

**RECENT DEVELOPMENTS IN INSOLVENCY REFORM IN ASIA
SUMMARY OF RECENT DEVELOPMENTS
IN INSOLVENCY REFORM IN JAPAN**

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Introduction

There has been considerable legislative activity in the field of insolvency law reform in Japan since 1996. The need for a fair, effective and efficient legal system is critical as the Japanese economy has been mired in recession, private work and composition can no longer be a panacea for corporate rescue regime. The practice of insolvency proceedings has also been gradually changing. As the courts were used to screen cases for eligibility when a filing for insolvency proceedings was made and to supervise debtor, the formal insolvency proceedings were time-consuming and expensive. For the sake of efficiency, the key player of the screening process and assessment of a prospect of a case for reorganization is shifting gradually from the court to the petitioner on behalf of the debtor or supervisor.

This article will first give a general explanation of Japanese insolvency law for a preliminary study. Secondly, it will describe the recent developments in insolvency reforms from 1996 in Japan. Finally, it will conclude with a discussion of the implications of the new corporate rescue regime.

Insolvency Law in Japan

There are five types of judicial insolvency proceedings in Japan, two of which can be categorized as liquidation proceedings and the other three as rehabilitation .

In 1922, the Bankruptcy Law (*Hasanho*)¹⁾ was enacted modeled after the German Bankruptcy Law of 1877. That following year, the Composition Law (*Wagiho*)²⁾ was enacted, which was basically modeled after the Austrian Composition Law of 1914. This proceeding can be filed only by the debtor. These two proceeding are applicable to natural persons and judicial persons such as business corporations.

Corporate Arrangement (*Kaishaseiri*) was introduced in 1938 in order to help the private workout to rescue corporations under the supervision of the court. Special liquidation was also introduced at the same time with corporate arrangement. It is a liquidation procedure under the supervision of the courts. These two are regulated by the corporate section of the Commercial Code³⁾.

After the World War , the Corporate Reorganization Law (*Kaishakoseiho*)⁴⁾ was enacted in 1952 based under on the Bankruptcy Act in the United States. That same year, a discharge system for individual debtors was introduced in the Bankruptcy Law, which was also under the influence of the Bankruptcy Act in the United States. The Corporate Reorganization Law is applied only for the stock corporations. Those five systems above were not necessarily harmonious with each other.

The number of the filings of insolvency procedure from 1997 to 1999 are in table1 shown below.

Most of the bankruptcy cases of individuals are consumer bankruptcy . The number of business bankruptcies is between 3,000 and 4,000 a year. Almost all composition cases are corporate cases. As the Corporate Reorganization Law is tailored for the large corporation, the number of cases is less than 100 a year.

There are approximately 14,000 to 18,000 business failures a year. If a company runs into trouble, its main bank would rescue it. As the formal procedures are time-consuming and expensive for the insolvent debtor, most of them are handled outside the court.

Reference

- 1.Law No.71 of1922
- 2.Law No.72 of1922
- 3.Law No.48 of1899
- 4.Law No.172 of1952

The Implementation of Rescue Schemes for Financial Institutions

A. The rescue package for financial institutions⁵⁾

The Japanese financial institutions have been protected under the tight regulations. Until the failure of the Hanwa Bank, a middling regional bank in 1996, no Japanese bank had undergone liquidation after the World War . If a financial institution was in trouble, a rescue plan, such as merger and acquisition was carried out under the guidance of the Ministry of Finance.

Most of the banks, hugely unprofitable and burdened with nonperforming loans since the early 1990s, no longer have enough funds to come to the rescue of failing firms of all types. The life insurance companies are also struggling to pay the fixed rates they had committed for annuities in the late 1980s because of falling premium income and large underwriting losses.

The government pushed through an unpopular and expensive scheme to liquidate seven home mortgage lending companies (*jusen*) under Ministry of Finance guidance in order to save agricultural cooperatives in 1996. Land values did not improve to bail out of troubled companies. As it became difficult to negotiate and reach an agreement of a rescue package for banks or life insurance companies under the leadership of the relevant authorities, the need of various efficient rescue proceedings is highlighted.

