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Bankruptcy Law in Japan and its recent development

*Tatsuo Ikeda**

I. Overview of Insolvency Law in Japan

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I. Overview of Insolvency Law In Japan

Figuratively speaking, any economic activity is subject to failure just as human beings are subject to disease or death. Insolvency can occur under a free market system as well as under a socialist economy. In the event of financial collapse, the debtor may be tempted to engage in activities such as claims for fraud, larceny, embezzlement, willful and malicious wrongs, or civil penalties and creditors may be tempted to fall upon the debtor, seize his goods in stock and carry them away in a truck.

The natural tendency is for the stronger to prey upon the weak and confusion will result if matters are left to run their natural course. Clearly a legal scheme is indispensable for the management of insolvency matters, and court intervention is even expected for the orderly settlement of financial affairs.

In Japan there is no such consolidated insolvency code such the U.S.Bankruptcy Code. Insolvency matters are primarily governed by the Bankruptcy Law, the

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This article is based upon the former work, Bankruptcy Law in Japan, JAPAN BUSINESS LAW LETTER (May 1989).

Corporate Reorganization Law, the Composition Law, and the Commercial Code. As their titles imply, these laws provide procedures to be followed in bankruptcy, corporate reorganization, composition, and the arrangement or special liquidation of corporations. These procedures are collectively termed 'legal arrangements' (in-court proceedings, judicially controlled proceedings) schemes as the courts intervene in the proceedings. The Bankruptcy Law (promulgated in 1922) is the nucleus of the rules governing insolvency matters. The insolvency law rules are divided into two groups: proceedings for bankruptcy and special liquidation are classified as a liquidation mode; and the proceedings for corporation reorganization, composition, and arrangement of a corporation are classified as a rehabilitation (See the table (below) for the frequency of use of each procedure). It is said, however, that no small number of Insolvency cases are settled between the parties without resort to the courts, such arrangement being called a 'private arrangement' (out-of-court proceedings). The biggest advantage of a private arrangement is that costs are low and expeditious management is expected, however the disadvantage is that just and due settlement is not always achieved.

In 1952, the Corporate Reorganization Law was enacted after the corporate reorganization model developed in the U.S., and in order to promote a bankrupt's "fresh start", the scheme of bankruptcy discharge, which is granted to honest debtors, was introduced.

Arguments concerning so-called "international insolvency law" have recently become more common and reconsiderations of the territoriality principle have been contemplated in legislative proposals and interpretations of the law.

II. Outline of Each Procedure

Five types of insolvency legal proceedings and private arrangement are as follows in detail.

A. Bankruptcy

1. In General: As shown in the table, the procedure provided under the Bankruptcy Law is the most often chosen form of insolvency proceedings. A bankruptcy court controls the proceedings: a case is commenced with a bankruptcy adjudication by the court; a court appointed trustee holds, administers, and disposes of all the property of the bankrupt. A bankruptcy trustee under the Japanese system differs form that of the U.S. in that the latter is appointed by the creditors' meeting. Profits from the sale of the bankrupt's estate are distributed pro rata to the creditors

whose claims have been filed with, and allowed by, the court (distribution). A corporate debtor is automatically dissolved by a bankruptcy adjudication and be vanished upon the completion of its liquidation. If the bankrupt is an individual, even if distribution of the estate in bankruptcy will not cover all his outstanding debts, he may still be relieved of the obligation to repay by being grounded a bankruptcy discharge.

2. Bankruptcy Capacity: 'Bankruptcy capacity' means the qualifications required by law to be designated a bankrupt. Every individual (natural person) and every private corporation (private juristic person) possesses bankruptcy capacity, as do foreign individuals and corporations (according to the prevailing scholarly view). Public corporations (public juristic persons) are generally denied this capacity. The writer's personal opinion is, however, that a public corporation may be granted such capacity if the matter of bankruptcy capacity would be distinguished theoretically from that of corporate dissolution.

3. Grounds for Bankruptcy: The common denominator here for every debtor is the inability to pay his debts. This is an objective condition in which a debtor is found to be generally and continually unable to pay his debts as they fall due because of a lack of the means to repay. In practice, the most important fact is a debtor's suspension of payment. Thus, for example, if a bill drawn by a debtor is dishonored, the condition of suspension of banking privileges is fulfilled. In such case, the debtor's inability to pay is presumed. Excess debt is another precondition for bankruptcy. This is a relative condition in which a debtor's debts exceed his assets. It is an additional basis for corporate bankruptcy and the sole basis of a bankruptcy application for a deceased's estate.

4. Rehabilitation of a Bankrupt: The bankruptcy procedure also takes into consideration the rehabilitation of debtors.

a. Fixed Bankrupt Estate and Exemptions (Free Property): The scope of property which constitutes a bankrupt estate is every seizable piece of property belonging to the debtor at the time of bankruptcy adjudication. Property acquired after the adjudication, (i.e., newly-acquired property) constitutes free property of which the bankrupt enjoys a free disposition. In addition, certain types of property of which seizure is forbidden (exempted property) and such property that the trustee withdraws from the bankrupt estate are included in a bankrupt's free property. Such property is helpful in the rehabilitation of a bankrupt.

b. Compulsory Composition; In the course of bankruptcy proceedings, a bankrupt in the hope of rehabilitation may make a payment plan and apply for composition with his creditors. Composition can be effected and the proceedings

concluded without liquidation if, in the creditors meeting, the majority of the present creditors with voting rights agree to composition and the total amount of such agreeing creditors' claims represents three quarters or more of the total allowed claims (Bankruptcy Law §306).

c. Bankruptcy Discharge: Bankruptcy discharge is significant only for individual debtors. There is no chance of discharge for corporate debtors which shall be dissolved upon a adjudication of bankruptcy. Since the second half of the 1970's, the number of filings for voluntary bankruptcy by individual debtors has been increasing rapidly. The reason for the occurrence of this phenomenon is that bankruptcy discharge has come to be used as a vehicle for rehabilitation individual debtors who have over-stretched their credit with loan sharks. It is necessary for a bankrupt to make an application for discharge. If the court rules that the bankrupt be discharged, his debts are deemed to be come 'natural obligations' under prevailing scholarly opinion (i.e., creditors have no legal means of enforcement; however, if the debtor pays his debts voluntarily, such payments are valid). While rehabilitation of bankrupts is promoted by this system. Critics assert that bankruptcy discharge does not discharge the obligations of guarantors or sureties of the discharged bankrupt (Bankruptcy Law §366-13) and a debtor is therefore practically forced to pay his debts if his guarantors or sureties are relatives or friends.

5. Holders of Secured Interests: Generally, secured interests are treated as independent and reserved claims and as such are not bound by the bankruptcy proceedings (that is, holders of secured interests have preference).

6. Avoiding Power of Trustee: Payments or other disposition of property by a bankrupt executed before the bankruptcy adjudication are valid. But if a bankrupt has committed fraudulent acts which decrease the assets of the bankrupt estate available for all creditors or engages in discriminatory acts which violates the notion of equality among creditors, the trustee has the power to cancel the efficacy of such acts of the bankrupt and recover such assets. Such power of a trustee is called an "avoiding power".

B. Corporate Reorganization

This is a rehabilitative procedure for joint stock corporations of larger scale. Under this scheme, the management of a reorganized corporation is deprived of its status and one or more reorganization trustees promote the rehabilitation of the corporation. Due to its distinctive character, the number of newly filed petitions employing this method has been very low recently.

When a corporation is unable to pay its debts without a significant hindrance to the continuation of its business, it may file for reorganization. Rehabilitation is the main objective of this scheme and no specific condition must be satisfied in order to file.

Unlike bankruptcy or composition, holders of secured interests are also bound by a reorganization plan and they are prohibited from enforcing their claims outside the plan. The framework of the proceedings is similar to that of bankruptcy proceedings, and the phase of the proceedings in which a reorganization plan must be decided upon by a majority of interested parties is similar to the composition proceedings.

C. Composition

As shown in the table, the annual number of filings for composition had remained above the 500-case level since 1980 (the frequency of insolvency cases as a whole dropped in 1987 because of an upturn in the economy) and composition is more regularly and frequently employed than corporate reorganization. This seems to show that debtors fully realize that compared with other rehabilitative corporate reorganization methods, the advantage of a composition procedure lies in the fact that the management of an insolvent corporation can commence rehabilitation without losing its managerial power (debtor in possession).

A debtor may file for composition if one of the grounds for bankruptcy under the Bankruptcy law is satisfied (Composition Law §12). The composition proceedings are similar to compulsory composition under the Bankruptcy Law in that a debtor must make a composition plan before filling and the majority of creditors may force a decision. In fact, however, once proceedings are commenced it is usually too late for rehabilitation, the scope of claims of the creditors is not defined if composition has been concluded, the holders of secured interests are not bound by the proceedings, and the debts agreed to in the proceedings are not always paid due to a lack of court control over enforcement.

D. Corporate Arrangement

In 1938, new provisions concerning corporate arrangement were inserted into the Commercial Code to cover the shortcomings of composition or private arrangement. The gist of this scheme is that private arrangement of a joint-stock corporation is conducted under 'soft control' by the court. The directors' managerial or decision-making power may be restricted or curtailed in certain cases. A corporate debtor may file for arrangement if it is believed that the debtor

will fall into insolvency. There is no trustee and the directors of the corporate debtor may usually retain managerial control and carry out corporate rehabilitation. One disadvantage is that unlike the composition procedure, a rehabilitation plan is not decided upon by the majority of creditors, that is to say, unanimous consent by the creditors is necessary for conclusion of a arrangement plan. This is covered by the courts' control over the matter. When a court has issued an arrangement order, it may freeze secured claims or interests.

