the restructuring effort. This support derives, in part, from the creditors' respect for, and faith in, the court-appointed professionals. All of this has the potential to result in the rapid development and approval of plans of reorganization—typically involving the sale of a business to a "sponsor" (whether before or after confirmation).[5]

As balance sheets and corporate structures become more complex—in particular, as a growing number of foreign institutions lend to and/or acquire the debt of Japanese borrowers—the constructs of the Japanese system are being tested. These foreign institutions (and, now, an increasing number of Japanese institutions) are beginning to more actively question the assumptions and strategies of the court-appointed professionals. Creditors are seeking more disclosure in order to better understand and assess their restructuring options. In short, they threaten to disrupt the culture of consensus.

Due to this changing dynamic, the Japanese insolvency system continues to evolve. As a practical matter, however, the system has not fully caught up with the demands of these creditors. The system's preference for consensus permits the largest creditors—creditors who control the votes of a class—to obtain a voice in the process. However, the system's lack of required notice, disclosure and hearings makes it difficult for smaller creditors (even financial creditors) to play an active role. Nonetheless, we believe that this evolution is moving in a positive direction for foreign creditors and the voice they seek in restructuring cases.

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3 As a technical matter, certain insolvency laws permit the court to recognize a "creditors' committee." However, this is not a creditors' committee as contemplated in the U.S. The fees of such committees are not anticipated to be funded by the estate, nor are such committees expected to be as active as their U.S. counterparts. Indeed, the practice of appointing creditors' committees has gained little traction in Japan. However, in 2009 and 2010, Bingham obtained recognition of and represented the first-ever officially recognized creditors' committee in a Japanese rehabilitation proceeding.

4 We note that the court process in Japan does not involve a publicly accessible docketing system. This is perhaps not surprising given the limited notice and disclosure requirements in cases. Instead, what little data is produced is available solely to creditors in interest (and not to the public at large) at the office of the court clerk. This has the potential to chill secondary market activity due to concerns about possessing material, non-public information.

5 Notwithstanding the system's culture of consensus, valuation of a secured creditor's collateral is a common area of dispute in rehabilitation proceedings. Typically, a trustee can be expected to produce and use low appraisals in negotiating the secured and deficiency claim amounts held by creditors. Given the preference for consensus, however, agreed terms will typically be reached between the parties without the need for a final litigated resolution.

HIGH-LEVEL SUMMARY OF INSOLVENCY LAWS

There are four types of insolvency laws in Japan—two that contemplate rehabilitation of the debtor and two that contemplate liquidation and dissolution of the debtor. Each of those laws is outlined at a high level below.

As a general matter, we note that the civil rehabilitation law is more commonly employed than the corporate reorganization law—with use of the corporate reorganization law typically reserved for larger, higher-profile and more complex cases.

Rehabilitation Laws

Corporate Reorganization: The corporate reorganization law came into effect in 1952. It is modeled on Chapter X of the U.S. Bankruptcy Act of 1898. Under the law, only a stock corporation (known as "KK") may be a debtor.[6] That said, the vast majority of companies in Japan are KKs. As a general matter, the corporate reorganization law may be used to modify the rights of all classes of creditors (both secured and unsecured). Until very recently, all corporate reorganization cases involved the appointment of a bankruptcy professional, typically an established bankruptcy lawyer, as "trustee" to run the debtor's affairs. In recent years, however, courts have begun to permit quasi-debtor-in-possession cases.

Civil Rehabilitation: The civil rehabilitation law was published on Dec. 14, 1999, and went into effect on April 1, 2000.[7] Any type of Japanese company may be a debtor under this law. Cases under the civil rehabilitation law are intended to be debtor-in-possession cases, although a trustee may be appointed if warranted. Although there are certain exceptions to the general rule, a civil rehabilitation case generally serves to modify only the rights of unsecured creditors—thus, use of a corporate reorganization case (rather than a civil rehabilitation case) may be necessary when a company's balance sheet is sufficiently complex so as to require involuntary changes to the rights of secured creditors.

6 There are four basic types of "companies" or incorporated business entities under Japanese law. These are: (1) stock corporations (kabushiki kaisha, generally referred to as "KK"), (2) incorporated totally limited liability partnerships (godo kaisha), (3) incorporated partially limited liability partnerships (goshi kaisha) and (4) incorporated unlimited liability partnerships (gomei kaisha). Of these, the KK is most prevalent and is therefore most likely to be the debtor in an insolvency proceeding.

