Submission in relation to Australian Government's *Improving bankruptcy and insolvency laws Proposals Paper* (April 2016)

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This submission offers a comparative perspective on "reducing the default bankruptcy period" as discussed in The Treasury's *Improving bankruptcy and insolvency laws Proposals Paper* (April 2016) (Proposals Paper) by presenting contemporary developments in Japan relating to this issue. Japan is a fellow OECD high income country, one of Australia's key trading partners and recent signatory to a bilateral free trade agreement with Australia (JAEPA, 2015), but Australian law reformers have not typically looked to Japan for insights or alternatives.

As academics, we research and teach about Japanese insolvency law and believe that experience based on reforms in Japan during the naughties may help to inform Australia's current reform agenda, despite differences influenced by specific jurisdictional contexts. Our recent co-authored publications include 'Insolvency Law' in *CCH's Japan Business Law Guide* (2016) and 'Insolvency Law Responses To A National Crisis: Great East Japan Earthquake And Guidelines For Individual Debtor Out-Of-Court Workouts' (*Journal of Japanese Law*, 2012). We would be happy to discuss our submission further at your convenience.

Executive summary: contemporary Japanese reforms go further than Australian proposals

Reforms to Japan's *Bankruptcy Act* (Hasan hō, Act No. 75, 2004) which became effective on 1 January 2005 and contemporary practice go further than the suggested legislative amendments in the Proposals Paper.[1] Moreover, recent experience in Japan suggests that in addition to the ideas presented in the Proposals Paper, further consideration should be given to the interaction between small-medium enterprises (SMEs) borrowing and personal guarantees given by directors to achieve the Australian reform's goal of encouraging "entrepreneurial endeavour".[2]

[1] Translations into English of legislation relating to insolvency law in Japan are available on the Ministry of Justice's "Japanese Law Translation" website (www.japaneselawtranslation.go.jp). These translations have their limitations and only the original Japanese legislation published in the Official Gazette may be used as official legislation. In addition to bankruptcy, an individual debtor in Japan may apply for civil rehabilitation or special conciliation.

[2] On the role of housing collateral and personal guarantees in small business lending in Australia, see: Ellis Connolly, Gianni La Cava and Matthew Read, Housing Prices and Entrepreneurship:
Evidence for the Housing Collateral Channel in Australia, *Reserve Bank of Australia Conference*, Reserve Bank of Australia, 2015, 118.

Reforms to Japan's *Bankruptcy Act* in 2004 focused on giving debtors a fresh start by, for example:

- Providing for so-called "simultaneous termination petitions" in cases where there are little or no assets. The Act deems the filing of a petition for bankruptcy to also be a request for a discharge unless there is clear evidence of a contrary intent. The majority of debtors in a simultaneous termination case are represented by a pre-petition lawyer and a trustee is not appointed.
- Reducing the cost of filing substantially and reducing scheduled fees for simple administrative cases in line with reduced work requirements for trustees and other legal representatives.[3] For example, debtors are required to pay 10,000 yen for a simultaneous termination filing where the filing is prepared by an attorney and no trustee is appointed (Tokyo District Court practice).
- Increasing the amount of exempt cash from 210,000 yen (approx. A$2700) to 990,000 yen (approx. $12,600). In the context of a debtor's spending power in Japan, this was a large increase.[4]

The late 1990s saw an upswing in the number of insolvency proceedings being dealt with in the courts as Japan's economic malaise continued. To some extent, the legislative amendments in 2004 caught up with practice in the Tokyo District Court since the late 1990s in cases where a debtor was represented by a lawyer. The vast majority of filings for personal bankruptcy ended in simultaneous termination between 1997 and 2011.[5]

The time between filing a petition to commence a personal bankruptcy proceeding and a discharge becoming final and binding is typically no more than a few months for cases in the Tokyo District Court, the busiest insolvency jurisdiction in Japan.

The following section responds to the queries and proposals in the Proposals Paper from a comparative perspective. Part two considers recent Japanese administrative mechanisms designed to encourage directors to deal with companies in financial difficulties.

[3] Trustees are typically lawyers in Japan.
[4] Debtors may also retain household furnishings, household goods, apparel and household appliances.
[5] http://www.kantei.go.jp/jp/singi/saimu/kondankai/dai01/siryou07.pdf

Part 1: Reducing the default bankruptcy period

Query 1.1: objections to discharge

A Japanese court may refuse a debtor's request for a discharge if s/he has committed a fraud or failed to perform any duties required under the law as requested by the trustee, but even in those circumstances the court has discretion to grant a discharge.