E. Special Liquidation of a Corporation

The special liquidation proceedings may be regarded as a summary-type bankruptcy procedure for a corporation, in which the courts, as a kind of guardian, will step in and direct corporate decisions if such conditions (e.g., excess debt) are found to render ordinary voluntary liquidation difficult. This procedure is only available for corporations which have been dissolved and are in the process of liquidation. As shown the Chart, the number of filings under this method has gradually increased. One reason for this is the convenience of this procedure as compared with the bankruptcy procedure. In a special liquidation, one or more special liquidators are authorized to manage liquidation matters (Commercial Code §434) and they are selected from among the ex-directors of the dissolved corporation (Id. §417(1)). It is also said that this procedure has some merit for taxation purposes. When special liquidation has been commenced, enforcement of secured claims may also be restricted depending on the circumstances of the case. A liquidation commissioner shall present an liquidation plan regarding the payment of debts at the creditors' meeting and such plan shall be decided upon by the majority of the creditors according to the applicable provision. Up to this point, the procedure resembles to the composition procedure.

F. Private Arrangement

Private arrangement is said to be a type of settlement outside the court. There are no special statutory provisions and the general rules of private law, especially, the general provisions of the Civil Code, apply. In the writer's opinion, however, a private arrangement should be understood in connection with the "legal arrangements" mentioned above, and therefore, with legal principles governing fiduciary transactions. One scholarly view recently gaining acceptance adopts the concept of a fiduciary relationship between the manager of a private arrangement and the debtors.

Courts have no occasion to interfere in a private arrangement, although they

may certainly do so by means of a party's filing an ordinary civil action where a dispute occurs among the interested parties. If such dispute impedes the management of the private arrangement, the procedure finally shifts to a legal arrangement such as filing for bankruptcy or composition and the courts will then become involved.

A creditor with a large claim usually takes office as the chairman of the creditors' meeting and manages the private arrangement. "Professional arrangers" sometimes interfere in private arrangement cases and attempt to coerce interested parties in the arrangement; for example, by means of obtaining creditors' claims at unreasonably low prices.

III. Recent Development

Now I would like to mention the recent situations. Aside from the recession of our society (especially many bankruptcy cases of financial institutions), the process of deregulation and structural change to the economy in Japan is likely to result in many challenging bankruptcy cases. In today's rapidly and radically changing economic order, comprehensive reform has become a mandate for both the legal system, in practice as well as in its legislative development.

These circumstances and the needs of global market economy threaten to try the insolvency system's ability to fulfill its function of realizing fairness and social justice with considering each legal right. In the face of these challenges, the form of present Japanese bankruptcy law system is currently undergoing thorough legislative view. As the number of personal bankruptcy cases has risen, along with the increasing number of international bankruptcy cases, deficiencies in the present Code have become more and more apparent. Treatment of property under secured claims is also a matter of considerable importance. On the other hand we should promote international cooperation by supporting the harmonization of standards for Bankruptcy procedures, even if we couldn't introduce the universality principle instead of the territoriality principle. These and many other issues are presently under discussion and review. Such working of the legislative review in Japan will be finished within a few years, at least.

The ideal insolvency law might be one system which allows flexible case management possible, for example a system in which the court may issue an 'order for relief' upon filing by the debtor, proceed with the case in a manner appropriate to the conditions of the particular case, and if necessary, change to another procedure in midstream. Such system is so-called one way with multi-tracks.

Although such a system may place a heavy burden on the courts, this problem will be solved by promoting and animating creditors' autonomy. As a first step toward such an ideal system, legislative efforts are presently expected which will offer a wide variety of options in the management of insolvency cases. The new proceedings for the rehabilitation of small-to-medium-sized enterprises and consumer debtors is very notable in this respect, and has been considered as the law systems similar to Ch. 11 and Ch. 13 (Adjustment of Debt of an Individual with Regular Income) of the U.S. Bankruptcy Code.

As for private arrangement, its biggest weakness is a lack of fairness. It has been proposed, first, that easier access to a legal arrangement be provided for; and second, that some intermediate organs between private and legal arrangements be created for the management of insolvency cases.

[For Reference]

Cases in Bankruptcy and Composition

The process of bankruptcy, needless to say, aims at dividing equally the obligor's property among the obligees where the property is not ample enough to satisfy their claims in full. The District Court, on application of the obligee or the obligor him/herself, investigates the case, adjudicates the obligor bankrupt if it deems appropriate, and appoints a trustee. Thereafter, this trustee liquidates, under the supervision of the District Court, the bankrupt's assets, converts it into money and divides it among the obligees.

The bankrupt (may be given discharge from the rest of debts. The District Court renders the ruling of discharge upon the bankrupt's motion where it is proper.

The composition is aimed at the recovery of the obligor by adjusting the obligations when the obligor is on the verge of bankruptcy. The process of composition commences with the application of the obligor to the District Court.

The court, after instructing the composition commissioner to investigate the case, renders the ruling of commencement of composition proceedings where the application is proper. If the conditions of composition are agreed upon at the meeting of the obligees and are confirmed by the court, the composition is successful and the proceedings come to an end. However, on the other hand, if the composition is canceled for the reason that the obligor defaulted to perform the conditions agreed upon, the bankruptcy procedure may then be commenced.

Corporation Reorganization Cases

The purpose of the Corporation Reorganization is to maintain and reorganize the business of a joint stock company when it finds itself in an extreme difficulty in paying its debts and yet has some possibility of reconstruction.

This procedure is inherent in a joint stock company. The District Court, on application of the company, the obligee or the shareholder, renders a ruling for the commencement of corporation reorganization procedure and appoints a trustee or trustees if the application is appropriate. The trustee takes control over the business and assets of the company under the supervision of the court and makes a draft plan of reorganization within the period designated by the court, that includes a large degree of Discharge from liability and payment in installments. The reorganization plan comes into force if it is adopted at the meeting of interested persons and approved by the court. And the claims and interests of obligees and shareholders are modified in accordance with the plan.

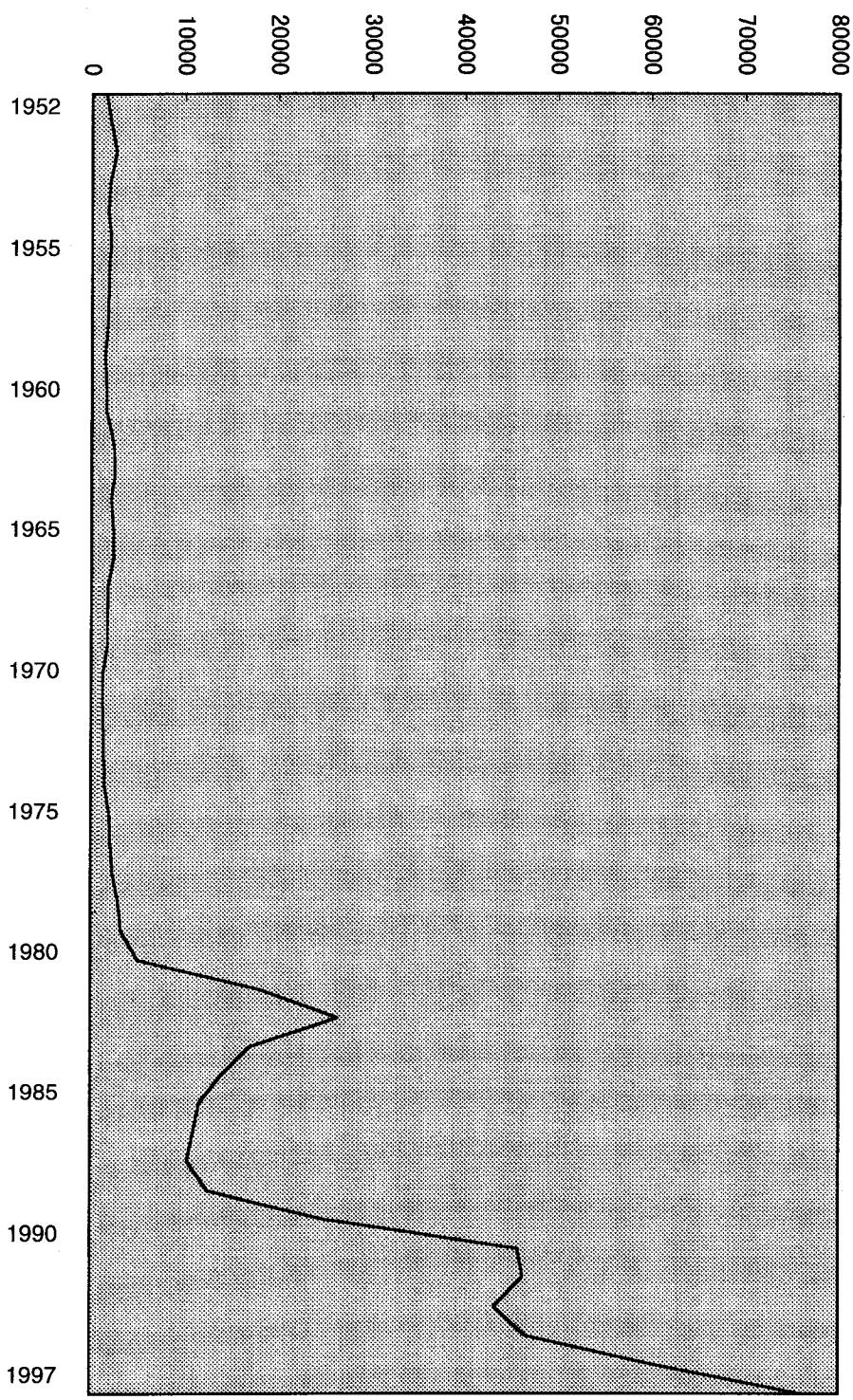
When the plan is carried out, the procedure of reorganization comes to an end.

