

Until recently, there were five statutory insolvency procedures available in Japan. Two of these procedures address cases of corporate liquidation – bankruptcy (enacted in 1921) and special liquidation (enacted in 1938). The other three procedures address cases of corporate rehabilitation – composition (enacted in 1921), corporate arrangement (enacted in 1938) and corporate reorganization (enacted in 1952). The law regarding composition proceedings has been repealed, and the law regarding corporate arrangement proceedings, while still in effect, is rarely utilized. Since the collapse of the so-called “bubble economy” in Japan, insolvency cases have increased dramatically, and new laws were enacted to address the changed circumstances facing Japan. Two new procedures for addressing cases of corporate rehabilitation were enacted – the special arrangement procedure and the civil rehabilitation procedure. These procedures are available to companies of any size, but are predominantly used by small to mid-sized companies. Finally, a new law was enacted in November 2000 (to take effect by June 2001) to accommodate the growing number of international insolvency cases by abolishing the so-called “territorial policy” now in place for bankruptcy and corporate reorganization cases. Other than the statutory insolvency procedures mentioned above, some insolvency cases in Japan are resolved by way of a court-supervised conciliation procedure.

1 Describe the nature and the effectiveness of the following processes:

a) Civil unsecured debt collection remedies.

If a debtor has defaulted in payment of its debt, a creditor may file a motion against the debtor with a competent local court to obtain a judgment ordering the payment. If the debtor has failed to pay the debt when a final and conclusive judgment has been obtained by the creditor, the creditor may execute the judgment against property of the debtor. The distribution of the proceeds of the public sale of such property will be made equally among such creditors and all other unsecured creditors that have filed their claims with the execution court.

If it is likely that a debtor will dispose of its property before a judgment is made, a creditor may seek provisional remedies to attach the property, or to prevent the debtor from disposing of the property by obtaining an appropriate order from a competent local court.

b) Secured property enforcement remedies.

A secured creditor may execute a public sale or a private foreclosure, depending on the type of security interest. In the case of real property, a creditor who has a registered mortgage over property may take a civil execution procedure for a public sale. A creditor who has a registered mortgage by assignment over property may sell the property through private sale. In the case of receivables and deposits, a creditor who has a perfected security interest over property, through either pledge or mortgage by assignment, will usually take title to the receivables and then collect the proceeds from the original payees of the receivables. With other movable property, including debentures and stock, a creditor who has a perfected security interest over the property may sell it by public sale under pledge and take title, or foreclose the property by private sale under mortgage by assignment.

c) Any special debt collection or secured property remedies that are available to banking sector creditors.

If a bank has received a promissory note from its customer for collection, the bank will be granted a possessory statutory lien against the note under certain circumstances.

d) Corporate bankruptcy/liquidation processes that are available to corporate debtors and creditors.

Bankruptcy procedure and special liquidation are available. Special liquidation is initiated by a creditor, liquidator, statutory auditor or shareholder if it is found that a debtor is likely to be insolvent after it is wound-up by resolution at shareholders' meetings. The process is implemented by a special liquidator under the court's supervi-

sion. The special liquidator may prepare an arrangement for debt repayment for consideration at a meeting of creditors. The arrangement is required to be passed by a majority of the creditors attending the meeting and who have three fourths of the total debts. The arrangement must also be approved by the court. Typically, such an arrangement includes provisions which favor the creditors and provisions which do not. Bankruptcy procedure is initiated by a creditor or a debtor if a debtor becomes insolvent. A bankruptcy trustee appointed by a court has the power to dispose of all the estate of a debtor and distribute the proceeds to creditors equally. Collateral covered by security interests is not included in the estate for liquidation or bankruptcy purposes.

**e) Formal corporate rescue processes that are available to corporate debtors and creditors.**

Corporate reorganization and civil rehabilitation procedures are available. Corporate reorganization is designed to reorganize large-sized limited liability companies with the aid of strong powers given to reorganization trustees. The collateral covered by secured creditors is incorporated into the estate and the payment of secured debts will be paid out under the reorganization plan. The civil rehabilitation procedure, which became effective in April 2000, is designed to rehabilitate middle- and small-sized companies under a more simplified process. It is effected by a debtor-in-possession process. A secured creditor may enforce its security interest in collateral separately.

