

RECENT INSOLVENCY LAW REFORM IN JAPAN:  
SOME TIPS FOR FOREIGN INVESTORS INTO THE JAPANESE MARKET

Hideyuki Sakai<sup>1</sup>

Introduction

Japan has undergone a comprehensive reform of insolvency laws over the past 9 years. Now, there are two restructuring proceedings (corporate reorganization and civil rehabilitation) and two liquidation proceedings (bankruptcy and special liquidation). Through the reform, the insolvency laws have become modernized, internationalized and easier to use. This paper aims to provide some tips based on this reform to international investors into the Japanese market.

I. Acquisition of Debtor or Debtor's Assets in Insolvency Proceedings

1 § 363-type Transactions

Since before the recent string of changes in insolvency laws, it has been permissible for trustees of the estates and debtors subject to insolvency proceedings to sell the assets of the estates and the debtors in § 363-type transactions, or cancel the existing shares and issue new shares to "sponsors." The sale of the assets was subject to the court's approval, but a longstanding uncertainty was whether the trustees or debtors may sell substantial assets as a going concern. Such sale has been, under the Commercial Code (and Company Code after the recent law reform), subject to the shareholders' approval by the statutorily required majority votes. In 1998, in the substantial corporate reorganization case of Japan Leasing Corporation, the court approved the sale of Japan Leasing Corporation's 10 billion dollar leasing business to General Electric as a going concern without waiting for the creditors' approval of the plan. It was, however, the only precedent where such an attempt was ever approved by the court, and it was still unknown whether the same practice was uniformly permissible and under what conditions.

A debtor exiting from a restructuring insolvency proceeding would generally cancel all of the existing stock and simultaneously issue new shares of stock to a party, which becomes the new owner of the debtor, and has been commonly called the "sponsor." As foreign investors came into the Japanese distressed market since 1997, these proceedings have significantly changed. The foreign investors desired to acquire

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<sup>1</sup> Mr. Hideyuki Sakai is managing partner of Bingham McCutchen Murase, Sakai Mimura Aizawa-Foreign Law Joint Enterprise in Tokyo.

the assets or business quickly, and consequently preferred the sale of assets rather than the traditional channel for exit, i.e., subscription of shares to be issued in accordance with the plan. Further, they preferred the § 363-type purchases before the plans are formulated or confirmed.

Naturally, the distressed market would benefit from certainty as to the permissibility of § 363-type transactions by the trustees and the debtors, which leads to the most favorable offers from the investors/sponsors. A quick exit will also ensure a higher probability of employment protection.

In response to the foregoing, the new laws made it clear that the sale of a business as a going concern, or of substantial assets of the estate/debtor, may be made upon the court's approval, without the shareholders' approval, (i) if the debtor is insolvent and the sale of the assets is necessary for continuation of the business, in the case of a civil rehabilitation proceeding, or (ii) if the sale is necessary for a successful restructuring of the debtor's business, in the case of a corporate reorganization proceeding. Although there are some requirements, such as a hearing from the creditors and the union, and others, § 363-type transactions have become much easier to effectuate and predictable due to the reform.

## 2 Free and Clear Acquisition

In a civil rehabilitation proceeding, the lien holders are NOT stayed, unless an injunction order is issued, from exercising their rights under the lien. As described further in the next paragraph, the new law provides a way for the debtor to eliminate the lien upon its important assets in order to protect the assets. Investors may use this elimination procedure in its purchase of the debtor's assets. To the contrary, in the case of a corporate reorganization proceeding, lien holders having security interests in the debtor's assets are stayed by operation of law. Those secured creditors are paid only in accordance with the plan. The new law, in addition to such protection, provides the trustee with the right to eliminate the lien upon the debtor's assets. The goal of the provision is to enable the trustee to sell the assets free and clear of liens.

In the case of a civil rehabilitation, a debtor may request that the court issue an order to eliminate a lien if the property subject to the lien has vital importance for the continuation of the debtor's business. The debtor should submit the valuation of the property, and if the court is convinced that the proposed amount is fair, it issues the elimination order. The lien holder can appeal the order, and the amount is finally determined by the court. The property becomes free and clear of the lien when the designated amount is deposited with the court, which distributes the proceeds among

the lien holders in accordance with the priorities of their security rights. In the case of a corporate reorganization, elimination of a lien may be approved if the court finds that the proposed elimination is necessary to a successful restructuring of the debtor's business. The court has broad discretion. By employing the steps introduced by the recent reform, investors may now acquire the debtor's assets and properties free and clear of liens even in the absence of the consent by the secured creditors.

### 3 Acquisition of New Stock

As for corporate reorganizations, cancellation of all of the existing stock and subscription for newly issued stock by a sponsor has been the typical structure of a reorganization plan, and both the cancellation and the issuance/allotment of new stock become legally enforceable by providing for this in the plan. As for civil rehabilitations, a shareholders' resolution was necessary for cancellation of stock (in the case of any type of stock company) and issuance of stock (in the case of a debtor with a restriction on the sale of stock) under the Company Code, and accordingly, the plan as approved by the creditors and confirmed by the court was not automatically enforceable unless the shareholders cooperated. This sometimes made the allotment of new shares to a desired sponsor infeasible, because existing shareholders normally do not have any interest in the results of the case insofar as they are not receiving any dividends from the debtor. In order to cure this shortcoming, the Civil Rehabilitation Law, as amended, makes it possible for the debtor to formulate a plan and, upon its confirmation, to cancel the existing shares and to issue and allot new shares to a proposed sponsor. The court can permit a plan with such provisions, only if the debtor is insolvent, and the allotment of new stock is vitally important for the debtor to continue its business. Thus, the scheme of reorganization has become more flexible and investors are given broader alternatives.