:the homepage presented by the Japan Supreme Court
(http://www.courts.go.jp/english/procedure/minji2-2_e.html)

Numerical Chart of Bankruptcy Cases (based on the "Annual Report of Judicial Statistics" (Civil and Administrative Law Version) of the Supreme Court)

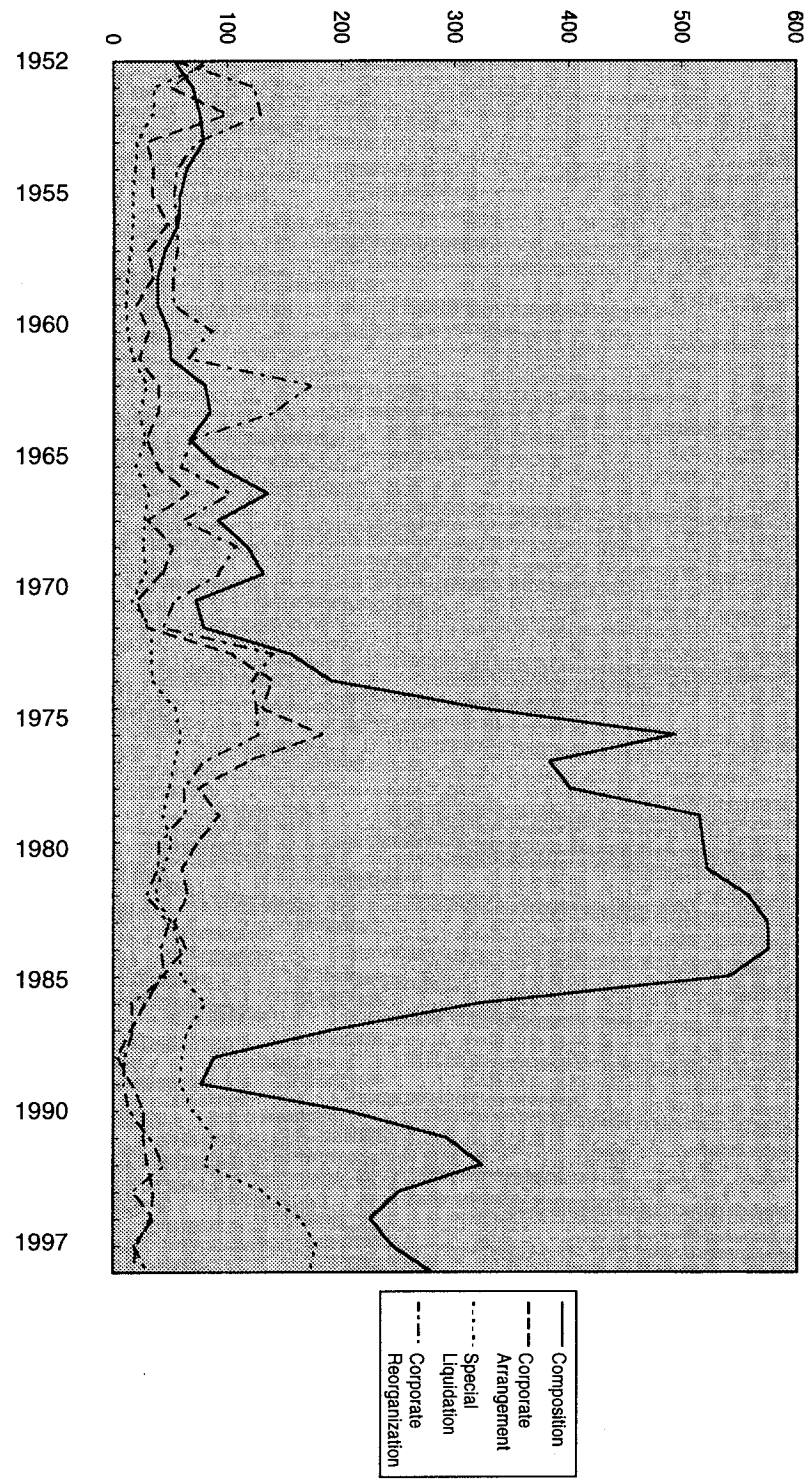
Year	Bankruptcy		Composition		Corporate Arrangement		Special Liquidation of Corporation		Corporate Reorganization	
	Number of new cases accepted	Number of cases adjudicated	Number of new cases accepted	Number of cases commenced	Number of new cases accepted	Number of cases commenced	Number of new cases accepted	Number of cases commenced	Number of new cases accepted	Number of cases commenced
1952	1,531	211	54	—	79	—	88	—	55	—
1953	2,010	287	70	—	52	—	36	—	123	—
1954	2,599	465	76	—	99	—	35	—	129	—
1955	1,949	406	79	—	29	—	21	—	74	—
1956	1,732	258	64	—	35	—	19	—	56	—
1957	2,009	374	58	28	34	4	17	6	53	17
1958	1,798	368	57	19	48	3	17	0	55	14
1959	1,789	417	45	14	30	4	15	5	56	12
1960	1,672	381	38	6	35	4	12	4	52	8
1961	1,403	334	38	8	20	2	11	5	53	16
1962	1,564	387	48	8	31	3	12	3	86	38
1963	1,643	341	50	14	22	5	17	6	65	28
1964	2,301	456	80	19	39	11	29	22	172	46
1965	2,514	606	84	21	39	8	22	6	141	56
1966	2,098	463	67	28	28	5	28	8	68	29
1967	2,322	507	91	29	39	5	19	3	59	24
1968	2,370	511	135	47	64	11	31	18	101	52
1969	1,794	457	91	33	30	8	27	17	61	35
1970	1,680	479	117	53	52	11	26	13	107	52
1971	1,730	573	131	42	43	7	28	15	91	45
1972	1,278	448	72	48	20	7	16	15	54	45
1973	1,243	468	79	44	30	5	33	32	43	17
1974	1,343	429	156	39	104	21	33	23	140	57
1975	1,408	575	191	63	139	44	34	30	121	94
1976	1,515	627	320	111	130	32	54	32	125	14
1977	1,984	912	493	206	182	47	59	46	126	77
1978	2,070	1,301	382	178	116	41	54	54	80	77
1979	2,321	1,561	401	165	74	27	48	36	61	38
1980	2,877	1,976	514	213	93	28	43	35	63	35
1981	3,221	2,411	517	265	74	27	51	46	40	38
1982	5,031	3,618	521	232	60	26	44	45	39	44
1983	17,878	11,572	557	272	65	18	36	32	28	23
1984	26,384	22,116	574	256	53	21	51	40	49	24
1985	16,922	17,833	575	287	64	22	58	44	41	19
1986	13,876	13,098	541	313	42	14	59	47	45	20
1987	11,584	11,379	320	211	28	22	81	70	16	27
1988	10,940	10,448	191	105	15	7	65	65	18	26
1989	10,319	9,995	88	67	4	3	60	51	10	14
1990	12,478	10,656	77	32	16	3	58	48	9	4
1991	25,091	19,289	203	45	27	8	70	60	14	7
1992	45,658	35,771	292	98	26	13	89	74	32	18
1993	46,216	43,370	323	140	30	10	80	70	44	31
1994	43,161	40,842	250	154	35	11	132	116	17	14
1995	46,487	41,731	225	129	33	9	163	131	36	22
1996	60,291	52,107	244	112	20	13	178	151	18	13
1997	76,032	68,718	279	119	18	10	172	148	31	19

(Note) The number of new cases accepted means the number of cases accepted in the applicable year (January 1 ~ December 31). The number of cases commenced (the number of cases adjudicated) means the number of cases for which there was a decision to commence proceedings (bankruptcy adjudication) in the applicable year out of the total number of cases accepted (including both new cases a accepted and old cases acepted that are repeated from the prior year). Prior to 1956, it is unclear how many cases were commenced for each proceeding excluding bankruptcy.



Transition of the Number of new Bankruptcy Cases accepted under the Bankruptcy Law

Transition of the Number of new Cases in Composition, Corporate Arrangement, Special Liquidation of a Corporation and Corporate Reorganization Proceedings



Details of New Bankruptcy Case Accepted Nationwide

Year	Total	Natural Persons			Legal Persons		
		Total	Voluntary	Involuntary Creditors	Total	Voluntary	Involuntary Creditors
1985	16,922	14,896	14,625	271	2,026	1,681	345
1986	13,876	11,708	11,432	276	2,168	1,785	383
1987	11,576	9,969	9,774	195	1,615	1,284	331
1988	10,940	9,610	9,415	195	1,330	1,028	302
1989	10,319	9,433	9,190	243	886	662	224
1990	12,478	11,480	11,273	207	998	759	239
1991	25,091	23,491	23,288	203	1,600	1,365	235
1992	45,658	43,394	43,144	250	2,264	1,920	344

Bankruptcy, Composition, and Discharge Cases Nationwide

Year	New Bankruptcy Cases	Adjudications	New Composition Cases	Composition Authorizations	Discharge
1973	1,243	468	79	41	43
1974	1,343	439	156	34	54
1975	1,408	575	191	63	46
1976	1,515	627	320	104	78
1977	1,984	912	493	164	116
1978	2,070	1,301	382	187	258
1979	2,321	1,561	401	159	476
1980	2,877	1,976	514	194	543
1981	3,221	2,411	517	242	880
1982	5,031	3,618	521	213	1,608
1983	17,878	11,572	557	261	6,767
1984	26,384	22,116	574	224	16,144
1985	16,922	17,833	575	268	13,711
1986	13,876	13,098	541	299	10,454
1987	11,584	11,379	320	221	9,445
1988	10,940	10,448	191	133	9,175
1989	10,319	9,995	88	65	9,355
1990	12,478	10,656	77	33	9,969
1991	25,091	19,289	203	35	15,895
1992	45,658	35,771	292	77	30,287

