

Introduction to Japanese Civil Rehabilitation Law

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In April 2000, Civil Rehabilitation Law (*Minji Saisei Hou*, or CRL) came into effect in Japan. Before its enactment, there were three types of reorganization systems in Japan: corporate reorganization (*kaisha kousei*), composition (*wagi*) and corporate arrangement (*kaisha seiri*). CRL was to reform composition by, roughly speaking, providing a speedy and reliable reorganization mechanism. Since its effective date, CRL has been very popular, with more than three times the number of filings than under Composition Law¹. This article is intended to outline the main features of CRL dealing with business debtors².

The Players

CRL, in principle, allows the pre-filing management of a debtor to remain in operation and take carriage of the proceedings, like a debtor-in-possession in a U.S. chapter 11 case. In most cases, the court oversees the case through a court-appointed supervisor³. The supervisor's main roles are (1) to grant or reject certain conduct of the debtor, (2) to investigate the debtor's business operations and/or assets, (3) to exercise avoidance powers, and (4) to supervise implementation of the plan⁴. In some cases, a certified public accountant may be appointed as an investigator to check the accuracy of the debtor's financial information. Creditors' Committee can be organized, but very few have been organized in practice so far⁵.

¹ 906 CRL cases were filed in its first year (April 1, 2000 - March 31, 2001), whereas there were only 231 case composition filings in the previous fiscal year (April 1, 1999 - March 31, 2000).

² At the time of its enactment, CRL was mainly designed for small- and medium- sized business. In April 2001, new provisions regarding rehabilitation of non-business individual debtors were added.

³ Under CRL, Art. 54, § 1, a supervisor is appointed "when the court considers it necessary." In practice so far, the courts have appointed one or more attorneys as supervisors in probably more than 90 percent of all the cases.

⁴ CRL, Art. 54, § 2; Art. 59, Art. 56 and Art. 186, § 2.

⁵ This is probably because Japanese creditors are not used to the adversary system in an insolvency setting, which necessarily calls for additional cost, and they basically rely on the supervision of the court and a third party lawyer/CPA.

In rather rare cases where the old management's misconduct is relatively clear, the court will appoint a trustee. Subject to court's supervision, the trustee is empowered to exercise all of the power and authority of management in place of the old management.

Civil Rehabilitation is usually more speedy than corporate reorganization because the rehabilitation binds only unsecured creditors without priority. Common interest claims, such as post-commencement debts incurred in carrying out debtors' business and/or civil rehabilitation procedure, can be enforced outside the civil rehabilitation procedure. Likewise, priority claims such as tax and employee's salary can also be exercised outside the procedure.

Further, secured creditors are, to the extent that their claims do not exceed the value of the collateral, outside the CRL proceedings in principle. This means that secured creditors are free to foreclose on the collateral in satisfaction of their claims. However, there are two important exceptions. First, the debtor may ask the court to order a temporary injunction against a creditor's foreclosure, if it can show that the injunction will serve the general benefit of the creditors and that the injunction is not likely to cause undue damage to the foreclosing party⁶. Second, the debtor may ask the court to determine the amount of the secured claim and the value of the collateral. The debtor may then pay the determined value of the collateral to the secured creditor, and thereby protect the collateral that is essential for the business from foreclosure⁷. By contrast, the Corporate Reorganization Law prohibits, without exception, foreclosure by secured creditors. In typical cases where the debtor seeks to keep control of secured assets, the debtor tries to (i) enter into agreements with secured creditors by offering the terms not less favorable than foreclosure, or (ii) sell and lease back the assets⁸.

Substantive Concerns

Setoff — A creditor may set off its claim against its obligations to the debtor, unless the creditor's obligation accrued or arose after the commencement order or after the creditor knew that the debtor had generally ceased making payments to its creditors, or unless some other conditions are met. Such "allowed" setoff rights can

⁶ CRL, Art. 31. In practice, the term of such an injunction, when granted, is not long.

⁷ CRL, Arts. 148-153

⁸ Foreclosure of security interest in real property involves auction by the court. Normally it takes about 8-14 months for foreclosure, and sales price is 20% or more lower than market price.

be exercised only until the deadline date for filing proofs of claim⁹.

Avoidance Actions — Under the CRL, the debtor itself may not avoid its own conduct. When a supervisor is appointed, he/she is authorized, to the extent empowered by the court in each case, to avoid certain preferential transactions¹⁰. A trustee, when appointed, always has the avoidance power.