**f) Informal corporate rescue processes.**

There are a number of cases where corporate creditors have agreed on the reorganization of a debtor and provision of financial aid to the debtor while reducing outstanding debts and releasing security interests. However, in order to successfully make this arrangement, it is necessary for the main banks to fully co-operate with the reorganization under a sponsor's commitment.

**g) Any other corporate insolvency, or insolvency-related, processes that are available under special legislation.**

There is a process known as a debt adjustment arrangement (the Debt Adjustment Process), which became effective in February 2000. The Debt Adjustment Process requires agreement between a debtor and each creditor, under the involvement of a conciliation committee which consists of court-appointed conciliation members.

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**2 What is the effect upon debt enforcement and secured property enforcement processes of:**

**a) An adjudication of corporate bankruptcy/liquidation?**

A request for debt enforcement against a debtor's property is not permissible, and a pending enforcement procedure ceases to be effective in case of bankruptcy and is suspended in the case of a special liquidation. There is no effect on the enforcement of secured property rights.

**b) The commencement of a formal corporate rescue process?**

A request for debt enforcement against the debtor's property is not permissible, and a pending enforcement procedure is suspended. A pending enforcement procedure of secured property rights is also suspended in the case of corporate reorganization, and may be suspended in the case of civil rehabilitation.

**c) The initiation of an informal corporate rescue process?**

The informal process does not affect enforcement of debt or secured property rights unless agreed to by the creditors concerned.

**d) The initiation of an insolvency, or insolvency-related, process under any special legislation?**

In the case of the Debt Adjustment Process, the court may order that debt and secured property enforcement procedures be suspended.

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- 3 What is the effect on the management of a corporation of:
- a) An adjudication of corporate bankruptcy/liquidation?  
The management is replaced by the trustee in case of bankruptcy, and by the liquidator in the case of special liquidation.
  - b) The commencement of a formal corporate rescue process?  
The management is replaced by the trustee in case of corporate reorganization. In the case of civil rehabilitation, management may be retained unless a trustee is appointed by the court.
  - c) The initiation of an informal corporate rescue process?  
Unless it is otherwise agreed between the creditors and the debtor, the existing management of a debtor corporation continues.
  - d) The initiation of an insolvency, or insolvency-related, process under any special legislation?  
The commencement of the Debt Adjustment Process has no effect on management.
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- 4 Who is responsible for “case management” control and administration:
- a) A corporate bankruptcy/liquidation?  
The trustee is responsible for administration in the case of bankruptcy. The liquidator is responsible for administration in the case of special liquidation.
  - b) A formal rescue?  
The trustee is responsible in the case of corporate reorganization. The management of the debtor is responsible in case of civil rehabilitation, unless a trustee is appointed.
  - c) An informal rescue?  
There is no trustee or liquidator in such cases.
  - d) A case of corporate insolvency under any special legislation?  
There is no trustee or liquidator in the case of the Debt Adjustment Process.
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- 5 Who has the responsibility for the preparation of the plan of rescue under:
- a) A formal rescue?  
In the case of corporate reorganization, the trustee must prepare a reorganization plan and submit the plan to the court. The debtor, creditors or shareholders also have the right to produce a plan. In the case of civil rehabilitation, the trustee (if one is appointed, or the debtor in the absence of a trustee) must prepare a rehabilitation plan and submit the plan to the court. Where a trustee is appointed, it is also possible for the debtor itself, or a trustee in foreign jurisdiction, or creditors who have filed claims, to submit a plan to the court.
  - b) An informal rescue?  
The plan is the result of the negotiation process between the creditors and the debtor.
  - c) A case of corporate insolvency under any special legislation?  
A debtor, creditor or the conciliation committee may produce the proposed debt arrangement.
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- 6 How are the different classes of creditors treated in relation to:
- a) A corporate bankruptcy/liquidation?  
Secured creditors may enforce their security interest in collateral outside the procedure. In the case of bankruptcy, the remaining classes are composed of (i) creditors having claims attributable to common benefits, such as trustee fees, (ii) senior unsecured creditors, such as employees, (iii) subordinate creditors and (iv) others. Each of these classes is treated differently in distribution. In the case of special liquidation,

debt repayments are made in accordance with a court-approved arrangement. The terms and conditions of the arrangement must be equal as among the creditors, except that a court may approve an arrangement that treats creditors differently if it is not inequitable.