7 The civil rehabilitation law effectively replaced two predecessor laws—the composition law and the corporate arrangement law—which both permitted a debtor to remain in possession. Due to significant deficiencies within those laws, however, neither was actively employed as an insolvency solution.

Liquidation Laws

Bankruptcy: The bankruptcy law was published in June 2004 and went into effect on Jan. 1, 2005.[8] The bankruptcy law provides for a proceeding in which a trustee is appointed by the court to liquidate the assets of a debtor and distribute the proceeds of such liquidation to creditors in their order of priority. As a technical matter, the liquidation process applies to both secured and unsecured assets. However, the law does not impose a stay upon foreclosure actions. As a practical matter, holders of security interests are typically permitted to exercise their security rights and/or requested to consent to the trustee's efforts to liquidate their secured collateral.

Special Liquidation: The most recent version of the special liquidation law—which is a sub-part of the Corporation Act—was published in July 2005 and went into effect on May 1, 2006. Overall, the special liquidation law provides for a simplified liquidation procedure that may be used in consensual situations. Most often, the law is employed by parent companies to wind down subsidiaries. The law permits the company, after a shareholder vote, to approve its own choice of a liquidator, but requires that liquidator to obtain creditor approval of a "plan of liquidation." The procedure applies only to general unsecured claims and cannot be used to alter secured creditor rights and/or priority claims that exist under non-bankruptcy laws.

The bankruptcy law is more commonly employed to achieve a liquidation than the special liquidation law.

8 The bankruptcy law replaced a predecessor law that was also referred to as the "bankruptcy law."

We generally find that the vast majority of our clients are interested in reorganization and rehabilitation proceedings. Accordingly, on the remaining pages, we summarize some of the key features of the corporate reorganization and civil rehabilitation laws from a practical perspective.

Who are the key players and what are their roles?

Corporate Reorganization Law

Trustee: An individual appointed by the court to run the debtor's affairs and to develop its restructuring Plan. Although historically the trustee has been an independent bankruptcy professional, recent cases have permitted the appointment of an existing member of management.

Examiner: Like in the U.S., although not common, examiners may be appointed to fill any number of specific and identified investigatory tasks. More recently, however, examiners have begun to be appointed in all cases where a member of management has been appointed as the trustee. In this regard, the examiner provides independent oversight of the trustee's activities—at least key activities.

No Creditors' Committee: As noted above, creditors' committees, as contemplated in the U.S., do not exist. The corporate reorganization law permits the establishment and recognition of a "committee" of collective creditors, but such committees do not serve the same function as a U.S. creditors' committee. We note that although an examiner may be appointed to monitor a debtor's affairs, examiners are not anticipated to be as proactive as a creditors' committee in the U.S.

Civil Rehabilitation Law

DIP: More often than not, management of the debtor remains in place during a civil rehabilitation case. Like in the U.S., a court may appoint a trustee to replace management if the debtor is determined unfit to manage.

Supervisor: In most civil rehabilitation cases, the court will appoint a supervisor to monitor the debtor's affairs. In this capacity, the supervisor will voice an opinion as to approval or disapproval of many trans-actions of the debtor.

No Creditors' Committee: The laws applicable to creditors' committees are virtually identical to those included in the corporate reorganization law. In turn, we note that although a supervisor may be appointed to monitor a debtor's affairs, a supervisor is not likely to be as proactive as a creditors' committee in the U.S.

Do creditors have any opportunity to voice their opinion as to who should fill the above referenced roles of monitoring the debtor's affairs? What duties (if any) do the "players" have to report to creditors?

Corporate Reorganization Law

Creditors are not typically afforded an opportunity to voice their views as to preferred examiner candidates.

Although, as a technical matter, the examiner owes certain fiduciary duties to creditors, as a practical matter, the examiner works for the court. Thus, the examiner will report solely to the court regarding his or her views as to the debtor's activities. That said, certain key reports, such as those pertaining to Plan confirmation, may be filed and made available for creditor review.

As a practical matter, an examiner may be willing to entertain the views of creditors if so requested. The size of the creditor(s) involved in making such a request and the relationship between counsel to such creditor(s) and the examiner will impact the degree to which the examiner considers such requests. Nonetheless, as discussed elsewhere in these materials, we note that examiners are not likely to be as active or influential as a U.S.-style creditors' committee.

Civil Rehabilitation Law

Generally speaking, the answers to these inquiries are the same as those pertaining to corporate reorganization cases, provided that a supervisor, rather than an examiner, would be involved.

Is there an automatic stay or, as a practical matter, a stay issued in most cases?