Flow of Procedure

A CRL case is triggered by the filing of a petition. It should be noted, however, that the court strongly encourages pre-filing consultations by the petitioner (usually the debtor) with the court, in order for the court to manage the case smoothly immediately after the filing. A commencement order will normally be issued within a week after the filing¹¹. The automatic stay has not been adopted in Japan, and it is the commencement order that stays pending and future litigation, enforcement and provisional attachments against the debtor. Between the filing and the commencement order, an injunction to stay these proceedings may be ordered by the court.

After the commencement order, creditors file their proofs of claim, and the debtor will either admit or object to them. The debtor then normally submits its rehabilitation plan¹². Under the plan, share redemptions can be carried out without satisfying certain conditions that are otherwise mandatory under the Commercial Code, while the issuance of new shares must follow the provisions of the Commercial Code¹³. The plan must be approved at the creditors' meeting by a majority of the creditors, both in number and in the amount of claims. If the plan is so approved, court confirmation will be given unless (1) the plan is unlikely to be performed, (2) the plan provides for less distribution to creditors than in a bankruptcy (straight liquidation) case, or (3) some other conditions are met. Some of the steps above can be omitted with the approval of three-fifths of creditors in order to speed up the procedures. An insolvent debtor's business may also be sold

⁹ CRL, Arts. 92-93.

¹⁰ CRL, Arts. 127-141. The court may not confer avoidance powers if the court considers, for example, that a speedy reorganization is more important than the exercise of avoidance powers.

¹¹ A commencement order can be obtained on the date of filing in a well prepared case.

¹² A trustee, when appointed, as well as creditors, has the right to file a plan without any significant restriction. CRL, Art. 163.

¹³ CRL, Art. 161, 166. In contrast, corporate reorganization plan may provide for change of articles of incorporation, redemption and issuance of shares, merger and other important corporate actions which otherwise call for special resolution at the shareholders' meeting.

with the court's approval after the commencement order¹⁴.

One of the new features of the CRL that contrasts with the Composition Law is the supervision mechanism provided in connection with the plan implementation. In current practice, where a supervisor is appointed, the court and the supervisor will supervise performance of the rehabilitation plan for three years after confirmation.

As for the time span for CRL proceedings, most courts strictly instructs the debtor that the plan be approved within 5-6 months from the filing, and does not easily grant extensions of the original deadline. The maximum time period for repayments under the plan is 10 years¹⁵.

Provisions regarding Cross-Border Insolvency

Reform under the CRL also includes cross-border insolvency cases. The CRL has abolished the notoriously strict territorialism of Japanese insolvency proceedings. A CRL commencement order is now effective over the debtor's assets regardless of where they are located. Other major reforms are as follows: Foreign trustees (including a U.S. chapter 11 debtor-in-possession (DIP)) are given standing to file Japanese insolvency proceedings and to be heard at the creditors' meeting.¹⁶ Cross-filing of proofs of claim is explicitly allowed. A Japanese trustee (including a DIP) may file proofs of claim with courts in foreign parallel insolvency cases on behalf of the debtor's creditors who filed proofs of claim in Japan, and vice versa for foreign trustees.¹⁷ Foreign trustees may file a rehabilitation plan if the original deadline to file a plan is extended,¹⁸ and the so-called hotch-pot rule has been adopted in international parallel insolvency distributions such that if a creditor is partly repaid from foreign assets of the debtor, the creditor may not receive a distribution in the Japanese case until the other creditors have received the same percentage on their claim that such creditor has received¹⁹.

Conclusion

Among Japanese reorganization mechanisms, the CRL is designed mainly for small- and medium-sized business, while the corporate reorganization procedure

¹⁴ CRL, Art. 42-43. Note that sale of business may be done at any time after the commencement order.

¹⁵ CRL, Art. 155, § 2.

¹⁶ CRL, Art. 198, § § 1 and 2.

¹⁷ CRL, Art. 199.

¹⁸ CRL, Art. 198, § 3.

¹⁹ CRL, Art. 89.

is for larger corporations. This is because (1) foreclosure of collateral is much more freely granted under the CRL than under the corporate reorganization procedure, and (2) the issuance of new shares can be carried out under a corporate reorganization plan, but not under a civil rehabilitation plan. However, the swiftness and flexibility of the civil rehabilitation process is sometimes attractive even to large corporations, and most practitioners believe that the civil rehabilitation procedure will be used regardless of the size of the debtor and whether or not the case involves cross-border concerns.

The first version of this paper titled "The New Japanese Reorganization Procedures" appeared in ABI Journal, October 2001, and has been updated by the author on this site²⁰. Uploaded with permission from the American Bankruptcy Institute. For regular updates of bankruptcy legislative activity and other insolvency news, as well as ABI membership information, visit ABI World at www.abiworld.org²¹.

²⁰ The last update was made in March 2003.

²¹ In case you need to quote, please indicate the source of the original as ABI Journal October 2001.