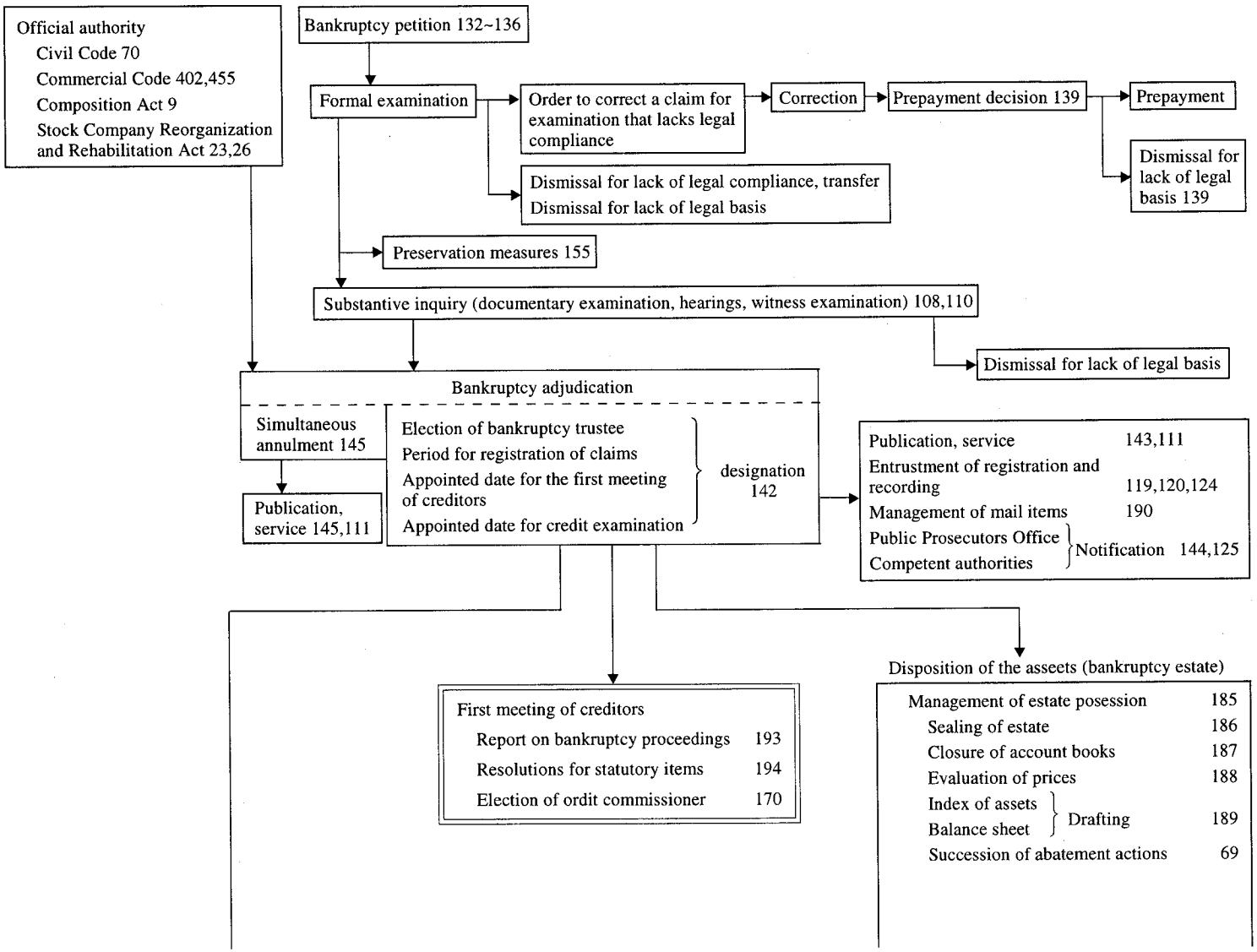
Details of Bankruptcy Cases Settled Nationwide

Year	Total cases	Before bankruptcy adjudication					After bankruptcy adjudication						
		Total cases	Dismissals	Withdrawals	Composition	Other	Total cases	Distributions	Compulsory composition	§145	§347	§353	Other
1952	944	859	38	798		23	85	13	2	52	3	11	4
1955	1,987	1,755	111	1,602	1	41	232	46	10	80	8	67	21
1960	1,791	1,364	67	1,262	5	30	427	115	16	171	30	85	10
1965	2,075	1,627	86	1,485	56		448	170	14	100	33	121	10
1970	1,660	1,218	52	1,127	39		442	221	11	63	36	109	2
1975	1,317	819	37	754	5	23	498	282	5	67	18	119	3
1980	2,072	816	52	725	14	25	1,256	610	11	399	15	211	10
1985	17,003	1,455	106	1,309	1	39	15,548	1,925	56	12,494	9	1,051	19
1986	13,321	1,182	114	1,042	2	24	12,139	2,243	37	8,540	11	1,290	18
1987	12,612	1,467	289	1,137	6	35	11,145	2,314	28	7,451	6	1,328	18
1988	12,376	1,124	129	956	9	30	11,252	2,598	26	7,228	13	1,370	17
1989	12,454	979	121	846		12	11,475	2,617	11	7,492	15	1,332	8
1990	13,619	987	84	808		95	12,632	2,580	20	8,392	17	1,306	317
1991	19,379	1,017	93	895	2	27	18,362	2,308	12	14,912	15	1,094	21
1992	33,908	1,712	145	1,492		75	32,196	2,101	7	28,976	4	1,087	21

* The "Dismissals" column in the "Before bankruptcy adjudication" category includes dismissals for a lack of legal basis in addition to dismissals for a lack of legal compliance. The "Other" column in the "After bankruptcy adjudiation" category includes revocations of adjudicated bankruptcy and the recognition of plans for reorganization.

(Hanrei-times, No. 830 p.20)