Firstly the special law with regards to the reorganization proceedings of the financial institutions⁶⁾ was enacted in 1996. Under the special law, the corporate reorganization proceedings are applied not only to banks all of which are stock corporation but also to the corporate financial institutions such as credit unions. The Minister of Finance is entitled to file a reorganization proceeding or bankruptcy proceeding with respect to any financial institution in a more formal and timely manner. The Deposit Insurance Cooperation can file depositors' claims on behalf of depositors in a reorganization proceeding. Although the Hokkaido Takushoku Bank collapsed in 1997, the Hokuyo Bank took over the operations with infusions by Bank of Japan. The reorganization plan under the special law was not applied.

Secondly the special law on emergency measures to revitalize the functions of the financial system⁷⁾ was enacted in 1998. Under the special law, The Financial Revitalization Commission⁸⁾ will identify insolvent financial institutions based on the Financial Supervisory Agency examination and this Commission is entitled to appoint a financial trustee (*kinyuseirikanzainin*) to removed the director and take over the management of insolvent financial institution. The Deposit Insurance Corporation can be appointed as a financial trustee. The financial trustee must investigate and take action against the delinquent director. The Financial Revitalization Commission is entitled to select an appropriate resolution specified in the special law. The insolvent banks must either be (1) operated by a financial trustee as a bridge bank to assume business until a private successor institution emerges, or be (2) temporarily nationalized by placement under special public management. Where the Financial Revitalization Commission determines that systemic risk is posed by a bank's failure, insolvent or nearly insolvent institutions will be temporarily nationalized through The Deposit Insurance Corporation's compulsory acquisition of their shares, set a price determined by the Commission. Public management of the bank will terminate when the bank has been rehabilitated, a private successor emerges, or its shares are reprivatized.

The Long-Term Credit Bank and Nippon Credit Bank were temporarily nationalized in 1998. Under both resolution mechanisms, nonperforming loans will be transferred to a new Resolution and Collection Organization, sound borrowers of the failed bank will continue to receive funding to prevent a chain reaction of bankruptcies in the real economy. The special law will cease to be effective on March 31, 2001.

B. The rescue package for insurance companies

Nissan Mutual in 1997 and Toho Life in 1999 were ordered to suspend operations. As the special law with regards to the reorganization proceedings of the financial institutions did not apply to insurance companies, they were handled under the Insurance Company Law.

When an insurance company fails, the insurance administrator is appointed to make a necessary plan to transfer the whole insurance policy package or merger with stronger financial institution. The Insurance Policyholder Protection Institute is entitled to extend financial assistance for the successor in order to cover the loss of the policyholder. The right of the policyholder can be altered in order to avoid paying the high, fixed returns on old policies without control of the court.

The rescue plan under the Insurance Company has the following shortfalls. While the general creditor is protected under the Insurance Company Law, the right of the policyholder can be diminished. The compensation fund is undercapitalized in order to clean up Toho Life in 1999, the need of various efficient rescue proceedings has become critical.

5. See Milhaupt, *Japan's Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design?*, 77 Washington University Law Quarterly, 399, 408 (1999)

6. Kin'yu kikan no kosei tetsuzuki no tokureito ni kansuru horitsu, Law No. 95 of 1996

7. Kin'yu kano no saisei no tame no kinkyu sochi ni kansuru horitsu, Law No. 132 of 1998

8. The Financial Supervisory Agency assumed supervisory responsibility over banking, securities, and insurance industries from the Ministry of Finance on June 22, 1998.

The Recent Developments in Insolvency Reform in Japan during last 12 Months

A. The Civil Rehabilitation Law of 1999 (Minjisaisei-hou)

The background

In 1996 on December, the Legislative Advisory Council announced it was to embark on a whole reform of the Insolvency Procedure within five years to update insolvency proceedings to meet the demand of the modern international business world.

The debtor can rehabilitate business without necessarily getting rid of ownership under the composition proceeding. As the Composition Law has the following shortfalls, most of the business failures handled by private workout although the number of middle and small companies facing liquidity and cashflow problems has been increased. The composition proceedings will commence when the causes of a bankruptcy such as the value of the company's assets is less than its liabilities (balance sheet test) or inability to pay one's debts exists (Art.12). On the filing of petition the proposal of rehabilitation plan should be submitted (Ar.13). These requirements pushed the filing of petition by debtor for rehabilitation too late. The supervision of the debtor after plan of payments agreed by creditors is also weak.

