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Old and new issues in cross-border insolvency proceedings in Japan

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The subject matter of this report concerns a group of cases before Tokyo District Court ("United Ocean Case"), involving various entities either as debtor or non-debtor in Singapore, Panama and the British Virgin Islands, in ship owning and maritime transport business, together with their 100% controlling individual shareholder.[1] The individual debtor involved in this cross-border insolvency is a national of the Republic of India, who has places of living in Singapore and in Japan ("Individual Debtor").

The individual debtor embarked upon his ship owning business in or around August 1998, and over some 17 years of endeavours in the business had come to own a group of companies owning vessels for chartering in maritime transport ("Individual Debtor").

These group companies are organised as follows:

1. one Japanese company engaged in transaction facility services by providing offices and secretarial services for loan transactions, loan repayments, ship building contracts, and chartering agreement ("Japan Company");
2. one Singapore company engaged in operating all vessels including navigating and manning services and providing all provisions for sea transport business for the group vessels ("Vessel Operating Company");
3. one British Virgin Islands financing company engaged in cash holding ("BVI Financing Company");
4. one Indian company supplying workers to the Vessel Operating Company; and
5. 40 vessel owner companies established in Singapore and Panama ("Vessel Owner Companies), such Vessel Owner Companies are each organised as single asset entities owning one vessel registered in their incorporation territory, and owing money liabilities to one lending bank and owing fees and expenses to the Vessel Operating Company.[2]

These Vessel Owner Companies were financed in their ship building contracts with Japanese builders by Japanese mega banks ("Lender Banks"). Each of the Lender Banks separately and exclusively made a loan to each of the Vessel Owner Companies. The delivery of the loan proceeds and repayment were made through a bank account held with the Lender Banks.

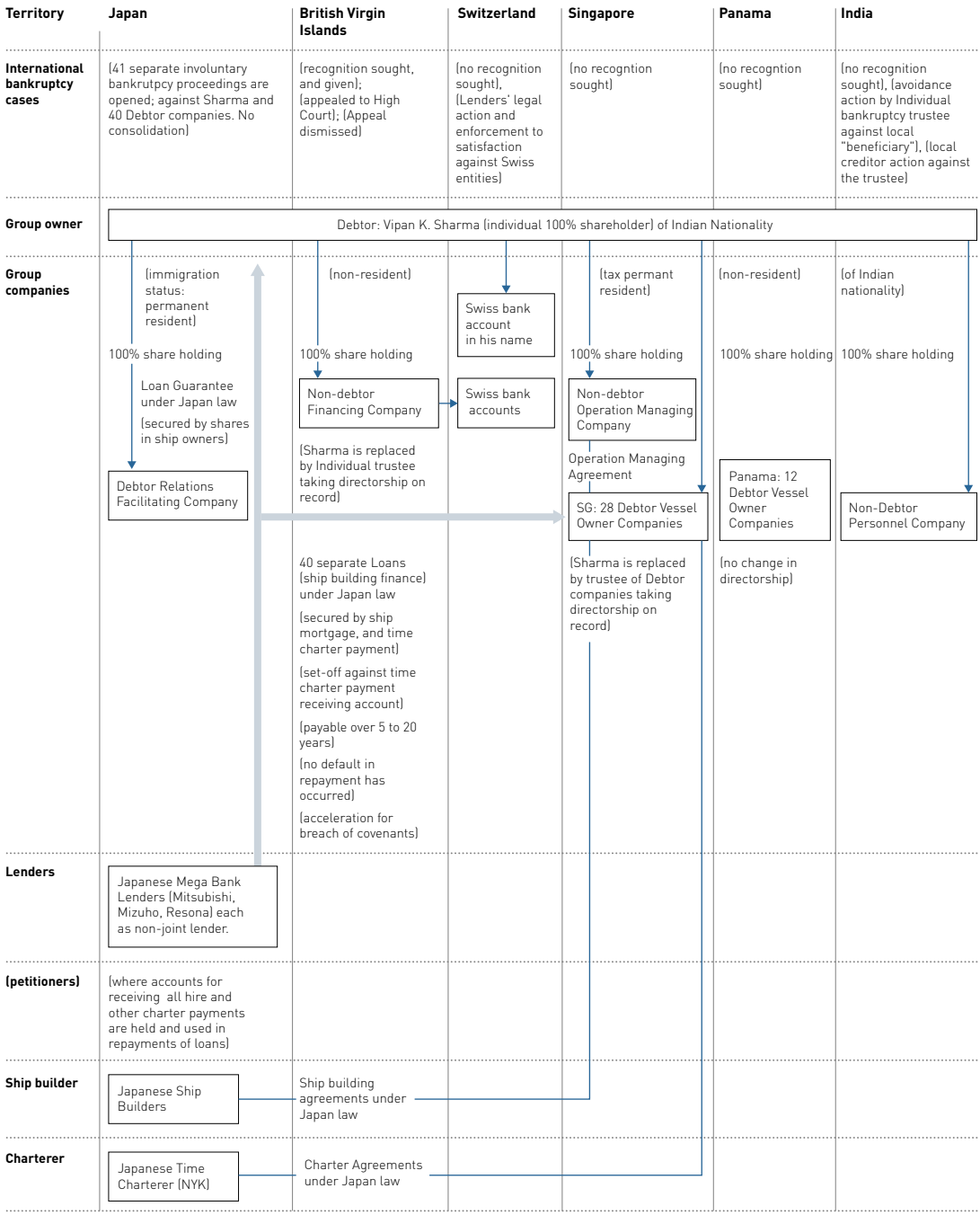
The Vessel Owner Companies each entered into time charter agreements solely with one leading Japanese logistics enterprise transacting worldwide on various forms of marine transport ("Time Charterer"). The terms of these time chartering agreements, though, were never fully negotiated or agreed, or executed, before the closing date on the loans from the Lender Banks. The execution of time chartering agreements usually took place post-closing. Lender Banks respectively secured their loan repayment rights by a mortgage in the vessel, a charge in the Vessel Owner Company, and a security interest in the time charter agreement.