A trustee or creditor has two opportunities to challenge a debtor's petition for discharge:

1. the trustee or creditor may provide an opinion to the court on whether a discharge should be granted; and
2. if a court grants a discharge, the trustee or creditor may appeal the court's decision.

There are no specific grounds for an appeal in the legislation. The types of circumstances that may give rise to an appeal would typically include those circumstances in which a court may have chosen not to grant a discharge had the court know of certain information. Accordingly, it is incumbent on the trustee and creditors to provide information, for example, that evidences that the debtor concealed or damaged property or otherwise significantly reduced the assets available to creditors by such acts as spending extravagantly or gambling.

Given the short timeframes involved in simultaneous termination cases which make up the bulk of Japanese personal insolvencies, the trustee or creditors must work quickly if they intend to lodge an objection or appeal. In light of the Japanese example, the time for gathering information in Australia under the proposal of one year is generous. Because trustees and creditors object to a grant of discharge by a court in Japan in few cases, the statistics show that courts refuse a discharge in less than 1 percent of cases.

In our view, the trust that the court places in the pre-petition lawyer representing the debtor is key to the court's reliance on the information provided by the debtor and its decision to grant a discharge with minimum investigation. Further, so-called abuse of the system of simultaneous termination is discouraged by the legislation which provides that a debtor may not receive a further discharge within seven years (a reduction from ten years under the previous legislation). The debtor is also required to co-operate with the court or trustee's investigation prior to any discharge and failure to do so is grounds for refusing a discharge.

Further, there are several categories of debts that will not be discharged when the bankrupt is discharged, for example: taxes, damages caused by a wilful tort, penalties and fines, and debts to a former spouse for child support.

Query 1.2.1a: obligations for a bankrupt after discharge?

First, by way of background, after a bankruptcy proceeding commences, a bankrupt is required to provide explanations to the trustee, creditors'

committee or creditors. The bankrupt must provide information about her/his salary and living expenses, for example. The bankrupt also has a duty to submit to the court written details in relation to real property, cash, securities and savings. If the bankrupt fails to provide the information or refuses to co-operate, this behaviour could form a reason for the court's refusal to grant a discharge and be a criminal offence. After the commencement of a bankruptcy proceeding, the bankrupt's mail will also be redirected to the trustee if appointed.

Once a discharge becomes final and binding, however, the proceeding is completed, there is no longer a trustee (if one was appointed) and these obligations cease. This legislative stance reflects the intention of the Japanese reformers to offer bankrupts a "fresh start" and means that the obligations typically apply for only a few months.

Query 1.2.1b: mechanisms to ensure compliance with obligations after discharge

As noted above, a bankrupt does not have any particular obligations after discharge.

Proposal 1.2.2: income contributions

In the case of bankruptcy in Japan, a bankrupt's income does not form part of the bankruptcy estate and the bankrupt is free to use moneys received as income. This stance has been criticised in Japan and was one of the drivers for the provisions in the individual civil rehabilitation procedure which provide for a debtor to agree to pay a portion of her/his salary for the benefit of creditors over a three to five year period. In practice, however, 80 percent of individual insolvencies proceed as personal bankruptcy cases in Japan, and 20 percent of insolvencies proceed as individual civil rehabilitation cases. Accordingly, this income contribution mechanism is not often utilised.

Query 1.3.1: restrictions on access to credit

In Japan, a person's credit rating will show whether s/he is a discharged bankrupt where a financial institution records that information with a credit information service. There is no legislative provision on the length of time that this information may be retained which we are aware of. The period appears to depend on the individual service and be somewhere between five and ten years.

In practice, these private reporting systems mean that the discharged bankrupt will be unable to obtain a credit card or new loan from a new bank for five to ten years.

1.3.2: restrictions on travel

A bankrupt is prohibited from travelling without obtaining the permission of the court under Japan's *Bankruptcy Act*. This provision has to be interpreted,

however, in light of the Japanese constitutional guarantee of a certain level of freedom of movement.[6] The bankruptcy prohibition has been interpreted, for example, as allowing a debtor to travel overnight for business or to return to her/his hometown. Domestic travel for two nights or more, however, is considered to be subject to the *Bankruptcy Act* prohibition and is likely to require court approval.