Overview of Bankruptcy Proceedings



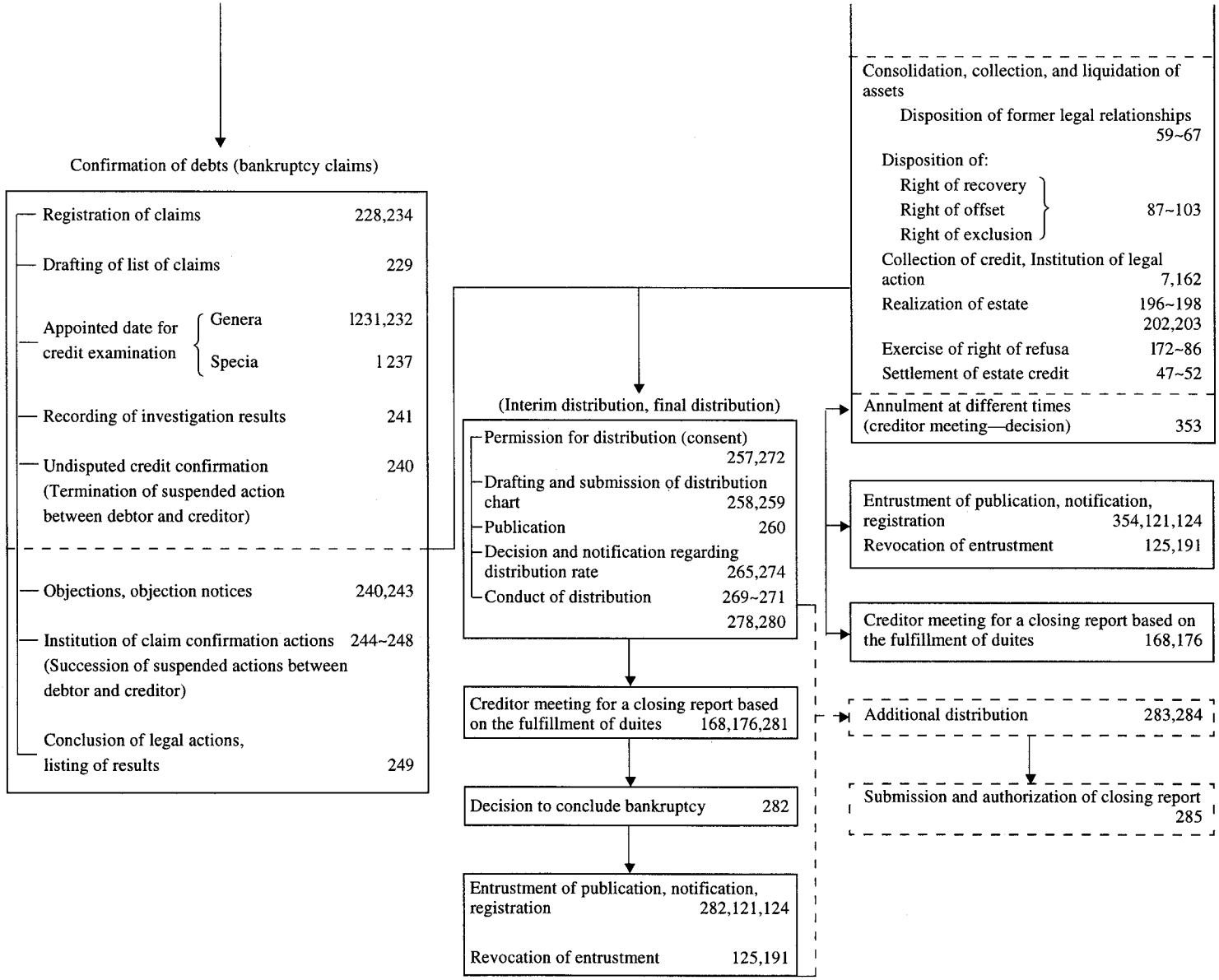

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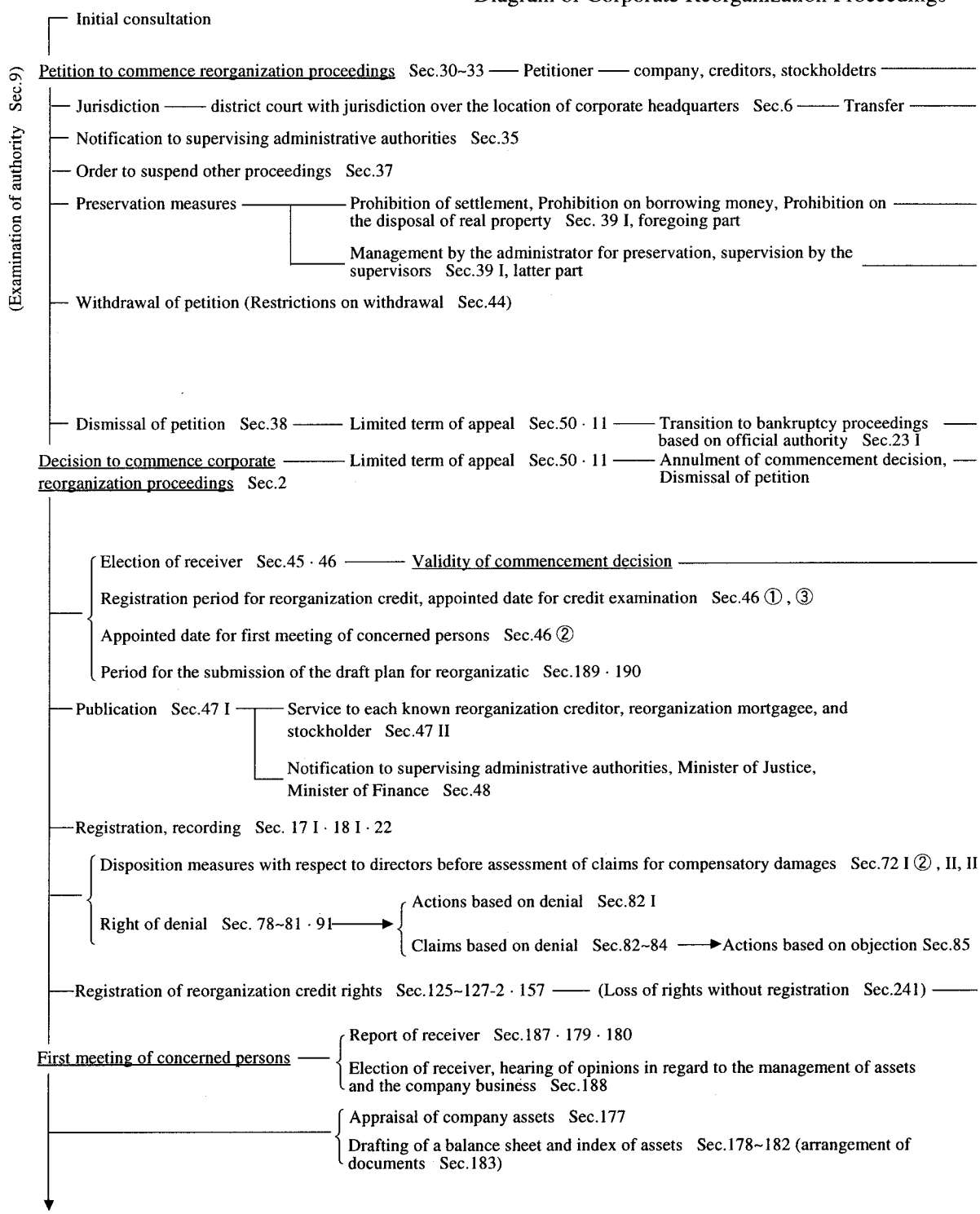
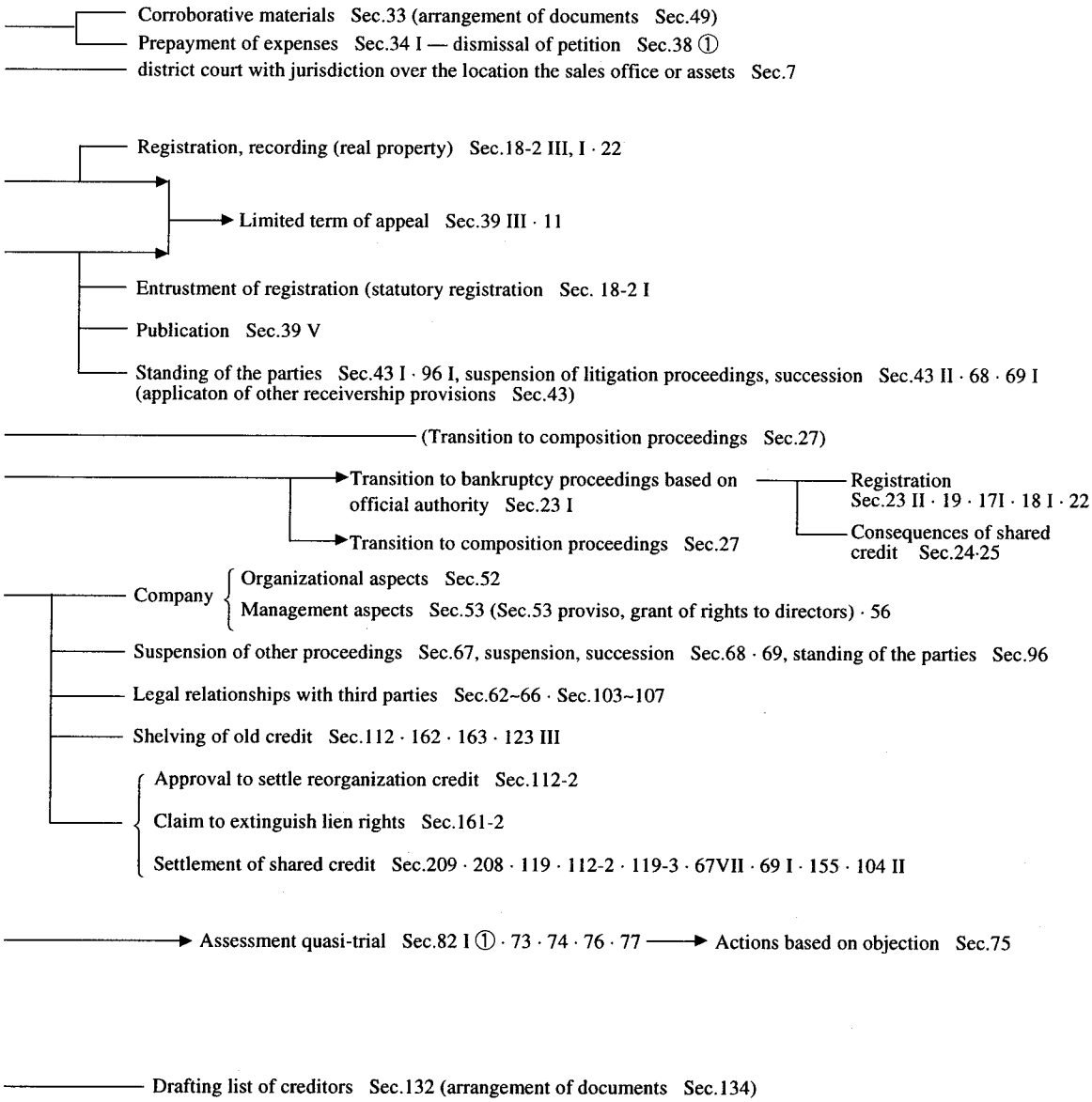
Diagram of Corporate Reorganization Proceedings