Additionally, the lead bank ("Lead Bank") alone among the Lender Banks, obtained a personal guarantee of the Individual Debtor on all its bank debts. This personal guarantee was secured by a security interest, i.e. a pledge, in all of the shares held by the Individual Debtor in respective debtor Vessel Owner Companies. Any shares in the Non-Debtor Companies, such as Vessel Operating Company, and BVI Financing Company, were free of pledge. There were given no cross-guarantees among the Vessel Owner Companies to the Bank Lenders.

The relevant key terms in the uniform loan agreements are those provisions setting forth:

1. conditions precedent that the borrower furnish a drawdown notice before closing, and a time charter agreement on closing;

Figure 1: Parties and transactions among or with bankruptcy debtor group entities



2. covenants that the borrower keep unchanged during the life of the loan the specific charter terms as provided in the loan agreement; and
3. acceleration of repayments, either automatically or upon advance notice, depending upon the nature of the breach in question.

In reality, with regard to the key term (1), the borrowers did not in most cases provide the drawdown notice as required, and the borrower did not provide in any case a copy of the executed time charter agreement on the closing, namely the Lender Banks all waived the condition precedent and supplied the loan funds on the closing date; with the key term (2), the time charter agreements were executed subsequent to the closing date, but some deviated from the loan agreements, more favourable or less favourable, but the borrowers delivered a copy counterfeit bearing

the untrue and should-be terms, after repeated requests by the Lender Banks. However, it was fiercely disputed whether the Lender Banks were aware or should have been aware of such deviation, or even the counterfeit nature of the submitted copy charter agreements, around the presumption affecting knowledge arising from the fact that the borrowers' account with the Lender Banks showed each monthly in-coming hires.

With regard to key term (3) (acceleration), in reality, (a) the borrowers have been meeting their repayment obligations fully and timely on principal or interest, and hence no default; and (b) no bankruptcy event has occurred; but (c) the Lender Banks, based upon their theory of breach of covenant of the charter term, and the act of counterfeiting, rather elected to take immediate acceleration by notice on November 10, 2015 ("Acceleration Notice"), rather than seeking rectification, of which the validity came to be fiercely disputed.

The bird's eye description of the foregoing factual statement concerning the United Ocean Case is reproduced in Figure 1.

