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# Can Change in Japanese Reorganization Law Save Distressed Shipping Companies?

## - Some Issues on Japanese Reorganization Law -

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Ladies and gentlemen,

My name is Takayuki Matsui, a shipping partner of Max Law Office in Tokyo. One of the specialties of our office is maritime insolvency. We have been deeply involved in many shipping insolvency cases in Japan and other forums. We have handled cases involving Progress Group (Denmark), Atlas Shipping (Denmark), Korea Line Corporation (Korea), East Wind (New York) and Dorval Shipping (Japan) amongst others.

Today I would like to give a speech on several important topics on Japanese reorganization law.

**(Territoriality Rule)**

After World War II, reflecting a strong American influence, we had a great deal of legal reform. We changed our constitution. We changed our family law. Such law reform also had an important impact on insolvency regulation in Japan. In 1952 a new Corporate Reorganization Law was enacted based on the concept of the American Chapter 11.

The reorganization procedures under the Corporate Reorganization Law are very similar to Chapter 11 in U.S.A. The most salient feature of the Corporate Reorganization Law is that secured creditors such as mortgagees or lien holders shall be fully subject to the plan. Therefore once the court order is given to commence reorganization proceedings under Corporate Reorganization Law any mortgagee or lien holder is prohibited to exercise a mortgage or a lien outside the reorganization proceedings. It is similar to the "Automatic Stay" in the U.S.A.

However, unlike Chapter 11 in the U.S.A, our reorganization proceedings had a unique provision. It is called the "Territoriality Rule".

The 1952 Corporate Reorganization Law adopted the principle of territoriality, which is expressed in Article 4, providing that "A Corporate Reorganization adopted in Japan shall be effective only with respect to the corporation's properties which exist in Japan".

This Territoriality Rule was a source of trouble in international insolvency. Corporate reorganization requires that the administrator is able to manage the business by using all of the assets domestic and foreign alike. If assets outside Japan are immune, the purpose of reorganization would be frustrated. Reorganization of a shipping business, in particular, would become almost impossible.

**("Kosei Maru" case in Canadian Court)**

This Japanese Territoriality Rule was tested in the Canadian Court in 1978. A Japanese shipping company commenced a corporate reorganization procedure in Kobe District Court while its ships continued in service abroad. When one of the ships called at the Canadian port of Hamilton, a Japanese mortgagee arrested it to enforce the mortgage through the Canadian juridical process. The administrator in reorganization filed an objection in the Canadian court arguing that such arrest was not permitted under Japanese law. After lengthy litigation in Montreal the Canadian Federal Court upheld the validity of the attachment by rejecting the objection from the Japanese administrator.

This case attracted much attention and created the concern amongst international insolvency practitioners and scholars in Japan.

Thereafter several challenges were made to overcome this Territoriality Rule.

In 1985 the Sanko Line filed a corporate reorganization procedure in the Japanese court. In 1986 however the Sanko Line also filed under Article 304 (now Chapter 15) to avoid arrests of ships in the U.S.A.

In 1991 Maruko, an international real estate company in Japan, commenced corporate reorganization procedure in the Japanese court. But at the same time the debtor filed Chapter 11 in America.

**(Change of the Corporate Reorganization Law and abolishment of Territoriality Rule)**

In 2001 our Corporate Reorganization Law was drastically amended and the new Corporate Reorganization Law abolished Article 4 which was basis of the Territoriality Rule. In addition the new Corporate Reorganization Law provides that the administrator has rights over the assets of the debtor (whether or not the assets are in Japan or outside Japan).

Generally it is said that this amendment abolished the Territoriality Rule and extended the power of the Japanese bankruptcy court to include foreign assets of the debtor. It is also generally said that the assets of the debtor outside Japan shall be subject to Japanese Reorganization Proceedings, like the automatic stay in U.S.A.

If this general understanding is correct, any mortgagee or lien holder of the debtor's assets may not arrest any ship of the debtor anywhere in the world once commencement of corporate rehabilitation is ordered by the Japanese bankruptcy court.

Is this true? I have strong doubts about it.

A Japanese Corporate Reorganization procedure is nothing but one sort of execution, which is an exercise of the sovereign power. It is common principle that the effect of a Japanese Reorganization procedure is limited to national boundaries. This is a fundamental principle of Japanese law and I doubt if just amendment of the provision of the Territoriality Rule can change this fundamental principle.

The practice which I have seen in the Japan Air Line case and the Taisei Fire & Marine Insurance Co., Ltd strengthens my doubts.

In 2010 Japan Air Line, "JAL", started Japanese Corporate Reorganization procedure in the Tokyo District Court. But after commencement of Japanese Corporate Reorganization procedures, Japan Air Line also filed under Chapter 15 in NY after getting approval from the Japanese Bankruptcy court.

I cannot understand why JAL had to file the Chapter 15 in NY if any assets of JAL abroad were subject to Japanese Reorganization law. If the assets of JAL abroad were subject to Japanese Corporate Reorganization Law automatically, they did not need the Chapter 15 in theory.