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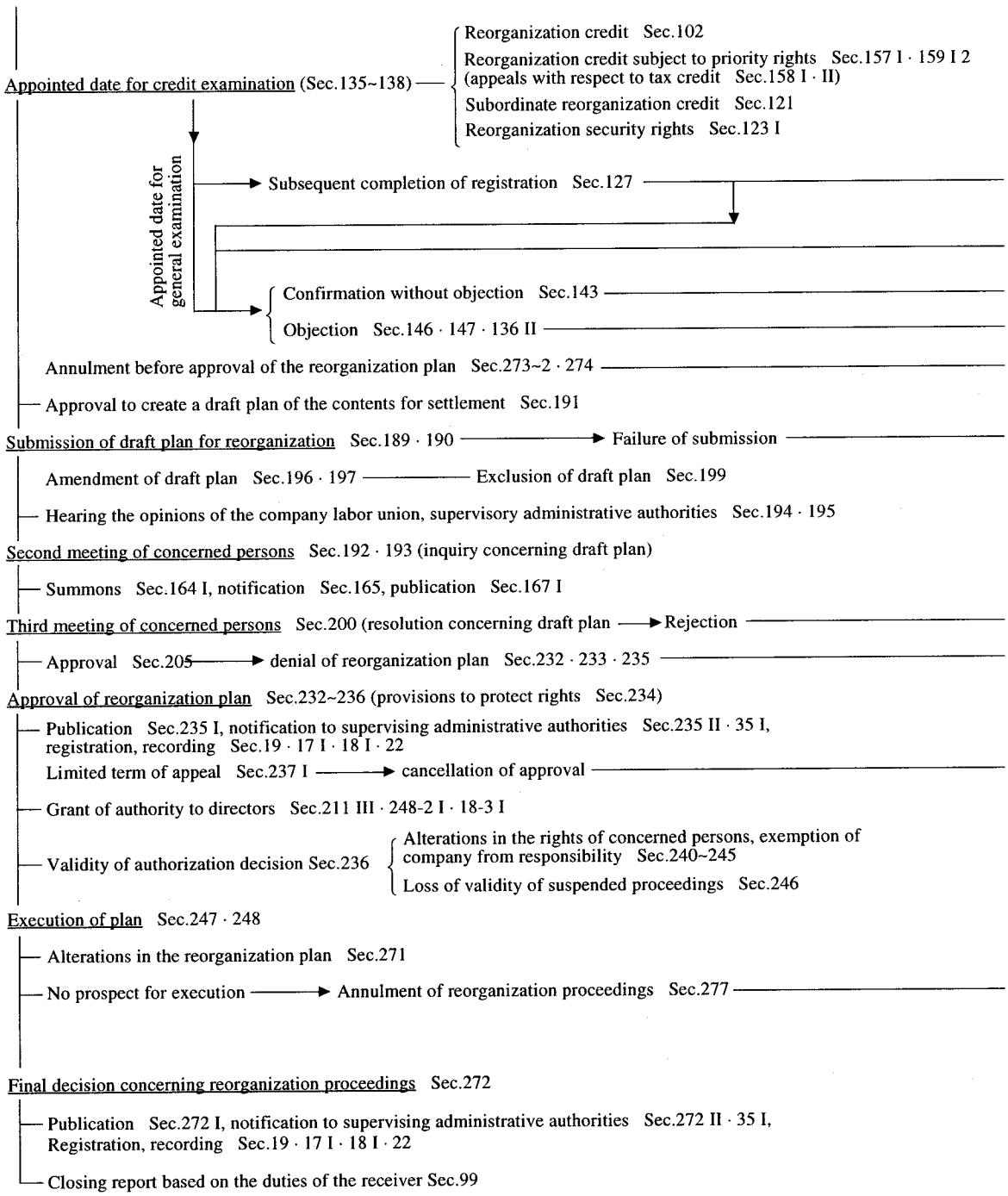
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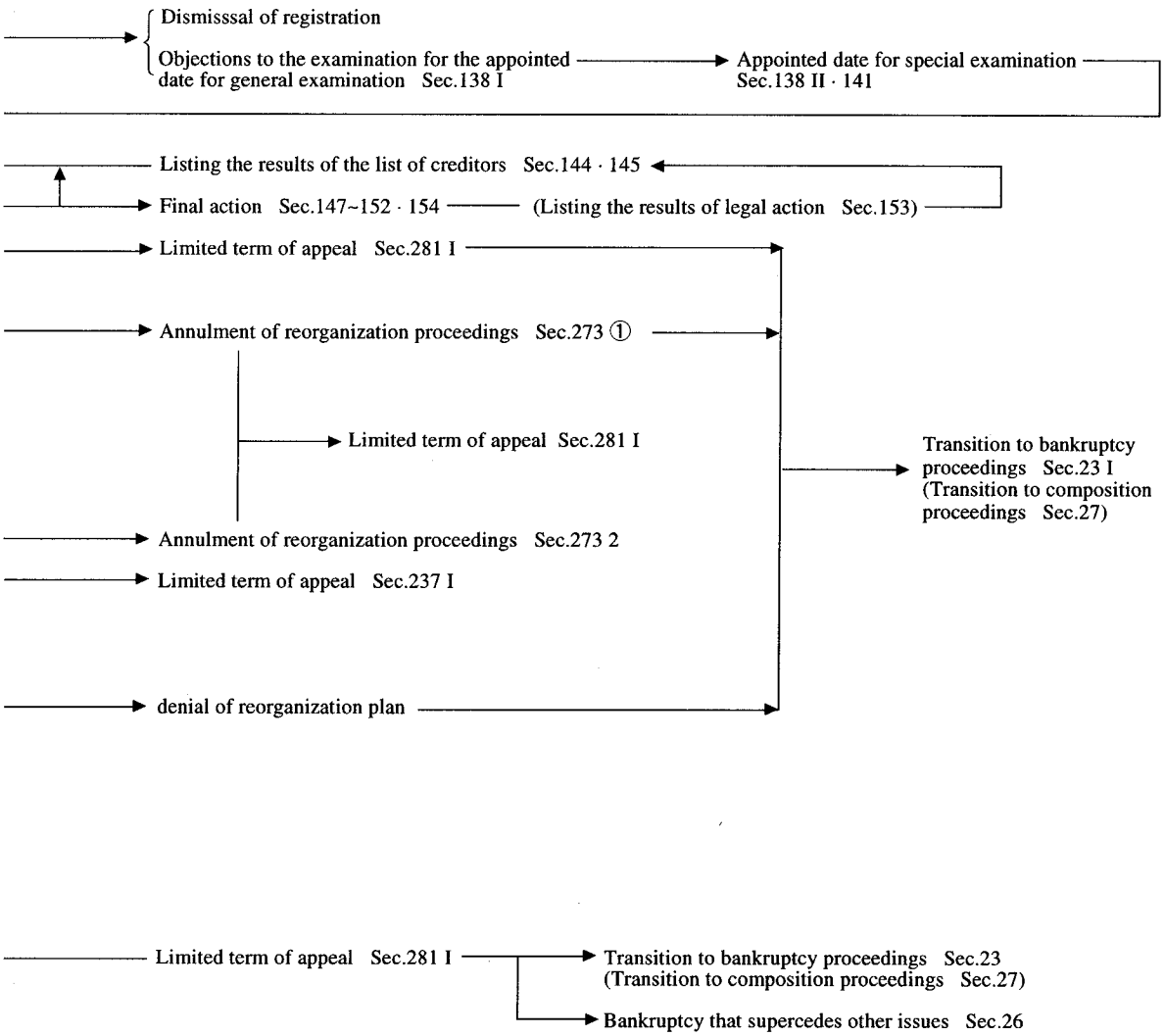
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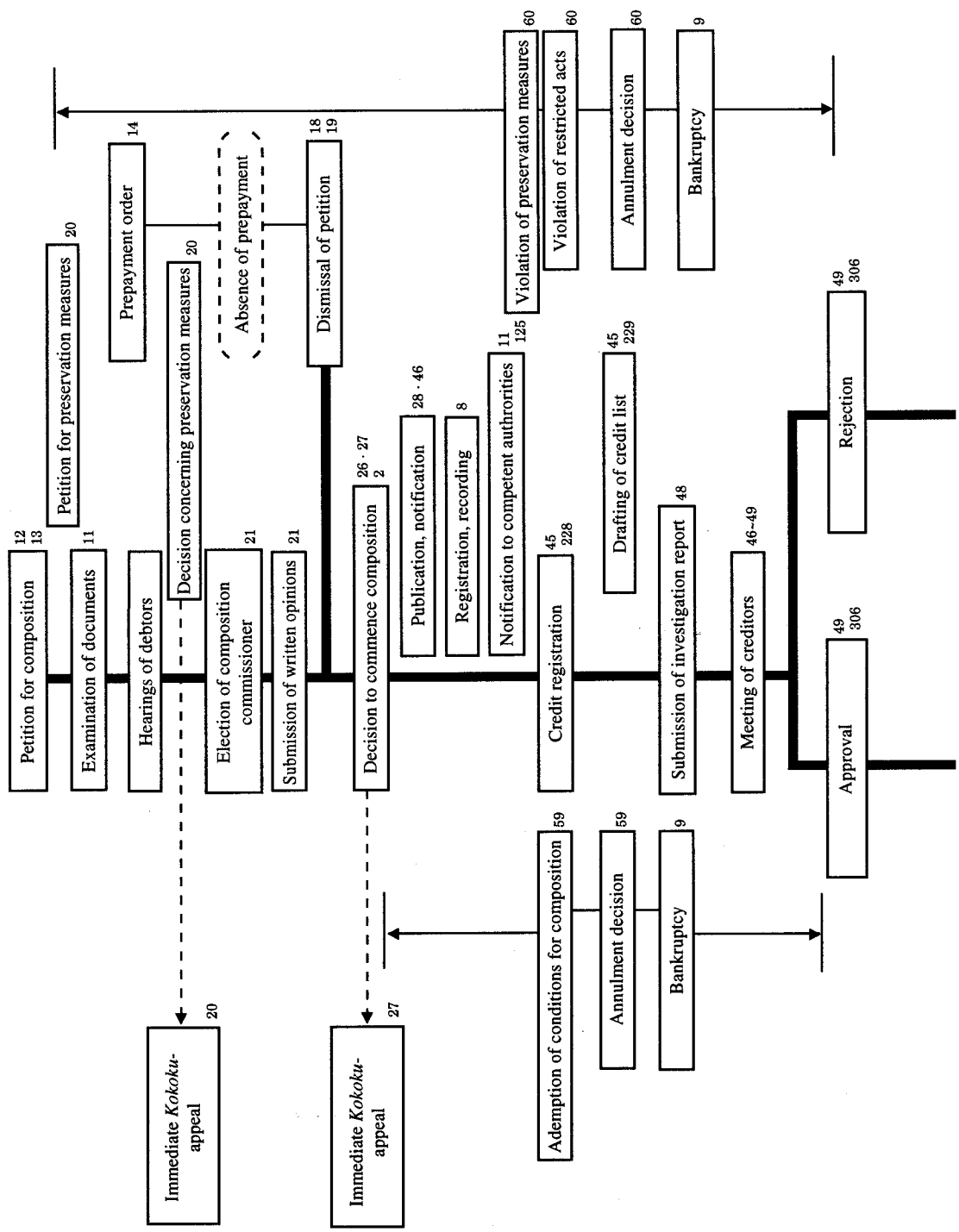