Involuntary petitions

Involuntary petition is provided equally in Japan's three independent bankruptcy laws, Bankruptcy Law,[3] Corporate Reorganization Law[4] and Civil Rehabilitation Law.[5]

Under the Bankruptcy Law, an involuntary petition (for straight bankruptcy) to a division of the court is permissible by only one creditor, even fully secured (but with a split in opinions), when his claim is proven, and where the debtor is insolvent, or has ceased payment, or in case of a corporate debtor, if it has more debts than assets ("Grounds for Bankruptcy Petition").[6]

Under the Corporate Reorganization Law, an involuntary petition (for corporate reorganisation) to another division of the court is permissible by only one creditor, having a claim in the amount of one-tenth or more of the debtor's paid-in capital, even fully secured (but with a split in opinions), when his claim is proven, and where the existence of the Grounds for Bankruptcy Petition as to the debtor is proven or suspected to exist.[7] However, the filing of an involuntary petition does not commence a bankruptcy or corporate reorganisation proceeding. A separate formal adjudication by the court ordering commencement of the proceeding is required.[8] But, at the same time, an involuntary petition does not secure the debtor rights of his continuing control of assets or business. Before a formal adjudication of commencement, the court in which the involuntary petition is pending may issue several provisional orders.

In case of straight bankruptcy, the court may order provisional orders staying, specifically or generally, creditor actions, including execution on judgement, garnishments or attachments, on-going litigation, and generally tax enforcement, and prohibiting the debtor from disposing of his assets.[9] In case of corporate reorganisation, stay orders may expand further to order against pending straight bankruptcy proceedings, enforcement of security interest, and specific tax enforcement, all in addition to the broad stay orders against non-secured creditor actions.[10]

Further, in a harsh and drastic action, the court may order preservative management order replacing the existing management with a court appointed preservative trustee.[11] The preservative order replacing the existing management is critical and can cause devastating effects that are irreparable, if made. This devastation completes nominally when the court issues commencement order.

Remedies lender banks petitioned for and responsive orders of the court

The Lender Banks simultaneously but separately filed an involuntary reorganisation bankruptcy petition against each of the 40 Vessel Owner Companies and the Japanese Company with the Tokyo District Court, Civil Division No.8, on November 10, 2015. The following day, November 11, 2015, the Lead Bank filed an involuntary liquidation bankruptcy petition for straight bankruptcy against the Individual Debtor with the Tokyo District Court, Civil Division No. 20. The theory employed is simple: because of the acceleration, all debtors, whether principal or secondary are insolvent.

On November 11, 2015, the day after the filing date, without any notice to the Vessel Owner Companies, the Japanese Company, or the Individual Debtor, both Divisions issued

bankruptcy preservative orders against the debtors, containing those provisions aforesaid. These orders combined to expel the Individual Debtor on November 11, 2015 from his group enterprise, namely, the management of the Vessel Owner Companies and the Japanese Company, and of his own property, including, most importantly, his shares in his group companies.

The enforcement process involved other elements as follows: the preservative trustee in reorganisation on November 11, 2015, came to be appointed as director of the Vessel Owner Companies replacing the Individual Debtor by enforcement of the Lead Bank's security interest in the shares; it is known and undisputed that the nominee shareholder entity for the Lead Bank entered into a contract in writing with the preservative trustee for reimbursement of costs in acting as the nominee shareholder; and the preservative trustee appeared surprisingly in person in Singapore to demonstrate his control as director of the Vessel Owner Companies on the very same date of November 11, 2015, and as such ordained there to indirectly control the affairs of the non-debtor Vessel Operating Company.

The power change in the management of the Vessel Operating Company took on an additional layer when the bankruptcy trustee for the Individual Debtor exercised trustee's power to vote on shares and appointed himself as its director.

Similar power change was effected as to the BVI Financing Company when the bankruptcy trustee became director on April 1, 2016 to expel the Individual Debtor. This action of expulsion in BVI took place before the bankruptcy of the Individual Debtor was recognised in BVI on May 26, 2016, subject to appeal and stay for lack of due notice, though this appeal was later dismissed.