b) A formal rescue?

In the case of a corporate reorganization, creditors are classified into (i) secured creditors and (ii) unsecured creditors. Unsecured creditors are further classified into (a) creditors having claims attributable to common benefits, (b) senior unsecured creditors, (c) subordinate creditors and (d) others. Creditors (other than those having claims attributable to common benefits) will be paid through the plan. In the case of a civil rehabilitation, creditors have the same classification as described in the case of bankruptcy above, and creditors (other than those having claims attributable to common benefits and senior unsecured creditors) will be paid through the plan.

c) An informal rescue?

This will depend on the outcome of the negotiations between the creditors and the debtor.

d) A case of corporate insolvency under any special legislation?

There is no provision for different classes of creditors under the Debt Adjustment Process.

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7 What is the position of both unsecured and secured creditors who vote against, do not agree with, or do not consent to, a plan of rescue in relation to:

a) A formal rescue?

In the case of corporate reorganization, the plan must be passed by unsecured creditors holding at least two thirds of the total unsecured debts and by secured creditors holding at least three fourths, (or four fifths if the plan proposes to cut off the secured debt), of the total secured debts. In the case of civil rehabilitation, the plan must be passed by a majority of creditors having claims of not less than one half of the total debts.

b) An informal rescue?

The proposed plan must be unanimously agreed.

c) A case of corporate insolvency under any special legislation?

The proposed debt adjustment arrangement must be agreed with each creditor.

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8 In relation to the need for an insolvent corporation to have urgent working capital funding, what difficulties are encountered in the provision of such funding in relation to:

a) A formal rescue?

In the case of corporate reorganization, a loan which has been funded between the filing and commencement of the procedure is not always granted a preferable position over other unsecured debts. If a loan has been granted a preferable position it will cease to keep that position if the procedure turns into bankruptcy before the commencement of corporate reorganization.

b) An informal rescue?

No preferable position will be given to a person who has provided a debtor with funding, unless all other creditors accept.

c) A case of corporate insolvency under any special legislation?

There is no provision under the Debt Adjustment Process legislation for such finance.

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9 Briefly describe the relevant provisions relating to the setting aside of antecedent and fraudulent transactions in relation to:

a) A corporate bankruptcy/liquidation.

A trustee of bankruptcy has the power to void certain fraudulent transactions, while a liquidator does not.

b) A formal rescue.

A trustee in the case of corporate reorganization and a trustee in the case of civil rehabilitation procedure has the power to void certain antecedent and fraudulent transactions.

c) A case of corporate insolvency under any special legislation.

A creditor is allowed to request a court to declare the invalidity of a fraudulent transaction between the debtor and another creditor.

10 Are there any provisions of law that might operate to invalidate a secured property transaction in relation to:

a) A corporate bankruptcy/liquidation?

In the event that a secured creditor has failed to enforce its security interest in collateral after the commencement of bankruptcy or special liquidation, the bankruptcy trustee or liquidator will be authorized to enforce its security interest in collateral under the rules of formal civil execution procedure.

b) A formal rescue?

Under corporate reorganization, secured creditors are subject to the reorganization process through which they will be given priority positions in a reorganization plan in relation to the repayment of debts. In the case of civil rehabilitation, (i) the court may, upon application of an interested person or its own motion, order the suspension of the execution of a security interest on the collateral if it deems that such order meets the general interest of creditors and there is no risk of inflicting undue loss or damages on the applicant for public auction, or (ii) a trustee or a debtor in possession may request the court to eliminate the security interest from the collateral by payment of the fair market price of the collateral, where it is dispensable to take such orders for the rehabilitation of business.

c) A case of corporate insolvency under any special legislation?