Corporate Reorganization Law

As of "commencement" of a corporate reorganization case, an automatic stay comes into effect that prohibits, among other things, both (i) the debtor from paying and/or creditors from attempting to collect unsecured pre-commencement obligations and (ii) secured creditors from attempting to exercise their security rights. The stay does not, however, prevent creditors from exercising rights of set-off.

As a technical matter, all cases in Japan, even voluntary cases, involve a "gap" period. That is, there is a period between the filing of an application for commencement and the date at which the court enters an order actually commencing the case. There is no automatic stay during this period, but courts routinely enter injunction orders that serve the same basic purposes as the applicable automatic stay.

Civil Rehabilitation Law

As of "commencement" of a civil rehabilitation case, an automatic stay comes into effect that prohibits, among other things, the debtor from paying and/or creditors from attempting to collect unsecured pre-commencement obligations. The stay does not apply to enforcement of security rights by a secured creditor. In addition, the stay does not prevent creditors from exercising rights of set-off.

The same "gap period" applies as in corporate reorganization.

May the debtor/trustee operate outside of the ordinary course (e.g., sell significant assets, enter into new contracts, make significant capex investments, etc.) without court approval? If court approval is required, is that approval on notice to all creditors, with an opportunity for objecting creditors to be heard?

Corporate Reorganization Law

Generally speaking, the trustee will need court approval before taking actions outside of the ordinary course. In turn, the court may solicit the views of the examiner in respect of such activities.

However, the debtor need not serve all creditors with notice of the intended action, nor must a public hearing be held. Thus, individual creditors who feel the debtor's actions are harmful to value may not be afforded an opportunity to object. Indeed, they may not even be provided notice of the activity until after the fact.

As a practical matter, with respect to sales of significantly all assets, the courts will typically hold a meeting of creditors at which creditors may voice their views to the court. In turn, although there is insufficient precedent to say with certainty, we believe that most examiners will require the debtor to produce evidence of a market bid process before the examiner will voice support for a sale of substantially all assets.

The above demonstrates that general unsecured creditors have less of a voice in the debtor's actions than they might typically have in the United States. Certain creditors, however, have even greater rights. In particular, we note that (i) executory contracts may not be assigned without consent of the counterparty thereto and (ii) liens on assets may not be stripped simply by producing evidence of sale at fair value (thus giving secured lenders significant consent rights to sales).

Civil Rehabilitation Law

Generally speaking, the answers to these inquiries are the same as those pertaining to corporate reorganization cases, provided that a supervisor, rather than an examiner, would be involved.

By when must a Plan be filed and confirmed?

Corporate Reorganization Law

Plan Timing: Plans must be submitted by a date established by the court, provided that the date must be within one year of commencement of the case. This period may be extended, where special circumstances exist, up to twice by the court and thereafter may be extended only if unavoidable conditions are found. There is no statutory limitation on the period of extension, but requests for such extensions are strictly scrutinized.

Civil Rehabilitation Law

Plan Timing: Plans must be submitted by a date established by the court, provided that the date must be within roughly nine months of commencement of the case. Technically, the date set by the court shall not be more than two months after expiration of the "claim examination period."

What type of claims may be addressed by a Plan?

Corporate Reorganization Law

Claims Addressed: A corporate reorganization Plan may address the rights of secured creditors, unsecured creditors and equity holders.

Civil Rehabilitation Law

Claims Addressed: Generally speaking, a civil rehabilitation case addresses only the rights of ordinary unsecured creditors and equity holders. The claims of unsecured priority creditors (such as labor claims) are exempt from the civil rehabilitation proceeding. Secured creditors are permitted to exercise their security rights during the proceedings and their deficiency claims (if any) become unsecured claims in the proceedings. Creditors with claims exempt from the proceeding (secured creditors and priority unsecured creditors) are not required to file proofs of claim in the proceeding.

What votes are necessary to confirm a Plan?

Corporate Reorganization Law

Plan Voting: Claims are generally grouped into two classes: secured and unsecured. Votes are counted by amount of claims (with the number of claimants holding such claims being moot). The required voting percentages work as follows:

- **Secured Class:** (i) 2/3 in amount to simply extend maturities, (ii) 3/4 in amount to approve a haircut and (iii) 9/10 in amount to approve a Plan that will liquidate the debtor's business.
- **Unsecured Class:** Simple majority in amount required to approve a Plan.
- **Equity:** Simple majority in amount required to approve a Plan (but equity holders are permitted to vote only when the debtor is solvent).

Interestingly, claims that are not voted on are counted as "no" votes. Thus, the trustee and/or debtor faces a significant burden in terms of encouraging all creditors to vote.