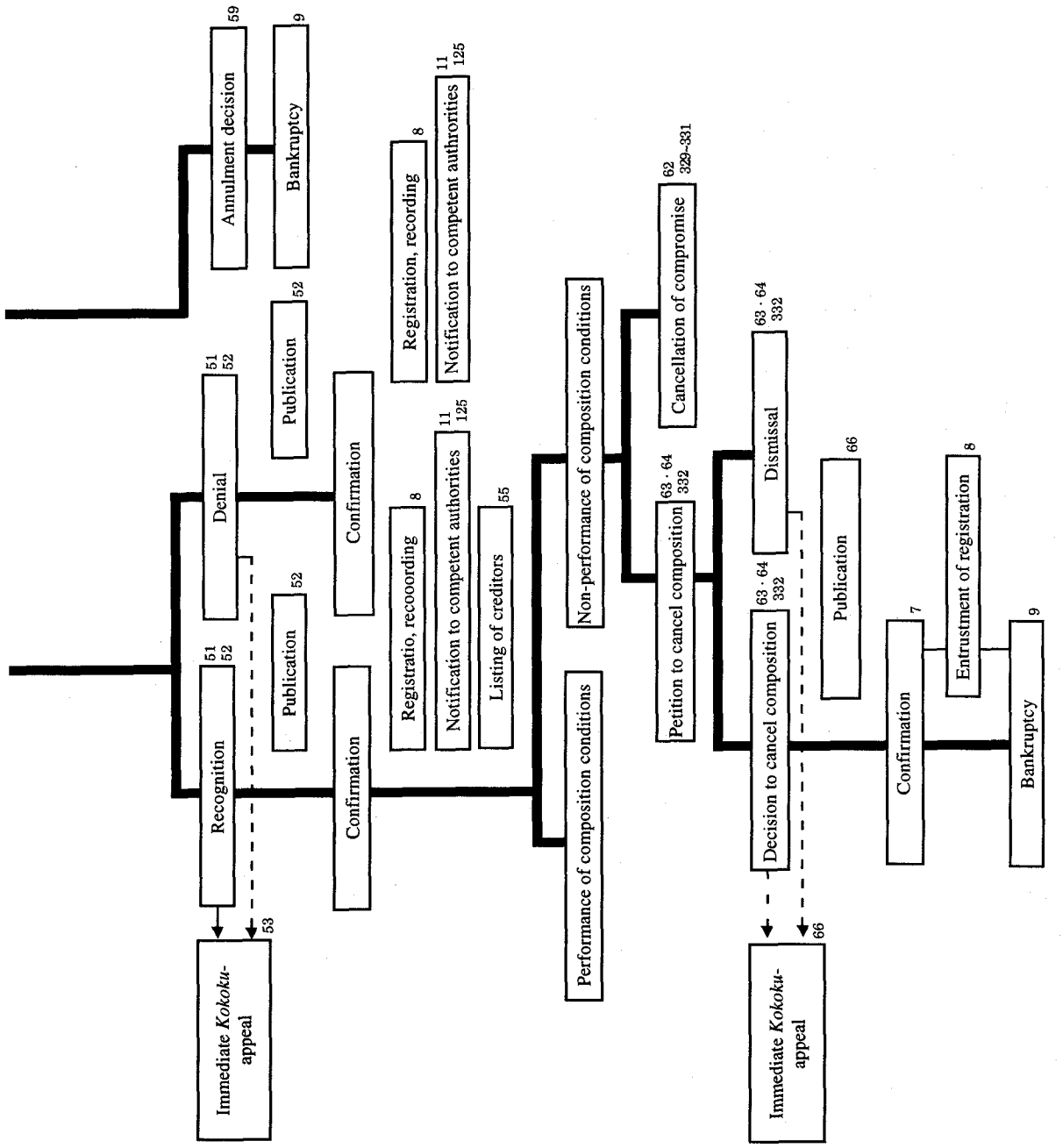
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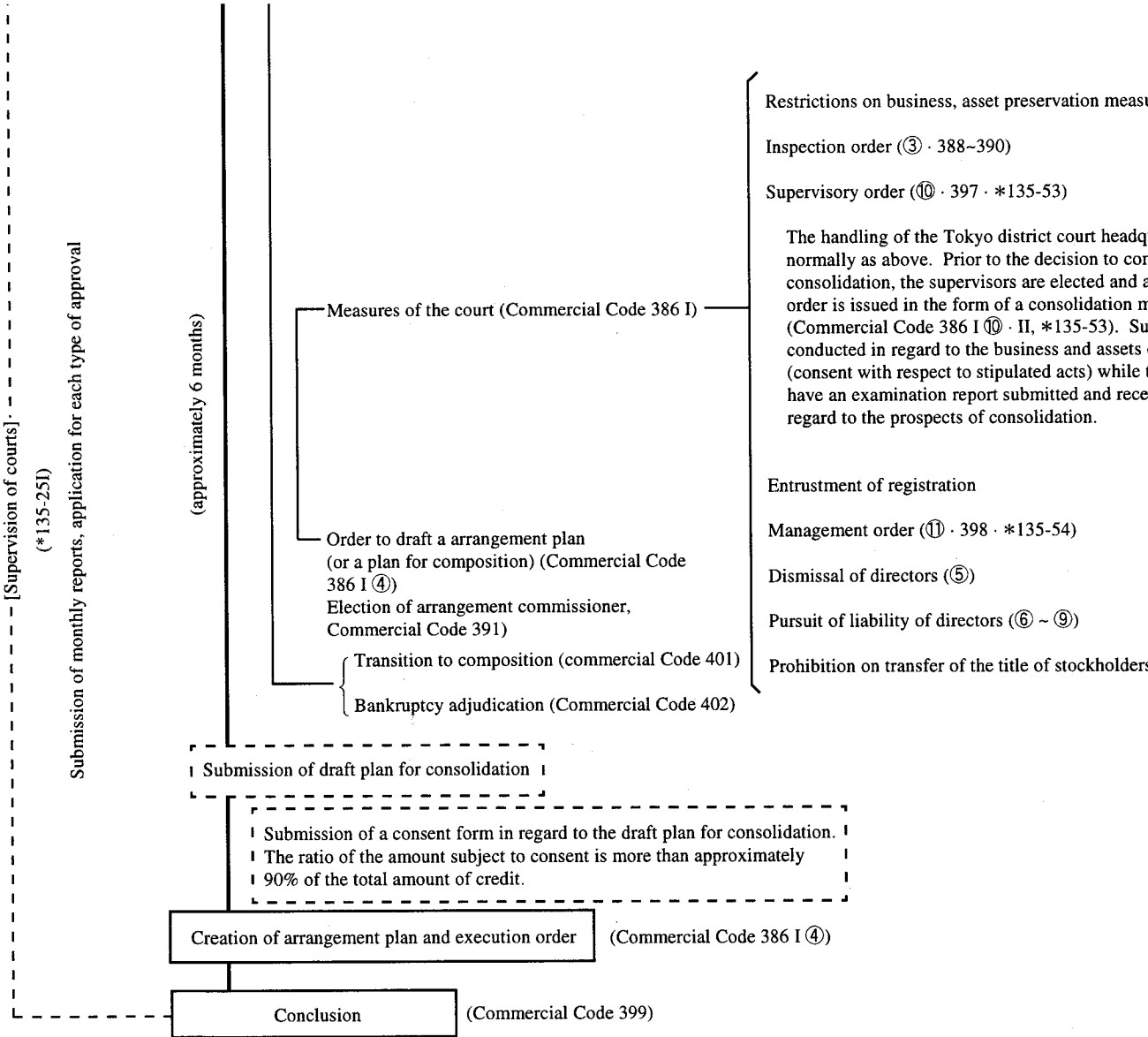
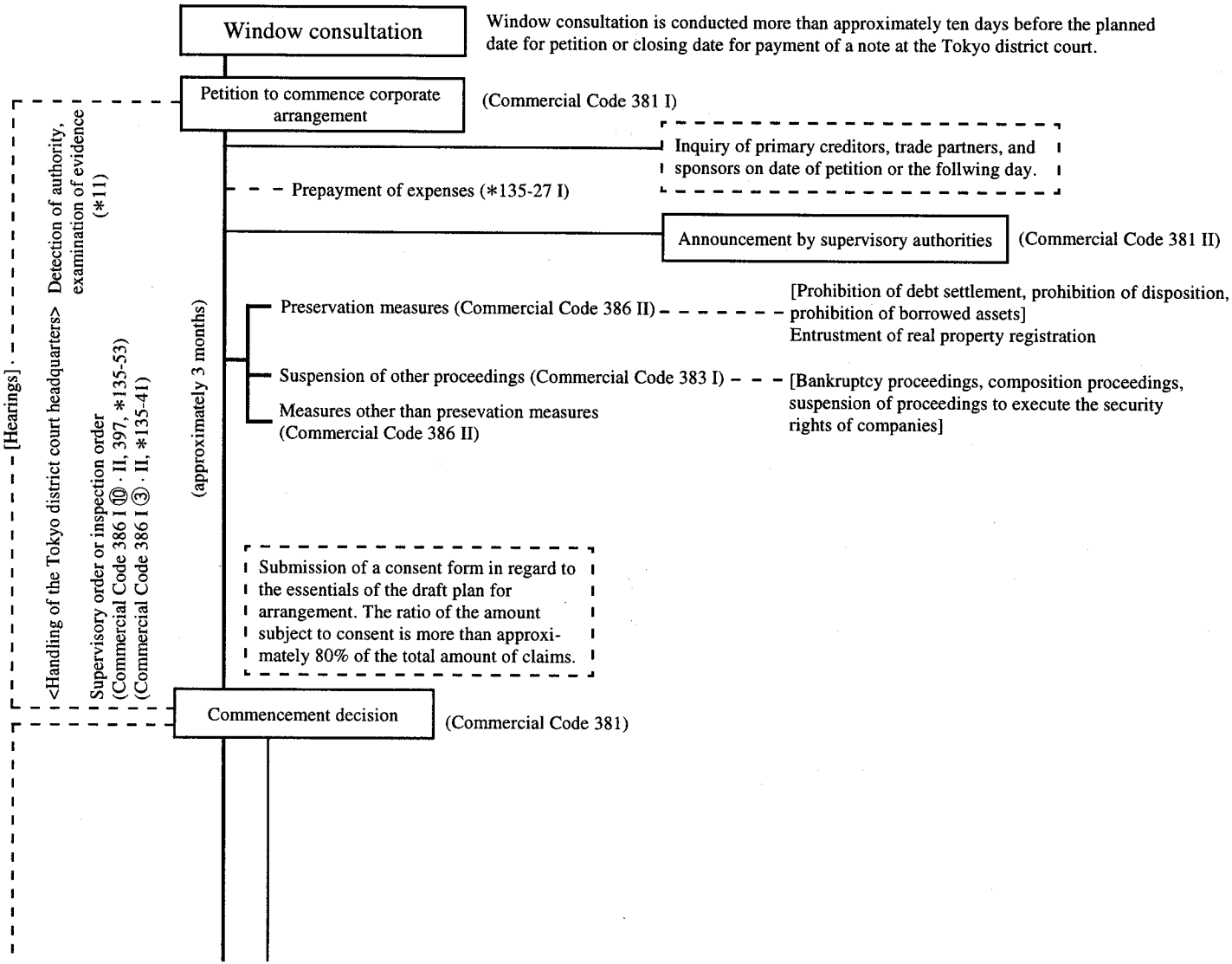
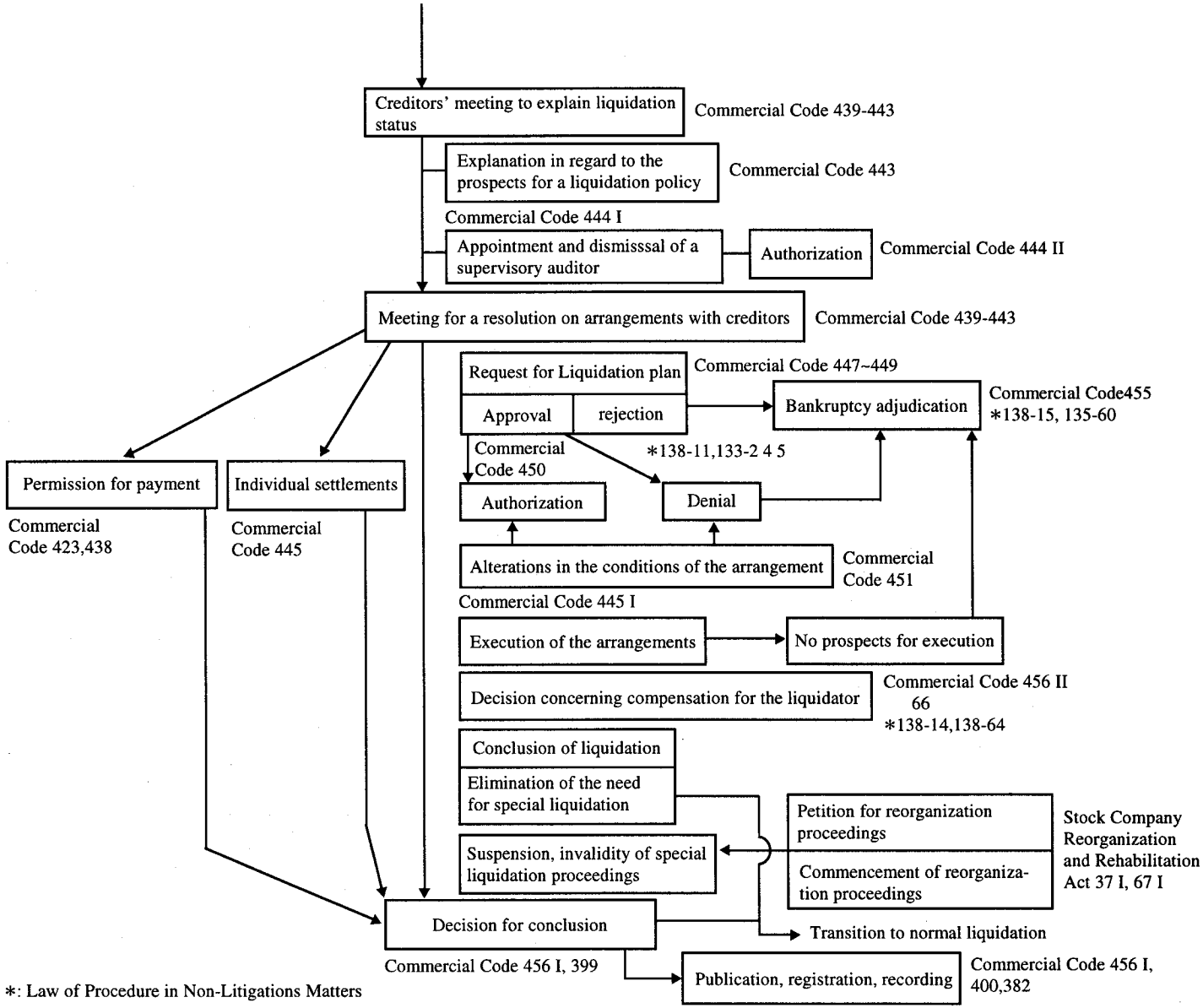


