

Japan's Personal Insolvency Law

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SUMMARY

I.	OVERVIEW OF JAPAN'S PERSONAL INSOLVENCY LAW: BANKRUPTCY PROCEEDINGS AND SPECIAL REHABILITATION PROCEEDINGS FOR INDIVIDUAL DEBTORS	766
	A. <i>Overview of Japan's Personal Insolvency Law</i>	766
	B. <i>Bankruptcy Proceedings of Individual Debtors</i>	766
	C. <i>Special Civil Rehabilitation Proceedings for Individual Debtors</i>	768
	1. Officers	768
	2. Claim Verification Process	768
II.	DEBTORS WITH ABILITY TO REPAY AND POSSIBILITY OF ABUSIVE FILINGS.....	769
	A. <i>Issues Discussed in the Legislative Process</i>	769
	B. <i>Possibility of Abusive Filings</i>	770
III.	CONCLUSION	771

The project involving the comprehensive reform of Japanese insolvency law started in October 1996, and was finished in November 2004. There are now two types of judicial proceedings for personal insolvencies under Japanese insolvency law. The first is straight bankruptcy proceedings based on the Bankruptcy Law, in which the debtor can be discharged; the other is special civil rehabilitation proceedings for individual debtors. In Part I of this Article, I offer a brief discussion of personal insolvency law, as well as bankruptcy proceedings and special civil rehabilitation proceedings, both for individual debtors. In Part II, I present an overview of the legislative discussion concerning the treatment of debtors, who might be able to repay more from future income than that which would be distributed in bankruptcy proceedings.

* Professor at the University of Tokyo, Tokyo, Japan. I would like to express special thanks to Professor Jay Westbrook for organizing the 13th Conference of the International Academy of Commercial and Consumer Law. This research was financially supported by the Ministry of Education, Culture, Sports, Science and Technology (MEXT), Grant-in-Aid for Scientific Research on Priority Areas (2), 16090207, 2005.

I. OVERVIEW OF JAPAN'S PERSONAL INSOLVENCY LAW: BANKRUPTCY PROCEEDINGS AND SPECIAL REHABILITATION PROCEEDINGS FOR INDIVIDUAL DEBTORS

A. *Overview of Japan's Personal Insolvency Law*

I start by providing a general description of the Bankruptcy Law and the Civil Rehabilitation Law before focusing on personal insolvency.

The Bankruptcy Law (*Hasan Ho*)¹ was comprehensively amended in 2004, and became effective on January 1, 2005. The Bankruptcy Law provides for bankruptcy proceedings, which are applicable to both individuals and legal entities.² A bankruptcy proceeding is a sell-out proceeding where a debtor gives up all assets (except for those exempt in the case of an individual debtor), the court-appointed trustee sells these assets, and the proceeds are distributed to creditors on a pro-rata basis.³ In 2005, there were 227,053 bankruptcy cases terminated; 216,582 of those cases involved bankruptcy proceedings of individual debtors.

The Civil Rehabilitation Law (*Minji Saisei Ho*)⁴ was enacted in 1999, and became effective on April 1, 2000. This law provides for civil rehabilitation proceedings, which are also applicable to both individuals and legal entities.⁵ A rehabilitation proceeding is a pay-out proceeding where a debtor can propose to keep all assets in exchange for promising to pay off debts from future income over a period of time according to a rehabilitation plan.⁶ A rehabilitation plan becomes effective upon its acceptance by a majority of unsecured creditors and court approval.⁷ In 2005, there were 27,478 rehabilitation cases terminated; 26,644 of those cases comprised special rehabilitation proceedings for individual debtors.

B. *Bankruptcy Proceedings of Individual Debtors*

There are several rules applicable to individual debtors, such as exemption and discharge. The law provides that exemptions shall include the debtor's household furnishings, household goods, apparel, household appliances, cash of up to ¥990,000,⁸ and the debtor's right to receive unpaid salary of up to ¥330,000⁹ per month. In addition, the court may, when petitioned by the debtor or at its own discretion,

1. Hasan Ho [Bankruptcy Law], Law No. 75 of 2004. The old Bankruptcy Law, Law No. 71 of 1922, was basically modeled upon the old German Bankruptcy Law of 1877, Konkursordnung. Although many provisions were amended when the new law was enacted, its basic structure has changed little.

2. *Id.*

3. *Id.*

4. Minji Saisei Ho [Civil Rehabilitation Law], Law No. 225 of 1999. When the Civil Rehabilitation Law became effective, the Composition Law (*Wagi Ho*), which was modeled upon the Austrian Composition Law of 1914, was repealed.

