

Insolvency & Restructuring - Japan

Supreme Court rules on rights of retention

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Summary

On December 15 2011 the Supreme Court ruled on the actions that a bank may take where it has both a claim against a company and a right of retention with regard to the company under the Commercial Code over a promissory note that the company has entrusted to the bank to collect. In such circumstances the bank may collect the promissory note and then allocate the collected cash for payment of the company's debt pursuant to a banking agreement, even after an order has been issued for the commencement of civil rehabilitation proceedings in respect of the company. This ruling was the first in which the Supreme Court explained the function of a right of retention under the Commercial Code over things belonging to a debtor in civil rehabilitation proceedings.

Background

Right of retention is the right of a creditor to retain a thing which belongs to a debtor, and which is in the creditor's possession, until the debt has been fully paid. Its function is to prompt the debtor to pay the debt; however, it differs from a mortgage in that the right holder cannot collect the claim before other creditors by auctioning the thing retained and allocating the cash to its claims. Japanese law recognises two types of right of retention: one under the Civil Code and one under the Commercial Code. A right of retention under the Commercial Code arises in relation to a claim deriving from a transaction between companies or individual traders. The right holder may retain anything that has come into its possession in relation to any transaction with the debtor.

When a Japanese company receives a promissory note from a debtor in payment of a debt, it generally deposits the promissory note with a bank and entrusts collection of the note. This is because Japanese banks can easily and quickly collect promissory notes through settlement in the interbank clearing house; thus, a company can collect the claim more easily than collecting by itself. Consequently, a bank often obtains a Commercial Code-based right of retention over such a deposited promissory note if the bank has claims against the company. However, it has long been debated whether the law allows for the allocation of the collected cash after commencement of civil rehabilitation proceedings on the company pursuant to a prior agreement on such allocation between the bank and the company, as such an agreement appears both to deviate from the function of a right of retention where a right-holder cannot collect the claim before other creditors and to conflict with the Civil Rehabilitation Act, which prohibits the collection of rehabilitation claims out of civil rehabilitation proceedings.

Facts

A company and a bank entered into a banking agreement on February 15 2006. The agreement contained a clause which stipulated that if the company failed to pay a debt owed to the bank, the latter was entitled to collect the company's promissory notes that were deposited with it at that point. Moreover, it was entitled to do so at any time, by any method (not limited to statutory proceedings under the applicable laws), and at any price that would generally be considered appropriate, subsequently allocating the collected cash for payment of the company's debt. Thereafter, the company borrowed money from the bank and separately deposited promissory notes obtained from its customers, entrusting their collection to the defendant.

Authors

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On February 12 2008 the bankruptcy court of Tokyo District Court made an order for commencement of civil rehabilitation proceedings on the company's petition. At the time of commencement, the amount owed to the bank under the company's loan agreement was at least Y968 million and the total face value of the deposited promissory notes was approximately Y562 million.

The bank thereafter collected the deposited promissory notes as they became due and allocated the collected cash for payment of the debt in sequence, pursuant to the clause in the agreement. The company filed suit before Tokyo District Court, claiming that the allocation was invalid and that the bank should transfer all collected cash to the company.

Lower court judgments

On January 20 2009 the Tokyo District Court upheld the company's claim, finding the clause to be void on the grounds that:

- the Commercial Code does not allow a creditor with right of retention over a deposited promissory note to allocate the collected cash for payment of its claims prior to the debtor's other creditors;
- there is no established customary law regarding banking transactions that would justify such an allocation;
- unlike the Bankruptcy Law, the Civil Rehabilitation Law does not entitle a creditor to a right of retention under the Commercial Code to receive payment of claims prior to other creditors of a debtor in civil rehabilitation proceedings; and
- the bank would be granted an unreasonably advantageous position in collecting its claims against the company if allocation pursuant to the clause were allowed.

The bank appealed. On September 9 2009 the Tokyo High Court upheld the first instance judgment, adding that although a creditor with a right of retention may auction things retained and receive cash, it must return such cash to the debtor to which the things belong. In such cases the creditor has a monetary claim against the debtor and concurrently owes a debt to the debtor, but it may not offset the claim against the debt under the Civil Rehabilitation Law. Therefore, a person with a right of retention does not have a substantial right to collect cash from the things retained and to allocate it for payment of a debtor's debt prior to other creditors by offsetting such debt against its claims.

The defendant appealed to the Supreme Court.

Supreme Court judgment

The Supreme Court annulled the Tokyo High Court judgment and dismissed the company's claim, stating that:

"A person who has a right of retention can put up the retained things for auction and retain the cash received from the buyer, which is also the case where the retained things are promissory notes and the person collected them, as long as the person keeps the cash distinguished from its own property.

As the person does not need to return the retained cash after commencement of a civil rehabilitation proceeding of the debtor, the cash shall not be expected to be the financial resource for business of the debtor and distribution to rehabilitation creditors under the rehabilitation plan. Therefore, it does not infringe the purpose of the civil rehabilitation proceedings if the company and the bank agree collection of the promissory notes, and allocation of the collected cash thereby, outside the statutory insolvency proceeding as a means to secure the bank's claims, which are substantially equivalent to security interests. As a result, allocation of such cash for payment of the company's debt pursuant to the clause shall be allowed."

Comment

This judgment refers specifically to circumstances in which the things retained were promissory notes, deposited with a bank which was part of a well-organised system of interbank settlement through a clearing house. However, as a Supreme Court judgment, it may influence other cases relating to rights of retention in the context of insolvency proceedings.

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