In order to cope with urgent demand to rescue small business suffering from cashflow problems from the long recession after the bubble economy collapsed in 1991, the reform schedule was advanced in 1998 to introduce more simple and efficient reorganization proceedings for small business within one year.

The government offered emergency loan-guarantees to rescue imperilled small businesses in October 1998.

The feature of the Civil Rehabilitation Law

The Bill of Civil Rehabilitation Law was enacted on 14 December 1999 and enforced on April 2000. The Civil Rehabilitation Law is modeled on the United States' Chapter 11 regime. The Civil Rehabilitation Law has the following scheme to provide a more efficient mechanism for a rehabilitation of a business and financial difficulties. The Composition Law was repealed.

The causes of a bankruptcy is not required when the debtor is in financial difficulties (Art.21). The Limit of proposal of the rehabilitation plan is extended within the fixed period set by the court (Art.163), it is not necessary to be submitted on the filing. These requirements are implemented to encourage debtor to file for rehabilitation earlier.

On presentation of a petition for a civil rehabilitation proceeding, the court may suspend not only provisional attachment and provisional disposition (Art.30) but also execution against debtor's assets (Art.26). The court may order a comprehensive protection with regards to debtor's assets (Art.27). The debtor is unable to withdraw the petition without permission of court (Art.32) in order to prevent the abuse of moratorium. The court may appoint an provisional administrator (*hozenkanrinin*) to take over the business and administrate the debtor's assets (Art.79).

Neither the petition nor any resulting civil rehabilitation proceedings affects substantive rights of secured creditors (Art.51). The court may order a stay of the foreclosure of security interest or mortgage within a fixed period if it will not cause great harm to the security creditor (Art.31). On application of the debtor, the court may order redeem the security if the security is necessary to continue business (Art.148).

The debtor can retain ownership and continue business in general (a kind of debtor in position) but the court may appoint a supervisor (*kantokuin*) to supervise the debtor (Art.54) or appoint a trustee to take over the business (Art.64). The supervisor will also supervise the debtor to carry out the plan of payments (*saiseikeikaku*) for three years. The trustee will supervise the debtor until the plan is complete (Art.188, s.2, s.3). The period of the plan is generally within ten years (Art.155, s.2). The supervision of the debtor after plan of payments is strengthened.

The failing corporation will either (1) operate business holding the ownership (a kind of debtor in position), (2) transfer whole or a part of the business, (3) eventually liquidate the business. The court may give permission to transfer whole or a part of the business on application of debtor after commencing civil rehabilitation proceeding if the stock company is unable to pay the whole debts and if it is necessary to continue business (Art.42, Art.43). In order to promote an efficient merger, neither the proposal of rehabilitation plan nor the confirmation of special resolution of general meeting (The Commercial Law, Art.245, s.2) is required.

The debtor does not have the exclusive right to propose a rehabilitation plan. The general contents of the rehabilitation plan will be to write off debt and reschedule the payments. It is also possible to reduce capital to

restructure the insolvent company with a confirmation by the court in advance(Art.154,s.3, Art.161, Art.183). In order to provide a more simple and efficient restructure proceeding, the confirmation of special resolution of general meeting(The Commercial Law, Art.375, Art.343) is not required. It is necessary to be confirmed by the board of directors to increase capital(The Commercial Law, Art.280-2,s.1).

The rehabilitation plan should be confirmed by over half of the holding shares having a right to vote on which a sum as been paid up equal to not less than half of the total sum paid up on all the shares conferring that right(Art.171,s.4) As the requirement of confirmation of the composition was a three-fourths majority of the total sum paid up on all the shares, it becomes much easier to reach the agreement if the main bank will accept the Rehabilitation plan.