5. *Id.*

6. *Id.*

7. *Id.*

8. Approximately US\$8,390 (US\$1=¥118). The cap amount was ¥210,000 before the amendment, and was raised dramatically—mainly to protect the debtor and dependents thereof.

9. Approximately US\$2,797 (US\$1=¥118).

extend the scope of exemption in consideration of certain factors, including the following: the total amount of other exempted properties, whether the debtor is employed, and the number and age of family members. Typical examples of exemption extensions are bank account deposits up to a particular amount, and ownership of a motor vehicle in cases in which the debtor lives in an area (where the public transportation system is not well-established or where the debtor runs a carrier business). There is no homestead exemption in Japan, so the debtor has to give up real estate.

A filing for a bankruptcy proceeding by the debtor is deemed to be a filing for discharge. The court grants a debtor a discharge—except in certain instances. Grounds for denial of discharge include the debtor's wrongdoing in or in connection with bankruptcy cases—such as concealment of assets to defraud creditors or making false statements feigning solvency when borrowing money—and refusal of the debtor to testify or cooperate with the trustee or court.¹⁰ The discharge is also denied if the debtor was granted a discharge in a previous bankruptcy case or rehabilitation case within certain time limits.¹¹ Under the old Bankruptcy Law, a debtor could not receive a discharge in a bankruptcy proceeding if a prior discharge had been received within ten years of the new filing.¹² It was argued that this period must be shortened to further protect debtors in the modern economy; although moral hazards must also be minimized. The new Bankruptcy Law provides that a debtor cannot presently receive a discharge if a prior discharge was received within seven years (rather than ten) of the new filing.¹³ Even in one of the above cases, the court may grant a discharge at its discretion in consideration of the grounds for financial failure.¹⁴

Under the old Bankruptcy Law, a discharge order did not discharge an individual debtor from debts for: (1) taxes; (2) compensation for damage caused by willful tort; (3) wages; or (4) penalties and fines.¹⁵ The new Bankruptcy Law, however, adds two categories of debts which cannot be discharged: (5) debts for personal injury or death caused by an intentional or reckless act of the debtor; and (6) debts to a spouse, former spouse, or child of the debtor, for alimony, maintenance, or support for the spouse or child.¹⁶

In the legislative discussion, it was argued that a cap should apply to debts under the above categories (5) and (6) to protect the debtor from unlimited obligations. However, the new Bankruptcy Law provides for no such limit or cap to discourage moral hazards.

In practice, most debtors who would satisfy the criteria for the commencement of bankruptcy proceedings never progress to being formally liquidated because it appears to creditors that there are no non-exempt assets in the estate with which to fund the administration of the bankruptcy proceeding, mainly compensation for the trustee. The Bankruptcy Law provides that a bankruptcy proceeding be commenced and then terminated simultaneously (often called “simultaneous termination”), and

10. Hasan Ho [Bankruptcy Law], Law No. 75 of 2004.

11. *Id.*

12. Hasan Ho [Bankruptcy Law], Law No. 71 of 1922 (amended 2004).

13. Hasan Ho [Bankruptcy Law], Law No. 75 of 2004.

14. *Id.*

15. Hasan Ho [Bankruptcy Law], Law No. 71 of 1922.

16. Hasan Ho [Bankruptcy Law], Law No. 75 of 2004.

no trustee be appointed.¹⁷ In 2005, of 216,582 bankruptcy cases involving individual debtors, there were 194,865 simultaneous termination cases (ninety percent). It is argued that because no investigation by the trustee is conducted in these cases, the debtor's wrongdoing that might otherwise lead to denial of discharge could be overlooked and a discharge could be granted. Recently, the court has appointed a trustee in some consumer bankruptcy cases, and awarded a comparatively lower amount of compensation to the trustee by limiting the scope of investigation that the trustee needs to conduct. Most of these cases turn out to be assetless cases, and are terminated after the trustee's investigation. In 2005, among 216,582 bankruptcy cases of individual debtors, there were 15,897 cases (seven percent) where trustees were appointed and terminated because of an assetless estate.