Under the Debt Adjustment Process, a creditor may request a court to suspend the execution of a security interest on the collateral if the court considers the suspension to be necessary for debt adjustment.

11 Describe the difficulties that are encountered in endeavoring to administer cases of corporate bankruptcy/liquidation and formal corporate rescue that involve property and business interests located in more than one jurisdiction.

The insolvency laws of Japan, except for civil rehabilitation, follow a “territorial” policy – there is no recognition of insolvency proceedings commenced in another jurisdiction and there is no effect upon property of the debtor located in Japan. Likewise, insolvency proceedings (except for civil rehabilitation) in Japan will have no effect in foreign jurisdictions. Thus, for example, even where there is a need to integrate the property and business assets among group companies which are located in more than one jurisdiction, separate proceedings (except in the case of civil rehabilitation) must be initiated in separate jurisdictions for each group company. However, a new law, which was promulgated on November 29, 2000 and will come into force within six months from such date, abolishes the territorial policy both in the bankruptcy procedure and the corporate reorganization procedure.

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1 Is the restructuring/insolvency legislation generally:

a) Understood?

Japan does not have a uniform insolvency code. Insolvency law consists of liquidation and reorganization laws. Under liquidation, the Bankruptcy Law and Special Liquidation (in Commercial Code) apply. Under reorganization, the Corporate Reorganization Act, the Company Resolution (in Commercial Code) and the Civil Rehabilitation Law (which replaces the Composition Law (“Waghi”) as of April 1, 2000) apply. These laws generally are in need of complete overhaul, but due to time constraints, only the Waghi has been amended. Company Resolution is expected to be abolished in the near future.

In addition, a new law for the rehabilitation of consumer debtors will be legislated soon. Provisions for international bankruptcy will be arranged as well so that a current strict territorial system (i.e. Japanese insolvency proceedings applicable to assets in Japan only) will be changed to a universal system (i.e. acceptance of foreign insolvency proceedings with possible parallel filings).

The insolvency/restructuring legislation is complicated and understood only by a limited number of insolvency lawyers. Some financial advisors, consultants, accountants, bankers and other professionals also have a good understanding of the legislation, but the legislation is not fully utilized. Rather, most of the restructurings have been done as out-of-court workouts under the initiative of banks, finance companies, lawyers and sometimes of “unlicensed” special fixers without any disclosure of information.

b) Being followed and/or available opportunities being taken up?

The situation has been changing since April 1, 2000 – the effective date of the Civil Rehabilitation Law. This new law allows a debtor to keep its operation as a debtor-in-possession (“DIP”) and promotes quicker solutions to problems and the regeneration of businesses. Indeed, in Fiscal Year 1999 (April 1999 to March 2000), 225 petitions under legal reorganization procedures were filed (excluding liquidation and winding-up), while more than 100 petitions were filed under the procedures of Civil Rehabilitation Law within the first two months (April and May 2000) of its effective commencement date.

c) Being enforced by relevant authorities?

Enforcement by the authorities has also improved thanks to the Civil Rehabilitation Law. The Waghi, which was a kind of composition or voluntary arrangement, was a notorious law because under its procedures many debtors did not abide by the agreed terms once supervision of the court was finished. Under the Civil Rehabilitation Law a court’s supervision will be maintained in most cases for three years, even after the confirmation of the rehabilitation plan. If the debtor does not follow the terms under the plan, it may be forced into liquidation proceedings by the initiative of the court. Though liquidation value may not be high in such cases, this enforcement mechanism is considered to be a necessary discipline.

2 Broadly speaking, in practice, does the restructuring/insolvency legislation tend to lead to:

a) Early recognition and action on financial difficulties experienced by a corporation?