It is the same in the case of Taisei Fire & Marine Insurance Co., Ltd. In this case Taisei Fire & Marine Insurance Co., Ltd commenced Japanese Corporate Reorganization procedure in Tokyo District Court. But this debtor also filed provisional liquidation procedure in England.

Even after the amendment of the law and the abolition of the Territoriality Rule, it appears that as a matter of practice we require help from a foreign bankruptcy court to overcome the Territoriality Rule which should have already been abolished.

Therefore I am of the view that it is very doubtful if a mortgagee or lien holder may be prohibited from exercising a mortgage and a lien outside Japan in case of the commencement of Corporate Reorganization procedures in Japanese court.

It is my view that a foreign mortgagee or lien holder can arrest a ship of the debtor outside Japan to enforce a mortgage or lien disregarding the Japanese procedures unless such debtor takes some special protection step in the foreign jurisdiction like Chapter 15 procedures in NY.

**(Charter Party and Japanese Corporate Reorganization proceedings)**

Briefly I would like to add one most typical issues which you will see in the event of insolvency of a shipping company. It is an issue on termination of charter parties after commencement of corporate reorganization proceedings in Japanese court. I would like to discuss the issues arising where a charterer under a charter party contract commences corporate reorganization proceedings in Japanese court.

"Under our law a charter party is an executory contract, meaning that a failure by one party to observe its unperformed obligations would constitute a material breach excusing performance of the other."

An administrator of the debtor appointed by the court is given an unspecified period to choose to continue its charter party or reject it.

An administrator of a debtor is required to make contractual payments for post-filing performance. Accordingly, to the extent not paid, these amounts are called "administrative" claims - defined as "the costs for benefit of all creditors". Administrative claims are the highest priority claims in terms of payment from the debtor's estate. So if the estate is "administratively solvent" then the owner should be paid its charter hire earned until the charter is "rejected" by the debtor/charterer.

If the debtor-charterer fails to pay post-filing hires then it is in breach of the charter and the right to cancel arises post-commencement of reorganization proceedings. A notice of cancellation for non-payment of charter hire can be provided to the administrator in advance as per charter party or any applicable law.

As I said the administrator of the debtor has a reasonable period to assume or reject executory contracts after filing the corporate reorganization.

If a contract is "assumed" then all pre-commencement of reorganization proceedings defaults (*i.e.* non-payment of hire) have to be "cured" (paid). If the debtor then breaches or terminates the assumed contract, the owner's claim for damages is given administrative status.

In contrast, if the debtor continues to pay post-commencement of reorganization proceedings and then decides to "reject" before the charter expires, such damages are "unsecured" and treated as pre-commencement of reorganization proceedings claims - which are a much lower priority in terms of payment.

**(Other Insolvency Procedures)**

The Corporate Reorganization is for a big company. JAL (2010), Sanko Line (in 1985), Kanasashi Heavy Industries (2010) took the procedures.

We have another law for rehabilitation. It is "Civil Rehabilitation Procedures". This is for small and medium sized companies. Recently Tokai Shipping and Dorval Shipping took this procedure. This procedure also came from Chapter 11. However, unlike Chapter 11 and Japanese Reorganization procedures, a secured creditor such as a mortgagee and lien holder is not subject to the procedures and they can enforce their mortgage or lien regardless of the procedure.

We have the same system as Chapter 7 in U.S.A. This is called "Bankruptcy procedures". This is not for rehabilitation. This is just for liquidation. The trustee appointed by the court just sells all assets of the debtor and pays dividends to the creditors basically on pro rata basis.

The Sanko Line took the ADR procedures recently. This is not an insolvency procedure in the court. It is mediation between the debtor and financiers in Japan. A special non-profit organization (Japanese Association of Turnaround Professionals; JATP) coordinates the mediation procedures in place of the court. The JATP shall appoint an insolvency practitioner and he becomes a mediator between the debtor and the financiers in the ADR procedures. The procedures have the nature of a voluntary arrangement with the financiers in Japan out of the court. However once the debtor starts these ADR procedures, the debtor is given special moratorium time during the ADR procedures period and the financiers may not exercise their rights (such as enforcement of mortgages) during the mediation period due to special ADR law. This is like the Automatic Stay in Chapter 11 to some extent. But this stay is very limited and any other creditors (outside the ADR) are not influenced by the ADR at all. We note that the M/V "Sanko Mineral" owned by the Sanko Line was recently arrested by some foreign shipowners in U.S.A. Such arrest is not unlawful under the ADR procedures. The ADR procedures have no power to stop such arrests. All financiers under the ADR procedures shall approve the plan for rehabilitation. If one of the financiers disagree to the plan, the debtor has no alternative but to taking the debtor into the insolvency procedures in the court.

I have explained only a few issues of Japanese Insolvency law. But I would be pleased if this article could assist your understanding of our law to some extent.

Thank you very much.