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Tokyo Bar Association
RECENT DEVELOPMENTS IN BANKRUPTCY
AND CREDITORS' RIGHTS IN JAPAN

As the Japanese bankruptcy system, laws and its creditor’s rights might have been seldom introduced in international society, let me give an outline view of them on this rare occasion before proceeding to discuss subject, that is, recent developments in bankruptcy and creditors’ rights in Japan, deviating a little from the format prepared by officers of this Committee.

1. Creditors’ right

The Civil Execution Act of 1979 (the “CEA”) provides not only for individual remedies to collect money for unsecured creditors, including execution and prejudgement remedies, but also for the execution to take over or surrender all kinds of assets including personal, real property and intangibles. It also provides for the foreclosure or realization of liens and securities as well. The enactment of CEA was designed to refine these proceedings and to put together in one act all provisions related to these proceedings which were separately included in Civil Procedure Code and Foreclosure Act. One of the remarkable improvements made by CEA is to shut professional buyers out of auction of real estate. As land prices in Japan are tremendously expensive, involvement in auction of lands was one of the most lucrative businesses for gangsters before the provisions of CEA paved the access for the laymen-bidders to the proceedings. CEA provides only for these proceedings, while stipulations of substance of liens and securities are provided for in Civil Code and Commercial Code.

Upon filing a petition with a competent district court by a creditor based on a judgement or a notarial deed, a judge renders an attachment order to start a proceeding for execution sale of a debtor’s assets other than chattels. A sheriff, who is an employee of the court, levies chattels of the debtor by taking possession of them, while a clerk takes necessary steps to record or register the commencement of the proceeding on real estate, buildings and houses. After an appraisal of the subject property, a judicial sale, by means of a bid, an auction or other proper way, takes place. After deduction of fees and costs of the sale and payment to creditors with liens or securities, the proceeds of the sale are distributed among the levying creditors and other creditors who filed their claims based upon judgements and notarial deeds, with any excess going to the debtor. Dividends to be distributed to the creditors who have obtained prejudgment orders must be deposited with competent registration offices until judgements are rendered in their favor. Foreclosure proceeding is the same as that of execution generally.

Garnishment is a collection remedy directed not at the debtor but rather at some third person, the garnishee, who owes a debt to the principal debtor, or has property of the principal debtor. Such debt or property is to be applied to the satisfaction of the creditor’s claim. A garnishment order is rendered
by a district court judge. Although industrial property such as patent or trademark is to be registered at an appropriate office, it also may be applied to the satisfaction of creditor’s claim under order similar to that of garnishment.

Attachment and garnishment are also available as pre-judgement remedies. The debtor, who owns the levied property, is deprived of the right to dispose of the subject property free and clear from attachment unless the debtor first files a certain bond. The orders of attachment and garnishment for pre-judgement remedies are issued by a district court judge upon the petition of a creditor-plaintiff, provided that the creditor is requested to file a certain bond.

No judicial proceeding, including judgement, execution, attachment, garnishment and levy, creates any lien and/or priority.

If requirements are met, each creditor is entitled to sue the debtor-conveyor and the covee to recover the concealed debtor’s assets avoiding the fraudulent conveyance under the provisions of the Civil Code outside bankruptcy or insolvency proceeding.

The Loan Business Regulation Act of 1978 forbids overzealous extrajudicial collection efforts against mainly, but not limited consumer-debtors, such as threatening, invasion of privacy, violation of peaceful operation of debtors’ business or other acts which constitute harassment under the sanctions, including a fine and imprisonment.

2. History of legislation of bankruptcy and insolvency laws:

Prior to the initial enactment of modernized bankruptcy system, which was made in 1890, there had been a unique bankruptcy system *bunsan* (distribution), which is a law merchant of the Shogun or

Tokugawa eras in Japan, but which is of little practical concern nowadays for lawyers.

Chapter 3 of the Commercial Code of 1890 provided for bankruptcy system and it was enacted following after French law. According to this Code, bankruptcy was for merchants only, and the debtor was deprived of some civic rights.

The present straight bankruptcy system was established by the enactment of the Bankruptcy Code of 1922 (the “BC”), which was formulated with reference to German law. The purpose of this enactment is to have the bankruptcy system in harmony with Civil and Commercial Codes of German origin. BC does not distinguish between merchant and nonmerchant. Although BC itself did not deprive the bankrupt of his civic rights, other statutes provided for deprivation of them. The disenfranchisement was in force until a few years after World War II. Although the discrimination was abolished later, no bankrupt is eligible to be an attorney at law or a certified public accountant. The most important revision was made in 1952, bringing in the Anglo-American discharge system. The BC of 1922 is still in force today with various minor changes and with the revision of 1952.

The Composition Act (the “CA”) was passed in 1922 concurrently with the BC and promulgated in 1923. This Act provides for preventive composition, while provisions for the composition to terminate the straight bankruptcy proceeding are in the BC. The CA of 1922 is still in force today with a few minor changes.