In the past, the legislation did not lead to early recognition and action on financial difficulties because, as explained above, most of the restructuring used to be settled as out-of-court workouts under the initiative of the so-called “main banks” and other related parties. Main banks used to control their borrowers by holding their shares, seconding executives and taking care of various financial problems. The main bank system used to be well maintained thanks to hidden reserves (unrealized capital gains of shares held by the banks) and less stringent disclosure rules (which allowed banks to carry bad loans without providing them appropriately and to write them off little by little, utilizing hidden reserves). These hidden reserves have substantially decreased due to the economic recession of the 1990s and the recent strict tightening

of disclosure requirements. Thus, the so-called main bank system has almost collapsed. Partly because of this collapse and partly because of the new Civil Rehabilitation Law, early recognition and action on financial difficulties will be enhanced.

**b) Restructuring alternatives as opposed to liquidation, and if not, why not?**

Banks have come to prefer solving their problems via transparent legal procedures to save time, costs and expenses.

According to the Civil Rehabilitation Law, a petition is allowed when a debtor is under the “apprehension” that it would be insolvent. This provision, when combined with the provision of the DIP, tends to lead to earlier recognition and action on financial difficulties.

Corporate Reorganization Law also has the same provision, but it has not been effective since the DIP concept is not allowed under this Law. In other words, once a petition is filed, the management of the debtor is replaced by the trustee (administrator).

Restructuring alternatives are usually preferred to liquidation, not because of the legislation but because of banks’ willingness to avoid write-offs. Most of the banks do not like to see realized losses after writing off deficiency claims in case of liquidation, they would rather restructure the loans by lowering interest rates and/or extending maturity dates.

Again, the Civil Rehabilitation Law will tend to lead to restructuring alternatives since it promotes the regeneration of businesses through asset sales and business sales at earlier timings, rather than waiting for confirmation of the plan.

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**3 What are the main practical difficulties being encountered in:**

**a) The preparation of restructuring plans?**

Forgiving indebtedness is common in Japan because the simple conversion from debt to equity at par is legally prohibited. After the forgiveness, the remaining debts, which are marked down to their market values, may be swapped into equity, but banks usually do not like such equity. From their viewpoint forgiveness is enough, as the additional swap to equity is a double penalty to them. Thus, in the preparation of restructuring plans, the main practical difficulties are how to determine the degree of forgiveness and how to convince the related parties, particularly banks.

Though the so-called main bank system is collapsing as explained above, it is still a market practice for the main bank to forgive more and for small lenders to forgive less.

In out-of-court workouts, the level of remaining debts is usually higher since banks want to minimize their losses from forgiveness. However, if the level is higher, the debtor will face financial difficulties again sooner or later. Ultimately, the cases may have to be settled pursuant to legal procedures under the Corporate Reorganization Law or Civil Rehabilitation Law.

In cases under the Corporate Reorganization Law, it is not rare for unsecured creditors to accept more than a 90 percent haircut, leaving the remaining claims to be paid in installments for 15 to 20 years. The preparation of such restructuring plans assumes that the debtors may not be regarded as restructured until they become debt-free companies in 15 to 20 years time. In addition, since a DIP is not allowed under this Law, a trustee (administrator) is appointed to manage the company’s operations. This is why utilization of this Law has been low. In Fiscal Year 1999 (April 1999 to March 2000), only 45 petitions were filed under this Law.

On the contrary, under the procedures of the Civil Rehabilitation Law the payments of claims should be finished within 10 years after confirmation of the plan. The 20-year maximum payment period allowed under the Corporate Reorganization Law is considered to be too long. The Civil Rehabilitation Law assumes that payments come in a shorter period of time when they are derived from the proceeds of a sale of the assets or a sale of the business.

b) The implementation of restructuring plans?

In the case of out-of-court workouts, the implementation of restructuring plans is difficult because, as mentioned above, such plans are usually not stringent enough to have the debtor regenerate its businesses. However, in the case of legal procedures under Corporate Reorganization Law or Civil Rehabilitation Law, implementation is not difficult since plans are enforceable.