If a creditors' committee organized outside the court and the court satisfied that it represents for whole of creditors and a half of creditors admit to participate it to participate in the proceeding, the court may recognize the creditors' committee to make an opinion to the court, debtor or supervisor. The court may also hear from the creditors' committee(Art.118). The creditors' committee may also exercise a further supervise the debtor to carry out the plan(Art.154,s.2)

Some feature of current practice in Tokyo District Court¹⁰⁾

The number civil rehabilitation cases filed from April 2000 to November 2000 is 160, 151 are judicial persons and 9 are natural persons. 80per cent of judicial persons are medium and small- scale enterprises, the remaining 20per cent are large company (the capital is over one hundred million yen and the debt is over 10billion yen) such as Sogo, a department store. The number of civil rehabilitation cases in 2000 is estimated to be six times as much as the number of former composition in 1999.

The standard timetable from filing is set in advance. On presentation of a filing for a civil rehabilitation proceeding, the court will give an order on the same day to a prohibition of the payments of debts and appoint a supervisor. The commence order will be made within 15days from the filing since 10 July, 2000. The supervisor will submit a report asking for major creditors. The supervisor will appoint an accountant as an assistant to conduct inquiry of the cause of financial difficulties, accuracy of books and records and existence of fraud. The accurate prospects of payment is not necessary to conduct as the supervisor will supervise the debtor to follow the rehabilitation plan for three years after the confirmation of the Rehabilitation plan.

The proposal of the rehabilitation plan must be submitted within two months from the filing and the Rehabilitation plan must be submitted within three months from the filing.

The creditors' meetings are generally held within 6 months from the filing(actual termination of the rehabilitation proceeding). Compared with the former composition, the civil rehabilitation proceeding is much swifter.

32 cases are held the creditors' meeting, 26 cases are confirmed the rehabilitation plan, 6 cases are denied the plan at the creditors' meeting.

At the Tokyo District Court, the judge used to screen cases for eligibility whether to make moratorium and to supervise debtor. Under the civil rehabilitation proceedings the judge set a timetable and conducts case management but does not involve itself directly with the screening of a prospect of a case or supervise the debtor. The petitioner on behalf of the debtor is now in charge of the function.

9. Law of No.225 of 1999

10. See Sono, "The current practice and issues of the Civil Rehabilitation Law at Tokyo District Court",91 saikenkanri,94(2001);"The practice direction and time schedule of the Civil Rehabilitation cases at Tokyo District Court",1594 kinyuhomujijyo,6(2000)

B. The Reform of Rescue Package for Financial Institutions and Insurance Companies

The Reform of Rescue Package for Financial Institutions¹¹⁾

The Bill of Reform of Deposit Insurance Corporation Law was enacted on May 24 in 2000 in order to structure the temporary legislation¹²⁾ to permanent rescue scheme for financial institutions from April 2001. The Deposit Insurance Cooperation is entitled to extend financial assistance for promotion of efficient mergers of insolvent depository institutions with stronger financial institution or promotion of purchasing of assets and assuming liabilities of insolvent institution by healthier institutions(Art.59,s.2,Art2).

Until 31March,2002, financial assistance for mergers of weak institutions may exceed the payoff cost limit(including those above statutory payoff limit of ten million yen until March,2003 (Supplementary Provisions, Art.17).

The private successor institution may provide funds for the insolvent institution to ensure the *pari passu* principles of distribution of the insolvent institution(Art.59-2). The Deposit Insurance Cooperation is authorized to make an agreement in advance with the private successor institution to compensate a part of losses when the claims transferred to the private successor institution become unable to collect (Art.2,s.10, Art59,s.1,s.5).

The special law was amended to appoint a financial trustee (*kinyuseirikanzainin*) by the Prime Minister to remove the director and take over the management of insolvent financial institution (Art.74,s.2, Art.77). The court may give permission to transfer the business and reductions of capital on application of the financial trustee if the financial institution is insolvent(Art.87). In order to provide a simpler and more efficient, a shareholder's meetings is not required Creditors are not allowed to oppose the reductions of capital(Art.89).

The insolvent banks must either be (1)operated by a financial trustee to assume business until a private successor institution emerges for one year , or (2)to create a affiliate of Deposit Insurance Corporation as a bridge bank to assume business until a private successor institution emerges (Art.81), (3)temporarily nationalized by placement under special public management(Art.102). Where the Prime Minister after holding a financial risk management conference determines that systemic risk is posed by a bank's failure, insolvent institutions will temporarily nationalized through The Deposit Insurance Corporation's compulsory acquisition of their shares (Art.102., Art.111, Art.112). Public management of the bank should terminate as soon as a private successor emerges, or its shares are reprivatized (Art.119).