* : Law of Procedure in Non-Litigations Matters

Diagram of Corporate Arrangement proceedings

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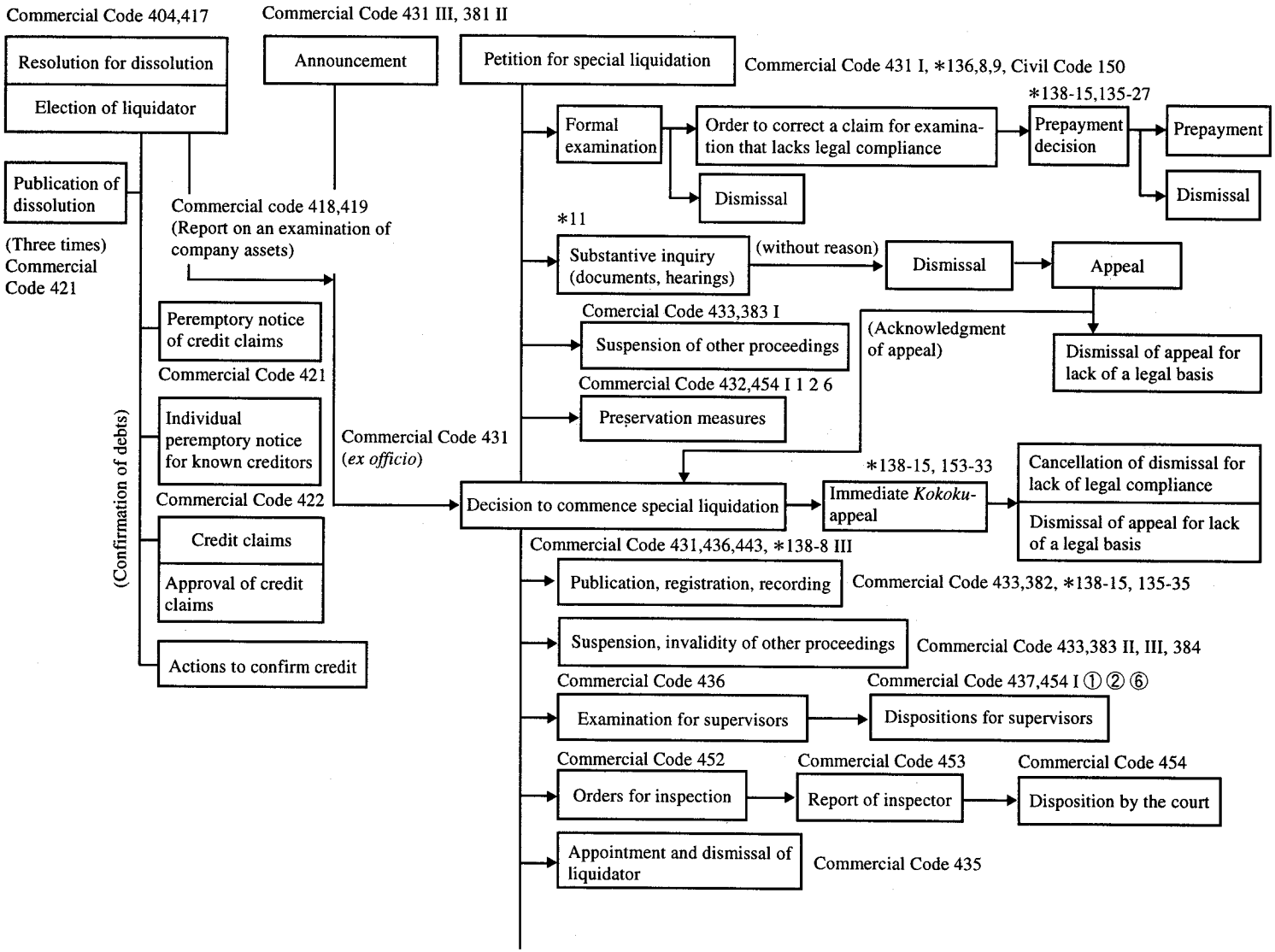
*: Law of Procedure in Non-Litigations Matters

Outline of Special Liquidation Proceedings