Asia Pacific Guide to Lending and Taking Security - Japan

If things go wrong

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# 1. Please provide a brief description of the insolvency regime. In particular what rights and duties do unsecured and secured lenders have on the insolvency of a debtor? Are there any other matters of concern?

There are several types of insolvency proceedings in Japan and they are either of a statutory nature or a voluntary nature.

**Statutory proceedings**

Statutory proceedings are either:

Winding-up proceedings:

Due to bankruptcy

By way of a special liquidation

Restructuring proceedings by way of:

Corporate reorganization

Civil rehabilitation

Please note that special liquidation and corporate reorganization are only available to stock companies (*Kabushiki Kaisha*). A stock company is a legal entity incorporated to carry out business and raise funds by issuing shares/stock.

Once statutory insolvency proceedings commence, unsecured creditors are not permitted to enforce against, or take security over, property that belongs to the insolvent debtor. In contrast, secured creditors are permitted to enforce their collateral outside those proceedings, except in the case of a corporate reorganization. In the case of a corporate reorganization, the enforcement of security can be restricted by the court (similar to an "automatic stay" under Chapter 11 of the Federal Bankruptcy Act in the US).

However, note that in relation to bankruptcy, corporate reorganization and civil rehabilitation, the debtor may file a petition with the court to seek permission to extinguish a security interest by allowing the debtor (or a trustee) to pay the amount that is equivalent to the value of the collateral. The court is likely to grant permission in particular circumstances. For example, in a bankruptcy situation, where the court finds that it is in the common interest of creditors or in the case of a corporate reorganization or a civil rehabilitation, where the court finds that the collateral is indispensable for the debtor's business. This may affect the lender's right to enforce the collateral at its discretion.

In addition, creditors (including secured creditors) may be subject to interim injunctions (see the answer to question 2 of this section).

**Voluntary proceedings**

There are several out-of-court processes. One of the most well-used processes is the "Guidelines for the Out-of-Court Workout," in which the debtor's bank makes a reorganization plan. A corporate debtor can also approach a support organization established by the government and banks such as the Resolution and Collection Corporation.

Voluntary insolvency proceedings are based mainly on agreements between the parties and do not bind creditors in the same way as statutory proceedings.

# 2. Is it possible to obtain a moratorium before insolvency?

Yes, the courts customarily issue stay orders during the period from the filing of the insolvency petition to the issue of the decree to commence insolvency proceedings. In insolvency proceedings, the courts may issue various orders including interim injunctions to preserve the assets, a cease and desist order to stop any enforcement and a comprehensive prohibition order that prohibits the creditors from pursuing pre-injunction claims.

# 3. When a company is the subject of a formal insolvency procedure, can the company’s pre-insolvency transactions be set aside?

If a transaction is deemed to be a preference transaction (e.g., where one or more creditors received a non-pro rata payment from the borrower when those creditors were aware that the borrower was unable to pay its debts as they fell due), the transaction may be voided (and the amount of the payment may be clawed back).

# 4. When can a lender enforce its security? Can security be enforced out of court following an event of default (or other contractual trigger event), or is a court order required? Are there any restrictions that apply before a lender may enforce its security?

A lender can enforce its security out of court by completing certain steps if an obligor has not performed its obligations by the due date (either the original due date or an accelerated due date).

A lender can exercise its rights by disposing of the collateral, through a court auction or by voluntary sale, subject to certain restrictions (see the answers to questions 1 and 2 of this section).

Court proceedings are not a popular method for the enforcement of security as they generally take six to 12 months to complete and usually result in large discounts. Importantly, court proceedings are not appropriate where a lender requires some measure of control over who acquires the secured assets. Furthermore, court auction bids must be denominated in Japanese yen. Voluntary sales, on the other hand, may be denominated in currencies other than Japanese yen.

# 5. Do any limitation periods apply in relation to bringing an action to enforce security?

No.

# 6. Is there any particular way in which secured assets must be liquidated on enforcement (e.g., by auction or court sale)?

Please see the answer to question 4 of this section.

# 7. Are there any particular legal or practical difficulties or delays in enforcing security?

Please see the answers to questions 1 and 2 of this section for the restrictions in the case of insolvency proceedings. Please see the answer to question 4 of this section for the downside of court sales.

# 8. In relation to enforcement, are there any specific requirements to be borne in mind if the lender is a foreign entity?

No. However, where the security is located in Japan, the governing law in relation to a right to the security, including in relation to creation, perfection and execution of the security, is Japanese law, irrespective of its wording, under Act No. 78 of 2006, as amended ("**Act on General Rules for Application**").

# 9. Is there any reason why you think that arbitration rather than litigation might be advantageous in resolving disputes under the finance documents, and if so, why? Please outline the relative merits of arbitration and litigation, including the ease of enforcement of foreign judgments and foreign awards from different jurisdictions. Is it possible to rely on a hybrid enforcement provision that allows the lenders to opt for either arbitration or litigation as they see fit?

Arbitration has both benefits and drawbacks when compared to litigation.

Japan is a member of the New York Convention and has a sophisticated arbitration law (Act No. 138 of 2003) based on the UNCITRAL Model Act on International Commercial Arbitration. Therefore, it can generally be said that a foreign arbitration award is easier to enforce in Japan than a foreign judgment because the enforcement of a foreign judgment is subject to several conditions including reciprocity, as provided under the Code of Civil Procedure (Act No. 109 of 2006).

There are several other benefits of arbitration including confidentiality and flexibility.

Generally, arbitral proceedings are confidential by default and so they are very suitable for highly sensitive matters. Parties are free to select the arbitrator (for example, an arbitrator with specific skills) and the language of the proceedings, whereas in litigation, cases are randomly assigned to judges within a district (with some exceptions) and all hearings must be in Japanese.

However, there are some drawbacks in relation to arbitration. Arbitration procedures do not permit an appeal to be lodged. Therefore, even if the result of an arbitration or an arbitration award is not satisfactory to a party, it cannot file an appeal against the result or an objection against the arbitration award.

In addition, sometimes arbitration awards may be unreasonably complicated whereas the lenders may expect a simple decision to order the obligor to pay the amount owed.

Although still not very common in the domestic market, a hybrid enforcement provision could be recognized as valid because the principle of party autonomy is generally upheld under Japanese law. However, note that the enforceability of an agreement (including an arbitration clause) is generally subject to the determination of the courts of Japan, which must consider the good order and moral doctrine, the abuse of rights doctrine and Japanese public policy. There is little guidance in Japanese law or reported decisions of the Japanese courts that assists in determining the scope of these concepts, especially in connection with the hybrid enforcement provision.

# 10. Are asymmetrical jurisdiction clauses enforceable? (By this we mean clauses that allow the lenders, but not the borrowers, to make certain choices in relation to choice of jurisdiction and how to litigate. These types of clauses allow the lenders, but not the borrowers, to commence proceedings in any court they choose, but restrict the borrowers to commencing proceedings in one jurisdiction only. This may also allow the lenders, but not the borrowers, to choose whether to litigate the finance documents before a court or to submit to arbitration in relation to them, but restrict the borrowers to either litigation or arbitration, as specified in the agreement).

There is no judicial view in relation to whether asymmetrical jurisdiction clauses are valid in Japan. Therefore there are risks that an asymmetrical jurisdiction clause may be considered void if it is found contrary to Japanese morality or public policy.

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