Also, as can be easily speculated, one will understand that each involuntary petition in this case was preceded by an informal customary counselling off record with the court. In any event, the commencement order in the involuntary reorganisation was issued on December 31, 2015, and in the involuntary straight bankruptcy on January 4, 2016. All these preservative orders and commencement orders survived the appeals to the High Court and the Supreme Court by the Vessel Owner Companies and the Individual Debtor.

Post commencement issues

First, the court in its commencement orders did not take time to differentiate their proceedings between main or non-main even though their cases involved abundant international elements. Since the Japanese Law on Recognition and Assistance to Foreign International Insolvency,[12] enacted following the principles of UNCITRAL Model Law, does differentiate main from non-main proceedings, the court should have been better advised to identify whether it acted in main or non-main proceedings. Such intended differentiation would have been helpful to foreign countries.

Second, the salient point of interest is that the reorganisation trustee for the Vessel Owner Companies never filed an application for recognition in any foreign jurisdiction, including Singapore and Panama, and yet he acquiesced in becoming director of the Vessel Owner Companies. Likewise, the straight bankruptcy trustee did not file an application for recognition in Singapore and Panama. And yet, the straight bankruptcy trustee, by exercising the voting rights in the shares in the non-debtor Vessel Operating Company (incorporated in Singapore) and in the non-debtor BVI Finance Company (incorporated in BVI), was appointed as director and managed and controlled these entities.

He had not filed an application for recognition in India, nor in Switzerland where the Individual Debtor kept a bank account in his name with the Lead Bank's affiliate, and where the bank's main office was located with whose Singapore branch the BVI Finance Company had an account. The only exception is the straight bankruptcy trustee's subsequent filing for recognition in BVI (and in Hong Kong where no known assets are located).[13]

Third, the Lender Banks initiated, after the commencement of straight bankruptcy of the Individual Debtor, several debt collection procedures in Switzerland against all the bank accounts aforesaid, going after not only the Individual Debtor's named personal account, but also the BVI Finance Company's account, claiming the latter account is just part of the Individual Debtor's property because the BVI Finance Company is owned 100% by him, not necessarily arguing the application of the alter-ego theory.[14]

The Individual Debtor disputed these procedures by asserting automatic stay of such post-bankruptcy creditor actions against the Individual Debtor because of the worldwide effect of the Japanese bankruptcy,[15] emphatically more so where the acting creditors in Switzerland are Japanese creditors.

The bankruptcy trustee, while aware of these procedures, took no action to carry into effect the automatic stay there, and even consented to the Lender Banks' actions by agreeing to some sharing of the proceeds of such actions. The Individual Debtor, after some objection, decided for insufficient funds to give up this Swiss battle.

In lieu of the Swiss battle, he filed an action in Japan to seek an injunctive judgement against the Lender Banks prohibiting them from pursuing the creditor action in Switzerland.[16] Naturally, the Swiss collection proceedings kept going in the absence of the Individual Debtor's opposition there, and the Lender Banks successfully obtained a money judgement and enforced on it to their satisfaction.

The Japanese court dismissed the Individual Debtor's injunction complaint, simply saying the bankruptcy debtor has no right to seek such an injunction. The Individual Debtor filed a plenary action post-bankruptcy for damages against the Lead Bank, alleging the filing of both the involuntary petitions were tortious, in breach of good faith, and fraudulent, arguing in essence that the alleged acceleration was unlawful.[17] The court here did not agree with the defendant as to *res judicata,* but dismissed the claim reasoning the acceleration was justifiable under all circumstances.

Fourth, it is theoretically of particular attention that all Lender Banks and courts concerned here take an approach that where a debtor in bankruptcy owns 100% shares in a corporation, then the debtor's bankruptcy trustee may merely thereby exercise direct control and dominance of each asset of the issuer corporation, i.e. reverse corporate veil piercing, without a separate intervention of a new bankruptcy for the issuer or its liquidation, and perhaps disregarding the elements of the alter ego.

Fifth, the bankruptcy trustee of the Individual Debtor filed several plenary actions of avoidance in India where he has not filed application for recognition by resorting to the Japanese Bankruptcy Law. Avoidance action in an international bankruptcy context has been and is still a big item to be researched and studied. Here, it seems that without prior recognition, such a claim may not stand *per se*.

