

# Comprehensive Reform of Japanese Personal Insolvency Law

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*The project of the comprehensive reform of Japanese insolvency law started in October 1996. After many enactments and amendments, there are now two types of judicial proceedings for personal insolvencies in Japanese insolvency law. The first category is straight bankruptcy proceedings in which the debtor can be discharged; the other is special Civil Rehabilitation proceedings for individual debtors. In this Article, I will first give a brief overview of the special Civil Rehabilitation proceedings for individual debtors (Part I), including a short description of two types of proceedings, and legislative issues. Then I will give a brief overview of major amendments of the Bankruptcy Law concerning individual bankruptcies (Part II), including amendments relating to the scope of exemption and discharge proceedings.*

## INTRODUCTION

The project of the comprehensive reform of Japanese insolvency law started in October 1996. The purpose of the project was to overhaul Japanese insolvency law, for both corporations and individuals, in both substance and procedures, thereby modernizing it. When the project started, the following three issues were generally accepted as priorities among others:

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(a) remodeling Civil Rehabilitation proceedings for small and medium-sized businesses; (b) creating a new legal scheme to deal with individual insolvency, and modernizing the discharge process; and (c) designing a new legal framework for cross-border insolvency cases. In October 1996, a Bankruptcy Law Committee was set up in the Legislative Council of the Ministry of Justice, and it was expected to submit all drafts of bills for new insolvency laws collectively by 2001. However, in consideration of the increasing volume of both individual insolvencies and business failures, the reform process was partially accelerated and divided into several steps.

The first product of the project was the Civil Rehabilitation Law (*Minji Saisei Ho*),<sup>1</sup> proposed primarily for business failures of small and medium-sized companies, although applicable to individuals and any type of corporation, which became effective as of April 1, 2000. At the same time, the Composition Law (*Wagi Ho*)<sup>2</sup> was repealed. In 2003, the Civil Rehabilitation Law was applied to 507 cases, excluding those involving special Civil Rehabilitation proceedings for individual debtors. In practice, some large companies were included among the Rehabilitation debtors.

The second step was: (1) to set up a new type of Civil Rehabilitation proceeding for failing individual debtors, and (2) to establish a new and well-harmonized framework for international insolvency. Two bills were prepared in the autumn of 2000. The purpose of the first was to amend the Civil Rehabilitation Law to include new chapters for pay-out proceedings for individual and regularly salaried debtors. The other was a bill for the Law on Recognition and Assistance of Foreign Insolvency Proceedings,<sup>3</sup> which was basically modeled after the UNCITRAL Model Law on Cross-Border Insolvency,<sup>4</sup> although the text of the law differed considerably from that of the Model Law. Both the amended Civil Rehabilitation Law and the Law on Recognition and Assistance of Foreign Insolvency Proceedings came into effect on April 1, 2001.

The third step was to amend the Corporate Reorganization Law (*Kaisha Kosei Ho*);<sup>5</sup> the new law has been effective since April 1, 2003.

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

2 Wagi Ho [Composition Law], Law of No. 72 of 1922. This law was modeled upon the Austrian Composition Law of 1914.

3 Gaikoku Tosan Shori Tetsuduki no Shonin Enjo ni Kansuru Horitsu [Law on Recognition and Assistance of Foreign Insolvency Proceedings], Law No. 129 of 2000.

4 Adopted by UNCITRAL on May 30, 1997, the Model Law is designed to assist states to equip their insolvency laws with a modern, harmonized, and fair framework to more effectively address instances of cross-border insolvency.

5 Kaisha Kosei Ho [Corporate Reorganization Law], Law No. 154 of 2002. The old

The final step was to comprehensively review the Bankruptcy Law (*Hasan Ho*)<sup>6</sup> and the substantive provisions of the Civil Rehabilitation Law and the Corporate Reorganization Law, in particular those regarding avoidance of fraudulent transfer and preference, limitations on set-off, treatment of executory contracts, and priority of claims. The bills were passed in May, 2004. The new Bankruptcy Law and amended provisions, meanwhile, became effective on January 1, 2005.

As mentioned above, there are two types of judicial proceedings for personal insolvencies in Japan. The first is a straight bankruptcy proceeding in which the debtor can be discharged; the other is a special Civil Rehabilitation proceedings for individual debtors. In this Article, I will first give a brief overview of the special Civil Rehabilitation proceedings for individual debtors (Part I) and then review the major amendments of the Bankruptcy Law concerning individual bankruptcies (Part II).

## I. SPECIAL CIVIL REHABILITATION PROCEEDINGS FOR INDIVIDUAL DEBTORS

### A. Overview

Because rehabilitation proceedings were originally intended mainly for small- and medium-sized businesses, they are rather burdensome for consumers and individuals who run a business as an individual proprietorship, due to the cost involved. 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<sup>7</sup> or less, with a three-year duration for the rehabilitation plan in principle.<sup>8</sup> Three major features of the simplified proceedings are as follows:

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Corporate Reorganization Law (Law No. 172 of 1952) was greatly influenced by the US Bankruptcy Act, Ch. 541, 30 Stat. 544 (1898) (repealed 1978) (especially Ch. X).