The Tokyo District Court, for example, expects a bankrupt to obtain permission for any domestic travel of three or more nights' duration. The interpretation in relation to travel overseas, however, is more rigid, with the Tokyo District Court expecting a bankrupt to seek permission for any travel overseas.

Once again, however, these restrictions will typically be short-lived, because they only apply until the discharge becomes final and binding which usually occurs a few months after commencement of a proceeding.

Proposal 1.3.3: restrictions on licenses and industry associations

A discharged bankrupt is permitted to act as a director.

In practice, however, a director's employment agreement may terminate on the commencement of a bankruptcy proceeding and a company may otherwise remove a director for bankruptcy by a vote at a general meeting of shareholders. These events to not prevent the discharged bankrupt from being hired by another company or starting a new business straight away.

Other laws prohibit bankrupts from participating in a number of business occupations including: lawyer, patent attorney, certified public accountant, notary public, guardian, curator, executor of a will, trustee, and limited or general partner. These prohibitions also cease after a discharge becomes final and binding.

Part 2: Japan's experience of resolving bankruptcy and personal guarantees[7]

The implications for business people who give personal guarantees to financial institutions in respect of their companies' obligations remained a significant issue for Japanese SMEs even after the reforms in 2004.

After an initial increase in filings for personal bankruptcy in Japan, there was a significant decline after 2011, as Table 1 demonstrates. The reasons for the increase and decline are multifaceted. Some of the substantial increase in personal bankruptcy filings immediately around the time just before the new

[6] Article 22. Every person shall have freedom to choose and change his residence and to choose his occupation to the extent that it does not interfere with the public welfare. Freedom of all persons to move to a foreign country and to divest themselves of their nationality shall be inviolate. The Constitution of Japan (promulgated on November 3, 1946; came into effect on May 3, 1947).

[7] *Guidelines in relation to the business owners' personal guarantee*

legislation became effective relates to the bankruptcy proceeding's interaction with the civil rehabilitation proceeding which quickly became popular after it became effective in 2000.[8] Further, there was pent up demand as debtors delayed filing until the new suite of insolvency legislation became effective. The significant decline over the last five years may be attributed to Japan's low interest rate environment which has made it possible for companies to operate on low margins and a renewed preference for out-of-court proceedings which do not involve the disadvantages presented by bankruptcy. The Japanese Government also appears to consider that the decline in formal filings relates to the lack of legislative support for entrepreneurs and in particular directors of SME companies.

Table 1: Number of filings for personal bankruptcy (hasan jiken) from 1999 to 2014 (selective)[9]

Year (selective)	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14
Number of personal bankruptcy filings	214,996	242,849	211,860	184,923	166,399	148,524	129,833	126,533	121,150	100,736	82,902	72,287	65,393

The Japanese Financial Services Agency (FSA) issued Administrative Guidance on 5 December 2013 to encourage financial institutions to refrain from enforcing personal guarantees given in relation to corporate debt by directors / managers, especially of SMEs, in certain circumstances.[10] The Guidelines apply to financial institutions as well as the government's Credit Guarantee Corporation (Shinyō Hoshō Kyōkai) which provides guarantees to financial institutions on behalf of SMEs who could not otherwise obtain a loan.[11] A debtor must fully disclose her/his personal assets and pay as many debts as possible to be eligible for relief.

The aim of the Guidelines is to encourage directors of struggling and so-called zombie companies to file in relation to their corporate debts because such a filing would not trigger personal bankruptcy as a result of enforcement of the personal guarantees provided by those directors. Because the director does not have to file for personal bankruptcy, her/his personal credit rating score is not affected, and future borrowing potential is not impeded. As discussed above, the impact of a bankruptcy record on a discharged bankrupt can be a key restriction on further borrowing capacity and thus entrepreneurial endeavour.

It is still too early to assess the impact of the Guidelines on Japanese bank behaviour, but Japanese Government support for the Guidelines highlights the possibility of continuing obstacles to a "fresh start" in Australia. Even if

[8] Civil rehabilitation proceedings may be transferred to bankruptcy proceedings under certain circumstances.
[9] http://www.courts.go.jp/vcms_lf/05_p33-p53.pdf
[10] *Guidelines in relation to the business owners' personal guarantee*
[11] See Credit Guarantee Association Act (Act No. 196, 1953).

restrictions on discharged bankrupts are eased and the time to discharge is shortened, to the extent that directors cannot avoid personal bankruptcy due to the prevalence of personal obligations which guarantee SME debt the current reform proposals may not go far enough to achieve the goal of encouraging entrepreneurial activity.

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