C. *Special Civil Rehabilitation Proceedings for Individual Debtors*

Because civil rehabilitation proceedings were originally intended mainly for small- and medium-sized businesses, due to the cost involved, they are rather burdensome for consumers and individuals who run a business as an individual proprietorship. In the year 2000, the Civil Rehabilitation Law was amended to add new chapters, one of which specified simplified procedures for individual and regularly salaried debtors owing ¥50 million or less, with a three-year duration for the rehabilitation plan in principle.¹⁸ Under special circumstances, the duration of a plan can be extended to up to five years.¹⁹ Two major features of the simplified proceedings are as follows:

1. Officers

In most regular civil rehabilitation cases, the court appoints a supervisor, while debtors continue to have rights to administer and dispose of the debtor's assets, subject to a broad range of supervision by the supervisor. On the other hand, they must remain inexpensive and simple, because such proceedings only deal with small cases. The court may appoint a Rehabilitation Officer for Individuals (*Kojin Saisei Iin*), whose function is limited to investigating the debtor's assets and income, assisting the court in reviewing the legitimacy or amount of claims to which the debtor or other creditor may object, and advising the debtor in drafting an appropriate plan.

2. Claim Verification Process

When an objection is raised to a claim filed by the debtor or other creditors, the court reviews the legitimacy or amount of the claim in summary, rather than plenary, proceedings. The court makes a binding decision only on the amount of voting rights for creditors' meetings—allotted to the creditor whose claim is objected to—and there are no provisions for appeal. This decision, however, does not have the

17. *Id.*

18. Minji Saisei Ho [Civil Rehabilitation Law], Law No. 225 of 1999.

19. *Id.*

same effect as a judgment, in the sense that the decision has no binding effect on the substance of the claim.

Chapter 13 of the Civil Rehabilitation Law provides for two kinds of simplified Civil Rehabilitation proceedings for individual debtors. The first type is for individual debtors with a generally regular income, and is referred to as "small size individual rehabilitation."²⁰ There were 18,567 cases of such proceedings in 2005. In these proceedings, a rehabilitation plan may become effective with the creditors' acceptance and the court's confirmation. A plan is accepted if the creditors that reject the plan in writing are owed half or less of the total allowed claims and number less than half of all the creditors. This "negative approval standard" assumes that creditors who do not reject a plan in writing accept the plan. Major requirements for court confirmation are: (1) a "best interest test," under which each creditor should receive an amount no less than that which he or she would receive if the debtor's assets were liquidated under bankruptcy proceedings; and (2) a minimum payment rate, basically twenty percent, depending on the total amount of debt.²¹

The second kind of proceeding is intended for individual debtors with regular stable income, such as wages, and is called the "wage earners rehabilitation." The most important feature of such a proceeding is that the rehabilitation plan becomes effective with the court's confirmation, and without the necessity for creditors' approval. There were 8,428 cases of such proceedings in 2003, and 8,077 in 2004. Major requirements for confirmation are not only (1) and (2), as aforementioned, but also a "disposable income standard," under which the debtor must repay his or her debts (as modified by a plan) from his or her regular income, less taxes, social insurance premiums, and permissible living expenses provided by the cabinet order.

II. DEBTORS WITH ABILITY TO REPAY AND POSSIBILITY OF ABUSIVE FILINGS

A. *Issues Discussed in the Legislative Process*

One of the issues most intensively discussed in the legislative process was the ability of the debtor to opt for bankruptcy proceedings, regardless of the amount of expected future income. The tentative draft that was publicized for comment in June 2000 proposed three alternatives: (1) the debtor would be able to choose between either bankruptcy proceedings or simplified rehabilitation proceedings; (2) the debtor would be discharged in bankruptcy proceedings only after attempting to

20. *Id.*

21. The following shows the minimum payment rate or amount based on total amount of debt:

<u>Total Amount of Debts</u>		<u>Minimum Payment Rate/Amount</u>
0 - ¥1,000,000	:	100%
¥1,000,000 - ¥5,000,000	:	¥1,000,000
¥5,000,000 - ¥15,000,000	:	20%
¥15,000,000 - ¥30,000,000	:	¥3,000,000
¥30,000,000 - ¥50,000,000	:	10%

repay his or her debts in rehabilitation proceedings, if his or her expected disposable income exceeded a certain amount; and (3) the debtor would be discharged in bankruptcy proceedings only once he or she had repaid his or her debts to the amount receivable by each creditor if the debtor chose simplified rehabilitation proceedings (where the “minimum payment rate standard” or “disposable income standard” would apply), if the expected disposable income of the debtor exceeded a certain amount.