6 Hasan Ho [Bankruptcy Law], Law No. 75 of 2004. The old Bankruptcy Law, Law No. 71 of 1922, was basically modeled upon the German Bankruptcy Law of 1877, *Konkursordnung*, v. 10.2.1877 (RGBl. S.351).

7 ¥50 million is approximately equal to \$455,000 (1 dollar = 110 yen). The limit was originally ¥30 million; amended to ¥50 million in 2004.

8 Under special circumstances, the duration of a plan can be extended to up to five years.

### 1. Officers<sup>9</sup>

Since such proceedings only deal with small cases, they must remain inexpensive and simple. The court may appoint a "Rehabilitation Officer for Individuals" (*Kojin Saisei In*), whose function is limited to investigating the debtor's assets and income, assisting the court in reviewing the legitimacy or amount of claims filed by creditors, to which the debtor or other creditors may object, and advising the debtor in drafting an appropriate plan.

### 2. Claim Verification Process

When an objection to a claim filed is raised by the debtor or by other creditors, the court reviews the legitimacy or amount of the claim, in summary rather than in 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 same effect as a judgment, in the sense that the decision has no binding effect on the substance of the claim.

### 3. Hardship Discharge

If the debtor has paid more than 75% of his or her debts as modified by a plan and it becomes quite difficult for him or her to continue to pay according to its provisions, the court may grant the debtor a discharge, but only when each creditor involved in the proceedings has already received an amount not less than that receivable if the debtor's assets were liquidated under bankruptcy proceedings.

## B. Two Types of Proceedings

Chapter 13 of the Civil Rehabilitation Law provides for two kinds of simplified Civil Rehabilitation proceedings for individual debtors. The first is for individual debtors with a generally regular income, and is referred to as "small size individual rehabilitation." There were 10,950 cases of such proceedings in 2003, and 18,567 in 2004. In these proceedings, a rehabilitation plan may become effective with the creditors' approval and the court's confirmation. A plan is approved if the creditors that reject the plan in writing are owed half or less of the total allowed claims and number less

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<sup>9</sup> In regular Civil Rehabilitation proceedings, the court may appoint a supervisor, or a trustee. In fact, a supervisor is appointed in almost all cases, while a trustee is appointed only rarely.

than half of all the creditors.<sup>10</sup> 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 20%, depending on the total amount of debt.<sup>11</sup>

The second kind of proceeding is intended for individual debtors with regular stable incomes 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 premium, and permissible living expenses stipulated by a Cabinet Order.<sup>12</sup>

### C. Issues Discussed in the Legislative Process

The issue that was most intensively discussed in the legislative process was the ability of debtors 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 bankruptcy proceedings and simplified Civil Rehabilitation proceedings; (2) the debtor would be discharged in bankruptcy proceedings only after attempting to repay his or her debts in Civil 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 repaid his or her debts to the amount receivable by each creditor if the debtor chose simplified Civil

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10 This "negative approval standard" assumes that creditors who do not reject a plan in writing accept the plan. In contrast, positive approval is needed for a plan to become effective in regular Civil Rehabilitation proceedings.

11 Total amount of debts : minimum payment rate/amount:  
 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%.

12 Technical matters are sometimes provided for in Orders of the Cabinet, the administrative branch.

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.

The Bankruptcy Law Committee finally chose the first alternative, mainly because both the second and third were rather impractical. Namely, calculating the expected disposable income in every personal bankruptcy case would be time-consuming and not cost-effective. This "gate-keeping" difficulty was critical in making the decision.

Some practitioners argue that current laws allow petitions for bankruptcy proceedings to be dismissed through abusive use (a 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 bankruptcy proceeding was dismissed because of the amount of the debtor's disposable income.

## **II. AMENDMENTS OF THE BANKRUPTCY LAW FOR INDIVIDUAL DEBTORS**

In 1999, the number of petitions for bankruptcy proceedings by individual debtors was 122,741. The annual figure has grown rapidly. There were 242,357 cases in 2003 and 220,261 in 2004. Many important but largely technical changes have been made to the bankruptcy proceedings in addition to a few major amendments. Major amendments made to the Bankruptcy Law in the areas of personal bankruptcy and discharge are as follows.

### **A. Scope of Exemption<sup>13</sup>**

Under the old Bankruptcy Law, cash of up to ¥210,000<sup>14</sup> was exempted. In the legislative process, an argument was made that far more money was needed for the debtor to make a "fresh start," because he or she sometimes was fired and needed to move to a new job. The new Bankruptcy Law provides

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13 The Bankruptcy Law and other laws, including the Civil Execution Law, provide for the scope of exempted property. Items of clothing, household furnishings, goods, and appliances crucial to the debtor and his or her family are exempted. So is a certain percentage of right to payment of wage. On the other hand, there is no homestead exemption in Japan.

14 Approximately \$1,900.

that cash up to ¥990,000<sup>15</sup> be exempted;<sup>16</sup> more than doubling the original amount.