The Reform of special law with regards to the reorganization proceedings of financial institutions also enacted in 2000. The Financial Agency¹³⁾ is entitled to file reorganization proceedings and civil rehabilitation against any financial institution(Art.178). The Deposit Insurance Corporation can file depositors claims on behalf of depositors in reorganization proceedings(Art.178-8 178-15). When the reorganization proceedings or the civil rescue proceedings commences and the trustee is appointed, the Deposit Insurance Corporation is entitled to provide financial assistance to cover the payments limited to the statutory payoff limit(ten million yen until March,2003)(Art. 127). On the petition of the trustee, the court may make a compensation payments order to eligible depositors. The Deposit Insurance Corporation can file the fund as reorganization claims or civil rescue claims. When the protection order is made or the reorganization proceedings starts, the depositors will be protected while the financial institution continues business.

The Reform of Rescue Package for Insurance Companies¹⁴⁾

The Reform of the Insurance Company Law and the Reform of special law with regards to the reorganization proceedings of financial institutions also enacted in 2000. Under the special law with regards to the reorganization proceedings of the financial institutions, the cooperate reorganization proceedings are applied not only for the insurance company but also to the mutual insurance company. The Financial Agency is entitled to file reorganization proceedings against an insurance company when the insurance company is deemed to be insolvent (Art.161). The Insurance Policyholder Protection Institute can file depositors claims on behalf of depositors in a reorganization proceeding (Art.177-22). The provision of executory contract is not applied in order to protect the right of policyholders. The right of policyholders is entitled as a statutory lien(*sakidoritoken*)(Insurance Company Law,Art.117-2). A statutory lien is recognized as a priority reorganization claim (the Cooperate Reorganization Law, Art.228,s.1) As a statutory lien is handled outside the civil rescue proceedings, the civil rescue proceedings is not applicable to the insurance company. When the reorganization proceedings commenced, The Insurance Policyholder Protection Institute is entitled to acquire the claims of policy holders(Art.177-20) and to provide financial assistance to the successor in order to cover the loss of policyholder (Art.177-29, 177-30, Insurance Company Law,Art.270-6-6, Art.270-6-7). When the protection order is made or the reorganization starts, the right of policyholders will be protected.

The right of the policyholder can be altered according to the reserve fund. The right of the policyholder who canceled in advance after the protection order is ordered or the reorganization proceedings is commenced, can be subordinated (Art.177-34,s.2). These are the special provision of the *pari passu* principles of distribution.

Chiyoda Mutual Life and Kyoei Life Company applied for the reorganization proceedings on October 2000. The reorganization proceeding of Kyoei was extremely swift; the case was filed on 20 October, 2000 and the Protection Order was made on the same day and Reorganization proceeding was commenced on 23 October, 2000.

11 .See Matsushita, "The New Deposit Insurance Corporation System and the Rescue Scheme for Financial Institutions", in *new financial system and law* (eds.Egashira and Iwahara, 2000),164

12. supra note 7

13. The Financial Supervisory Agency was reorganized to The Financial Agency on July,1999

14.Yamashita,"In cooperation of Mutual Insurance Company and the Rescue Scheme for the Insurance Company", supra note11at107

C. Cross Boarder Insolvency¹⁵⁾

Japan is sometimes referred to as a country which has adopted the territorial principle(The Bankruptcy Law , Art.3(1), The former Composition Law, Art.11,The Corporate Reorganization Law, Art.4, (1). The principle of territoriality can cause inequality among creditors between Japan and foreign countries and also causes great

inconvenience in the reorganization of an international company. With ever increasing amount of trade and investment between Japan and other countries, it is necessary to harmonize the international insolvency proceedings.