### 4 Limitation of Rejection of Executory Contracts and Unexpired Leases

The laws after the reform have made it clear that the landlord or its trustee cannot reject an unexpired lease, if the lease has been registered or otherwise perfected. Licenses of intellectual property rights or other interests are treated in the same way. Investors should, therefore, be aware that (i) in acquiring a debtor as lessor, it cannot reject unprofitable but perfected leases to improve the debtor's business, and that (ii) in acquiring a licensee of unregistrable rights, the license of these rights or interests as copyrights or know-how may be terminated if the licensor undergoes an insolvency proceeding and the trustee or the debtor so elects.

## II. Issues related to Securitizations and Derivatives

### 1 Security Deposits between Landlord and Tenant

Tenants are ordinarily required to make a security deposit with landlords. When the landlord goes into an insolvency proceeding, the tenants' rights to the deposits will be unsecured claims subject to reduction. On the other hand, tenants are obligated to pay rent to the landlord even after the case has commenced. Often in the past, tenants asserted that they should be deemed discharged from their rent obligations as a result of setoff of their rights for the safe return of deposits against the rent obligations, and consequent disputes sometimes occurred, especially between the purchaser of the property and the tenants of the same property.

Under the insolvency laws, as amended, the tenants' rights for the safe return of deposits are granted the same priority as administrative claims up to the amount equivalent to six-months' rent. The rents paid post-commencement are also given the same priority up to six-months' rent. When an investor contemplates to securitize future rents to be generated from a property, the foregoing should be taken into account.

On the other hand, where future rents have been assigned pre-commencement of a case, the insolvency laws acknowledged perfectibility of such assignment but restricted this only up to the rents for the current and immediately subsequent terms. As securitization became popular, such restriction was lifted in recent amendments to the laws.

### 2 Close-out Netting

The uncertainty involved in a netting agreement was cleared by the recent law reform that acknowledged the international standard. Any contract involving transactions of commodities or derivatives with market prices, which are timing-sensitive and, from their nature, the goal of the contract will be destroyed unless settled on the agreed timing or agreed period, is terminated upon the commencement of an insolvency case with regard to a party, without any notice, by operation of law. With respect to the computation of the damage that the termination may cause, the netting clause in the master agreement, if any, shall control.

### 3 Avoidance-Sale of Real Property for Fair Market Value

Japanese courts have created case law that a sale of real property may be voidable as a fraudulent conveyance, even if the sales price was for fair market value, insofar as the transaction took place when the seller was financially in peril. The

underlying rationale of the case law was necessity: it is hard for the trustee, appointed later for the seller upon its bankruptcy, to establish that the sales proceeds were concealed or paid to creditors in a preferential manner, and/or that the purchaser knew such intention of the seller when it purchased the property. However, in some extreme circumstances where such facts are strongly suspected, the court needs to pursue justice by avoiding the sale and purchase transaction to distribute the value of the property in accordance with the legally provided priority. There have been long-standing arguments about the case law but, when at the last moment of the law reform, a forum established for the first time in the history in Japan by bankruptcy practitioners and lawyers/business people within the securitization industry made a joint proposal for the amendment of the law, the proposal was adopted into the final draft bill.

Under the new law, the sale of properties for a fair market price is not voidable, unless (i) the transaction caused real risk of concealment of the sales proceeds or other acts prejudicial to the creditors to arise, (ii) the debtor had the intent to conduct such acts at the time of the sale, and (iii) the purchaser had knowledge of such intent of the debtor at the time of the sale. As a result of the amendment, the risk of avoidance has been substantially decreased in the securitization by an originator in financial difficulty.

#### 4 Contractually Subordinated Loans/Bonds

The new law also adopted the above forum's proposal in respect of the treatment of contractually subordinated loans and bonds. Under the new law, contractually subordinated loans/bonds are treated as such in the insolvency proceedings. Prior to the reform, even if parties agreed to make loans/bonds subordinated to other claims, they were still granted with higher priorities under the insolvency laws than statutory subordinated claims, such as post-petition interest on unsecured claims. Accordingly, parties experienced difficulties in making those loans/bonds truly subordinated in order to help improve the financial index of the borrower/issuer.

### III. Cross-Border Insolvency

Japan adopted the UNCITRAL Model Law on Cross-Border Insolvency in 2000 and put the new law into effect in 2001. Although only two cases have been filed to request recognition of foreign proceedings since then, the law has provided the framework of harmonization of insolvency proceedings in different jurisdictions and close cooperation among the representatives of those different cases. Where there remains any uncertainty about the safety of transactions with a debtor due to

cross-border aspects of the deal, the parties should perhaps think about utilizing the procedures in the 2001 law.

#### Conclusion

The Bankruptcy Law in Japan was enacted in 1922. The enactment of the Corporate Reorganization Law was the latest among all of the insolvency laws in Japan, but it was still back in 1955. In view of the rapid and significant changes in the environment surrounding the insolvency practice, it was absolutely unavoidable, and perhaps too late, for Japan to reform the insolvency regime. Now that the nine year efforts towards such reform have been completed, various tools are ready to be used. It is expected that foreign investment into the Japanese market will be benefited by this modernized legal framework.

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