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4 To what extent are companies that are going through any formal or informal restructuring merely adjusting their debt/equity structure, rather than genuinely restructuring their business operations?

In most of the cases, restructuring in Japan results in a mere adjustment of the debt/equity structure of the debtor. Forgiving indebtedness is common in Japan, and the debtor may not be regarded as restructured until they become debt-free companies, which can take 15 to 20 years. Since this concept underpins restructuring in Japan, a mere adjustment of the debt/equity structure is common and a genuine restructuring of business operations is rare.

If a genuine restructuring of business operations is done in Japan, it is in the context of Mergers and Acquisitions (“M&A”). When a debtor faces financial difficulties, it has the option to sell its businesses to investors who are either strategic buyers or financial buyers. Once the M&A is completed, the buyer usually restructures the acquired business to coincide with the existing businesses.

However, if the debtor files a petition for legal procedures after a M&A, the sale may be avoided as a preference or a fraudulent conveyance. Therefore, many buyers like to close the deal in the course of legal procedures. The Corporate Reorganization Law is not a suitable law for M&As because it is interpreted that a M&A can be done only in the reorganization plan.

It generally takes a few years before the plan is confirmed and by then, the businesses deteriorate and their value decreases. The *Japan Leasing case (1999)* is an exceptional example because the court approved the business sale before the confirmation of the reorganization plan with the intention that the business should not deteriorate before sale. It is not known, however, whether the scope of this precedent is wide enough to cover future business sales under the Corporate Reorganization Law. However, now that the Civil Rehabilitation Law has come into effect, this is no longer an important consideration.

Subject to the court’s approval under the assumption that a debtor’s equity value is zero or negative, this new law allows the debtor to sell its businesses, partially or entirely, to a buyer without waiting for the plan to be confirmed. Thus, if a debtor wants to restructure its business operations genuinely through a M&A, it is better to do it through procedures under the Civil Regeneration Law.

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5 What are the main areas from which funding is generally being utilized by companies which undertake either formal or informal restructuring?

Although the main bank system has been transfigured substantially, it is still common for a main bank to fund a debtor that undertakes restructuring, either in out-of-court workouts or in legal procedures. For example, a general merchandising store, Nagasakiya, filed a petition under the Corporate Reorganization Law in February 2000 and its main bank is still providing working capital as a result of its responsibility of being the “main bank”. Subject to the court’s approval, such credit extensions after the petition are protected as “claims for common benefits” (equivalent to “administrative expenses” under the U.S. Bankruptcy Code). Higher priority is given to general unsecured claims under the condition that the court decides to commence the procedures of the Corporate Reorganization at a later date.

Under the Japanese insolvency system there is a gap period between the filing of the petition and the court’s decision to commence the case (equivalent to “order for relief” under the U.S. Bankruptcy Code). In the case of Nagasakiya, the court decided to commence the case under the Corporate Reorganization Law in May 2000, therefore the main bank’s post-petition claims have been protected as “claims for common benefits”.

If the decision of commencement of the case is not made by the court and the case is converted into a liquidation under the Bankruptcy Law, then such post-petition claims under the Corporate Reorganization Law are regarded as general unsecured claims under the Bankruptcy Law. Though the court usually gives guidance to the debtor so that such claims are paid in advance, this has been a problem of post-petition finance under the Corporate Reorganization Law.

Again, the Civil Rehabilitation Law has rectified this problem by stating that even in the case of conversion to liquidation, such claims are protected with priority to other general unsecured claims under the Bankruptcy Law. Since “super-priority” (which is admitted in Section 364(c)(d) of the U.S. Bankruptcy Code) is not granted to post-petition creditors even under this new law, their claims are *pari passu* with other “claims for common benefits” unless security interests are attached to unencumbered assets.

This is a remarkable difference from a DIP finance mechanism under the U.S. Bankruptcy Code. Thus, only main banks are still reluctantly providing post-petition finance to debtors, and DIP finance by a third party is rare. The majority of creditors are of the opinion that granting super-priority and/or security interests to a DIP finance provider is unfair and that such finance is a responsibility of the main bank.

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