The Bill of Recognition and Co-operation of Foreign Insolvency Proceedings was enacted on 21 November 2000 and will be enforced from April 2001. The Bill was under the great influence of UNCITRAL Model Law . The Law of Recognition and Co-operation of Foreign Insolvency Proceedings¹⁶⁾ contains of recognition proceedings and requirements of recognition of foreign insolvency proceedings(Chapter2), co-operative measures to be extended to foreign insolvency(Chapter3) , relations between concurrent domestic and foreign insolvency proceedings(Chapter4). The Law repeals infamous provisions setting forth strict territorialism and adopts the principle of moderate universality.

On the petition of the trustee, the court makes an order of the recognition of foreign insolvency proceedings(Art.22). The order of recognition itself will not bring any effect automatically, but the court may suspend execution, provisional attachment and provisional disposition against an assets of debtor, law suits or administrative proceedings with regards to an asset of debtor(Art.25). The court may order a prohibition of the disposition of assets or business of debtor, a prohibition of the payments of debt(Art.26), and stay of the foreclosure of security interest or mortgage(Art.27).

Insolvency proceedings filed under Japanese insolvency laws before or after the recognition of foreign proceedings will prevail over insolvency proceedings in foreign countries(Art.57,s.1). However, foreign insolvency proceeding filed in a country where the principal place of business of the debtor exists may at the discretion of the court prevail over Japanese concurrent proceeding , provided that the interest of the creditors in Japan will not be unduely prejudiced and the recognition of such foreign proceeding will promote the benefit of the creditor as a whole. In such case , concurrent Japanese insolvency proceedings will be discontinued.

15.Recent Articles with regards to Japanese international insolvency are Kashiwagi "The Cross Border Insolvency Situation in Japan", Int.Insol.Rev.,Vol.9:205, 2000,Matsushita, "On Current International Insolvency Law in Japan", Int. Insol. Rev., Vol.6:210, 1997

16. Law No.129 of 2000

D. Consumer Bankruptcy

The number of consumer bankruptcies has increased radically since 1995 because of unemployment or income interruption. Under the discharge proceedings of Bankruptcy Law, the individual debtor may not keep a home, it is necessary to draft the special provision to allow the debtor to keep the home if the debtor can pay the arrearage in the home mortgage with future earnings through rescheduling the payment plan. As the civil rescue Law is tailored for the middle and small company, it is necessary to introduce much more simple and efficient rehabilitation proceedings for the regular income debtor and small private business. The Bill of reform of Civil Rehabilitation Law enacted on 21 November 2000 and will be enforced April 2001 ¹⁷⁾

17. Law No.128 of 2000

Conclusion

The overhaul of the insolvency system has not yet been completed in Japan. The Bankruptcy Law and The Corporate Reorganization Law is now under revision.

We are now at the start of economic restructuring , it is too early to assess the effect of the reform but these new developments to shift the corporate rescue regime from the private workout or compromise to more formal and fair proceedings in recent legislation are undoubtedly welcome. The rescue scheme for the financial institution conducted under the leadership of the relevant authorities is amended to provide more efficient and fair options to rescue financial institutions with the assistance of The Deposit Insurance Cooperation as a safety net. The judicial rescue scheme to reorganize financial institutions and insurance companies was also implemented to assure fair proceeding.

Under the civil rehabilitation proceeding the practice of formal insolvency is also gradually changing to become more efficient in order to keep with the needs of modern business life for reorganization. The former practice which relied heavily on the court for control and supervision of the rescue process is gradually changing. The petitioner now plays a key role of screening the prospect of reorganization and supporting and supervising the business in co-operation with a financial advisor and a merger and acquisition advisory service .

The attitude of creditors is also changing, heavily relied on the value of the security during the bubble time is snow shifting much more to the cash flow of the debtor.

Although, the Civil Rehabilitation Law provides an efficient scheme for reorganization, most of the debtors still regard filing a civil rehabilitation as a last resort because the social stigma of insolvency is strong. The number

of lawyers who specialized in insolvency proceeding is limited and the special division for insolvency proceeding at court is also limited in large cities such as Tokyo, Osaka and Nagoya, it will take more time and effort to establish and maintain a fair and efficient practice.

It is necessary to establish a system to provide financial assistance for promotion of efficient rehabilitation of insolvent and distressed companies.

It is also necessary to provide an efficient mechanism to restructure the insolvent company to reduce the capital and increase the capital with debt equity swap to enhance the return for creditor