In addition, the court may, when petitioned by the debtor or at its own discretion, extend the scope of exemption based on: the total amount of other exempted properties, whether or not the debtor is employed, the number and age of family members, and so on.<sup>17</sup> 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.

### **B. Automatic Stay in Assetless Estate Cases**

Under the old Bankruptcy Law, discharge proceedings were separate from bankruptcy liquidation proceedings. Moreover, until and unless a court adjudicated bankruptcy, the debtor could not file a petition for discharge. In most cases, debtors had no substantial assets aside from property, and a court simply declared them to be insolvent without commencing actual liquidation proceedings. Usually, it took several months for a debtor to (1) file for bankruptcy, (2) file a petition for discharge, and (3) obtain a discharge order. In 1990, the Supreme Court of Japan held that because no actual liquidation proceedings commenced in such no-asset cases, individual creditor actions were not to be stayed. Therefore, if a creditor were satisfied from a debtor's assets through individual judicial proceedings implemented before the debtor had obtained a discharge order, this satisfaction would not constitute unjust enrichment. This ruling encouraged creditors to collect their claims against the debtor in a rush; that is, before the court had granted a discharge. However, it was widely recognized that this case law could prevent a fresh start for debtors and potentially cause inequality among creditors.

Under the new Bankruptcy Law, a petition for bankruptcy proceedings by the debtor is presumed as one for discharge, thereby combining the two proceedings. In addition, even when no actual liquidation proceedings commence because of a debtor's poor estate, individual creditor actions are automatically stayed once a debtor files a petition for discharge, until

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<sup>15</sup> Approximately \$9,000.

<sup>16</sup> Hasan Ho [Bankruptcy Law], Law No. 75 of 2004, § 34(3)(i).

<sup>17</sup> § 34(4).

the court grants or denies discharge, unless the debtor withdraws the petition.<sup>18</sup>

### **C. The Debtor's Obligation to Cooperate with the Court and the Trustee**

Under the new Bankruptcy Law, the debtor must cooperate with the court and the trustee in investigating the requirements of granting a discharge.<sup>19</sup> When the debtor intentionally fails to perform this obligation, the court shall deny discharge.<sup>20</sup>

### **D. Minimum Time Lapse Between Discharges<sup>21</sup>**

Under the old Bankruptcy Law, a debtor could not receive a discharge in bankruptcy proceedings if a prior discharge had been received within ten years of the new filing. 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 receive a discharge if a prior discharge was received within seven years (rather than ten) of the new filing.

In addition, a debtor cannot receive a discharge in bankruptcy proceedings if he or she filed for Wage Earners' Rehabilitation proceedings and a plan finalized in these proceedings was confirmed within seven years of the new filing. A debtor may also not receive any discharge in bankruptcy proceedings if he or she received a "hardship discharge" within seven years prior to the new filing.

However, this limitation on discharge does not apply if the prior discharge in Civil Rehabilitation proceedings was received with the creditors' approval. Therefore, if a debtor filed for small size individual Civil Rehabilitation proceedings and received both creditors' approval and a confirmation order by the court within less than seven years of the new filing, he or she would still be eligible for a discharge in bankruptcy proceedings.

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18 § 249.

19 § 250(2).

20 § 252(1)(i).

21 § 252(1)(x).



**E. Scope of Discharge<sup>22</sup>**

Under the old Bankruptcy Law, a discharge order did not discharge an individual debtor from debts relating to: (1) taxes; (2) compensation for damage caused by willful tort; (3) wages; or (4) penalties and fines.<sup>23</sup> The new Bankruptcy Law adds two further categories of debts which cannot be discharged, namely: (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 said spouse or child.

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

**III. THE FUTURE OF JAPANESE PERSONAL INSOLVENCY**

In this Article, I have reviewed the recent changes introduced into Japanese Insolvency Law, given an overview of Civil Rehabilitation proceedings, and touched upon the Bankruptcy Law concerning individual debtors. Although there have been few individual insolvency cases reported after the new Bankruptcy Law became effective, I think Japanese insolvency law will face many issues, including the following, in the near future:

(a) Development of legal frameworks, such as means-testing, to refuse bankruptcy relief to debtors who have disposable income, thereby forcing them indirectly to apply for Civil Rehabilitation proceedings, in order to prevent abuse of bankruptcy and discharge proceedings by debtors who can repay their debts.

(b) Effectiveness and requirements of reaffirmation agreements: Is an agreement between a creditor and a debtor, under which discharge of a particular debt is waived, enforceable? If so, which requirements must such an agreement meet?

(c) Necessity of verification for attorneys representing debtors: In order to prevent abusive filings by debtors, do attorneys representing debtors need to

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<sup>22</sup> § 253(1).

<sup>23</sup> If a debtor fails to list a certain debt intentionally, the debt is not discharged either, unless the creditor knows that bankruptcy proceedings have commenced for the debtor.

check if their clients' allegations and factual contentions have evidentiary support and are well-grounded?

Comparative study of individual insolvency is always useful for review of and reflection on current legislation. The Japanese legislature will need to take into account not only foreign legislation but also how each particular system works effectively and what kind of background lies behind it.