Civil Rehabilitation Law

Plan Voting: Claims are generally grouped into one single unsecured class, for which votes of a majority in both number (of those voting) and amount (of all claims in the aggregate) are necessary. Shareholder votes are generally deemed moot and unnecessary unless the debtor is solvent.

Interestingly, claims that are not voted are counted as "no" votes for purposes of counting the "amount" of votes (all claims in the aggregate). Claims that are not voted are not counted, however, for the purpose of establishing a majority in "number" (of those voting).

Must a Plan treat similarly situated creditors in a consistent manner?

Corporate Reorganization Law

Similar Treatment: Generally speaking, similarly situated creditors must receive similar treatment. Like in the U.S., there are some exceptions to this general rule, including (i) convenience claim treatment, resulting in greater recovery percentages for small claims, and (ii) possible equitable subordination of shareholder and management claims. We note that the convenience claim process tends to be liberally employed in Japan — often pegging the convenience claim threshold at a number that ensures improved recoveries for virtually all trade creditors (to the detriment of financial lender claimants).

Civil Rehabilitation Law

Similar Treatment: Generally, the same as corporate reorganization cases.

Must a Plan satisfy an equivalent of the U.S. absolute priority rule?

Corporate Reorganization Law

Respect for Priorities: The corporate reorganization laws respect the priority of creditor claims, but do so through a "relative," rather than "absolute," priority rule. This rule essentially provides that a junior creditor may recover some level of recovery notwithstanding the fact that a senior creditor has not recovered in full, provided, however, that the junior creditor must receive less favorable terms than the senior creditor. By way of example, it is not unheard of for a Plan to propose that secured creditors will be paid 90 percent of the value of their security, with the balance used to improve recoveries of unsecured creditors.

Civil Rehabilitation Law

Respect for Priorities: This point is largely moot in the context of a civil rehabilitation case given that the proceeding does not apply to secured creditors (i.e., given that there is only one creditor class). However, we note that it is not uncommon in small- or medium-sized cases for creditors to determine that the best prospects for reorganization are with existing management and equity holders in place — thus permitting a retention of equity by such parties.

As a practical matter, what is the typical form of exit from a case (e.g., sales or debt for equity)?

Corporate Reorganization Law

Corporate reorganization cases typically end with the debtor finding a buyer ("sponsor") to acquire the debtor's assets, with the proceeds of such sale being used to fund creditor recoveries. Technically, debt for equity swaps are permitted under the laws, but, in practice, they are very rarely employed.

A Plan may be confirmed without a sponsor having been located. In such cases, the Plan will provide alternative paths: (i) one path by which the trustee will continue to run the business and pay a stream of creditor distributions over time and (ii) an alternative path by which, if the trustee finds a sponsor, the business may be sold, so as to prepay the creditor distributions. In either instance, the reorganization case will remain open and subject to the court's jurisdiction until the significant majority of creditor distributions have been paid.

Civil Rehabilitation Law

The practice in civil rehabilitation cases is generally the same as that of corporate reorganization cases.

What is a typical timeline for a case?

Corporate Reorganization Law

Pre-Filing: One to two weeks of debtor consultation with the court.

Day 1: Filing, entry of injunction order, appointment of a "provisional" trustee and private notice to creditors by the petitioner.

Week 3: Entry of a formal commencement order, appointment of a trustee and, as applicable, appointment of an examiner.

Week 9: Claims bar date.

Weeks 9 – 20: Asset evaluation and claim examination period.

Week 21: Submission of a Plan of Reorganization. (This period may extend to as long as 52 weeks or more in complex cases. If so, all dates hereafter would be revised accordingly).

Weeks 21 – 25: Plan voting.

Week 26: Plan confirmation.

Thereafter: Implementation of the Plan until the significant majority of claim distributions have been paid. This can last anywhere from months to several years.

Civil Rehabilitation Law

Pre-Filing: One to two weeks of debtor consultation with the court.

Day 1: Filing, entry of injunction order, appointment of a supervisor and private notice to creditors by the petitioner.

Day 15: Entry of a formal commencement order.

Week 6: Claims bar date.

Weeks 6 – 11: Asset evaluation and claim examination period.

Week 12: Submission of a Plan of Reorganization. (This period may extend to as long as roughly 36 weeks or more in complex cases. If so, all dates hereafter would be revised accordingly).

Weeks 12 – 24: Submission of supervisor's report and holding of creditors' meeting for voting on the Plan.

Week 24: Plan confirmation.

Thereafter: Implementation of the Plan until the significant majority of claim distributions have been paid. This can last anywhere from months to several years.

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