Accounting and tax issues

The Individual Debtor's estate has been threatened by the Japanese tax authorities with suspected tax evasion of Japanese Income Tax for undistributed company income of the group companies withheld, which if proven would exceed ¥50bn. Most of such income was related to these companies' accounting practice in US dollars of their corporate affairs including their Japanese yen loans in particular from the Lender Banks, and emerged as the deemed exchange valuation income for exchange rate fluctuation.

This threat was critical because such tax claims enjoy super priority as administrative claims or priority as preferred claims. Not much objection was raised except residency issue for the Individual Debtor. But, new arguments were presented that (1) if these companies' location of the centre of main interests for purposes of international insolvency are in Japan, then the formal accounting currency would be Japanese yen, producing no exchange income or loss; (2) the company reorganisation trustee prepared all financial papers required under the Reorganization Law in Japanese yen currency, which formed the basis of the plan; and (3) these companies engaged in crucial positive activities in Japan such as ship building, financing, and time chartering contracts, which would recognise their permanent establishment here, and their possible income Japan sourced, thus subjecting these companies directly to Japan foreign company taxation rules under the Corporate Tax Law, without resorting to Japanese BEPS measures.[18]

These new voices persuaded the tax authorities to release the bankruptcy estate of huge tax liabilities. Similar accounting and tax issues may arise in other jurisdictions, and the United Ocean Case could present some solution.

Wrap Up

The United Ocean Case has given rise to old issues, such as notice and ex-parte issues,

and new issues, discussed above.[19] It is a fair statement that Japan has not seriously, or at most insufficiently, tackled these old issues, whereupon this agony of new issues has befallen. Whether lawyers here by learning more can bring themselves to a new norm and practice is to be seen.

Notes:

* The author represented and represents the debtors in the involuntary bankruptcy proceedings that are made the subject of this report. The author has tried to be objective in making factual statements. The author has refrained from expressing the author's personal legal opinion without referring to different or confronting views or practice, if any. Failure to comply with these self-ordained rules is the author's responsibility.

1 Tokyo District Court, Case No. (hu) 9711 of 2015; Tokyo District Court, Cases No. (mi) 3 through 41 of 2015.

2 The following is a short list of several of these Vessel Owner Companies totalling 40 or more in number: Rams Wood Chip Carrier S.A., Rams Shipping S.A., Rams Challenge Shipping Pte. Ltd, Rams (PCTC) Pte. Ltd., United (PCTC) Pte. Ltd., etc.; as non-debtors, United Ocean Ship Management (SG) Pte.,Ltd, and United Ocean Ship Management (BVI) Limited.

3 Law No.75 of 2004.

4 Law No.154 of 2002.

5 Law No.225 of 1999.

6 Bankruptcy Law sections 15, 16 and 18.

7 Corporate Reorganization Law section 17.

8 Bankruptcy Law section 30, Corporate Reorganization Law section 41.

9 Bankruptcy Law sections 24, 25, and 28.

10 Corporate Reorganization Law sections 24, 25, and 28.

11 Bankruptcy Law section 91, Corporate Reorganization Law section 30.

12 Law No.129 of 2000.

13 Claim No. BVIHC (COM), 62 of 2016, In the matter of part XIX of the Insolvency Act of 2003, and In the matter of Sharma Vipan Kumar (a bankrupt).

14 For example, initial action of sequestration order by the Geneva Debt Enforcement Office in case 15 070 553 N, dated December 4, 2015.

15 Bankruptcy Law sections 34 and 42.

16 Vipan Kumar Sharma v. Mitsubishi UFJ *et al.*, Tokyo District Court Case No. (wa) 21431 of 2017.

17 Vipan Kumar Sharma v. Mitsubishi UFJ, Tokyo District Court Case No. (wa) 10271 of 2016.

18 The new argument was obviously offered by the Individual Debtor.

19 The pattern emerged in the United Ocean Case, formulating the lack of notice, the lack of recognition, the taking of direct foreign directorship, and the reverse corporate veil piercing would be remembered as "United Ocean Great Shortcuts."

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