As long as a debtor chooses a rehabilitation proceeding, creditors will be able to receive an amount no less than what they would receive if the debtor’s assets were liquidated under bankruptcy proceedings, because a “best interest test” applies when a rehabilitation plan is confirmed. On the other hand, if a debtor with the ability to repay more than hypothetical bankruptcy distribution chooses a bankruptcy proceeding and is discharged, it could be argued that the interest of creditors is damaged in the sense that they lost an opportunity to be repaid from the debtor’s future income. This concern is serious when a debtor has minimum assets to maintain his or her life now but where high and regular future income is definitely expected.

An argument for the second and third alternatives is that creditors—namely consumer financing and credit card companies—usually look to debtors’ future income rather than, or at least in addition to, debtors’ current assets. Under the second and third alternatives, debtors would be forced, directly or indirectly, to pay more than what would be distributed in bankruptcy proceedings.

The Bankruptcy Law Committee finally chose the first alternative, mainly because both the second and third were rather impractical. Calculating the expected disposable income means having to initially estimate the debtor’s income in the near future, and then deducting tax, social insurance, and necessary expenses of the debtor and dependents, which may vary based on the number and age of dependents. Calculation would have to be done by neutral court-appointed officers, and hearings of debtors would also be necessary. Although there is no empirical study on the ability of debtors who filed for bankruptcy proceedings to repay, it is said that only a small portion of debtors would be able to repay more from their future income. Calculating the expected disposable income to pick up debtors with the ability to repay more in all personal bankruptcy cases,²² numbering as many as two hundred thousand, would be time-consuming and not at all cost-effective. This gate-keeping difficulty was critical in making the decision. Therefore, under the current law, a debtor can choose between either bankruptcy proceedings or rehabilitation proceedings, regardless of the amount of expected disposable income.

B. Possibility of Abusive Filings

Some practitioners argue that current laws allow petitions for bankruptcy proceedings to be dismissed through abusive use (general clause in Japanese law), if the amount of the expected disposable income of the debtor is relatively high. As far as I know, however, there has been no reported case in which a petition for a

22. One of the related issues is whether calculating the expected disposable income is required for all personal bankruptcy cases or only in cases where creditors request it. Under the latter scheme, the required cost would be less, but there is a concern that a particular type of creditors would request it abusively.

bankruptcy proceeding was dismissed because of the amount of the debtor's disposable income. It is pointed out that an argument for dismissal based on abusive filing is problematic because there are no clear criteria for judging whether a certain filing is an abuse and judgments could vary from judge to judge.²³

Should Japanese insolvency laws be amended in the future to introduce a new legal scheme to prevent abusive filings? In order to answer this difficult question, I first focus on who will bear the burden of defaults in a legal scheme to prevent abusive filings. On the one hand, under current law, the cost of defaults of individual debtors could be passed along to other persons who borrow money from consumer financing companies (some of which are financially related to mega banks), in the form of higher interest rates;²⁴ the cost could even be passed on to all other people, in the form of higher interest rates and higher prices. On the other hand, if the second or third of the aforementioned alternatives (Part II.A) is introduced, the cost of gate-keeping in bankruptcy or rehabilitation proceedings would be a burden to courts, and ultimately to all tax payers. It would also cause a delay in insolvency proceedings and other regular civil cases. It could be argued that a solution to the cost problem is a legal scheme under which gate-keeping—that is, calculation of debtors' future income—is needed only in cases in which one or more creditors request it, and the cost for gate-keeping is borne by the creditors who requested it. But this idea cannot be an answer, because those creditors can easily pass along the cost they paid to the court to other people in the form of higher interest rates and higher prices.

Should the view that a legal scheme is needed to prevent abusive filings prevail, it should first be discussed whether it can be justified to help creditors (mainly consumer financing companies and credit card companies) in collecting their loans, by establishing a threshold to sort out debtors and by imposing costs to apply the court system to all taxpayers. Would this be cost effective? Even if it were, could we call it justice?

III. CONCLUSION

The consumer credit industry has developed dramatically for several decades, and it has both a bright and dark side. To enjoy the bright side of consumer credit, we need to pay the cost that inevitably accompanies its development. When we design a legal scheme for personal insolvency, we must decide how to allocate the cost and whether it can be justified from the viewpoint of justice. I hope this paper interests commercial lawyers and consumer lawyers worldwide.

23. There was a judge who rendered many decisions to deny discharge, most of which were reversed in appellate courts. Although these are exceptional and extreme cases, bankruptcy attorneys are concerned about arbitrary decisions.

24. In this context, it is interesting that there was recently a legislative discussion to lower interest rate caps from 29% a year to 15-20% a year.