The Commercial Code of 1899, whose Chapter 2 provides for corporations, was amended to set up the corporate composition procedure as well as the extraordinary winding-up procedure in 1928. These provisions are still effective as of today.

The most significant innovation was made through the enactment of the Corporate Reorganization Act
3. Unique problems in Japan on bankruptcy and insolvency:

In Japan promissory notes are commonly used as means of payment for debts owed through routine business transactions. Proceeds for goods and materials, compensation for service rendered, contract money to subcontractors and other debts are paid, within a few months after the transactions, in promissory notes whose dates of maturity range from three months to six months after the issue dates. If the issuer, within any six month period, twice fails to pay its promissory notes upon maturity, then follows a declaration of dishonor made public by a local association of bankers. As member banks are compelled to refuse banking transactions with the issuer of dishonored notes upon the declaration of dishonor, the issuer is disqualified to issue notes for two years after the declaration. This consequence means severe sanction against the issuer because of the important role of promissory notes in routine business transactions as indicated above. To avoid the declaration is of utmost concern for a debtor in distress. Creditors usually have a huge pile of claims, which consists of aggregate amounts of all notes issued from the issued date of the dishonored note to the date of the declaration and accounts receivable of which have not yet been paid in notes at the time of the declaration. Moreover, creditors have to repurchase bad notes at the request of banks who discounted the notes. A creditor who lost a good customer falls into triple distress and comes to face a crisis of chain bankruptcy. Sometimes creditors rush to seize materials, goods and machines which are in the debtors’ possession as soon as they come to know about the declaration of dishonor. Thus the dishonor of notes and the declaration to that effect creates in fact a panic. In some cases so-called shiken-ya or seiriya, who might be members of the yakuza or gangsters, become involved as agents of creditors or debtors. Therefore it is an important role for bankruptcy lawyers to perform liquidation or rehabilitation proceedings in an orderly fashion in order to forestall a possible panic.

To forestall panic, it is vitally important that a stay order be issued by the court immediately after the petition of composition or other insolvency proceedings, except straight bankruptcy, but before such proceedings begin. Nevertheless, the court sometimes takes too long time to render the stay order for fear of wrong use of the order; for instance, some debtors might abscond with money gained by wrongful disposition of their remaining assets, taking advantage of the protection of the order instead of pursuing the pending case in a fair manner. Because the main role of district court judges is fact finding and making conclusion of laws prudently they are not familiar with worldly business operations, and the result is that necessary approvals or decisions are not rendered in a timely fashion in some cases. To get around these burdensome proceedings or to manage cases with unfair intention of escaping from court supervision, a 10: of cases are dealt with out of court in arrangements known as shitebiseiri or nin-i-seiri. In case of involvement of the yakuza in shitebiseiri, there are serious problems.

As a consequence of wide use of the notes, in case of business bankruptcy, a majority of creditors are unsecured creditors with claims accruing in the ordinary operation of business transactions, and the
number of holders of bonds or debentures is small in general. A majority of claims are unsecured claims of routine transaction.

4. Liquidation:

All debtors, whether merchant or not, are eligible for straight bankruptcy under the BC. Petitions may be voluntary by the debtor or involuntary by a creditor or creditors. The district court, which is the ordinary court of first instance, adjudicates a debtor as bankrupt when it finds the opening requirements, including, insolvency are met. Insolvency means inability to make payments, and cessation of payments is deemed as inability to make payments. When the liabilities exceed the assets, it is deemed as insolvency if the debtor is a corporation. Failure to settle by preventive composition is not required to start the procedure. Foreigners are eligible if Japanese are eligible in their own countries. A plurality of creditors is not required. The trustee takes possession of the estate other than exempt property as of the adjudication and manages it in order to reduce the estate to cash. Usually a qualified lawyer is appointed as the trustee by the court. After-acquired property does not constitute a part of the estate. The adjudication prevents foremost the levying of further attachments and voids the prior attachments as well. The court sets the time limit for filing claims with the clerk of court. A verification meeting of creditors follows in which the claims are verified. The holder of contested claims must sue the trustee before any contested claims will be allowed. Foreign claims have equal status with Japanese claims. A court action is always necessary to obtain an avoidance. The trustee may ask for the avoidance of preferential and fraudulent transfers when the requirements are met. The trustee has the option to perform or reject executory contracts. The trustee collects and sells the assets belonging to the estate and distributes dividends, subject to supervision by the court. Secured creditors may go through the normal foreclosure process. If separate recovery does not occur within a certain period, which may be set by the court upon the motion of the trustee, the trustee may sell the secured property. Tax authorities enjoy high priority in the distribution.

The court may grant a discharge only once every ten years. Upon the petition of the debtor, after notice to creditors and a hearing, discharge is granted, unless the debtor committed bankruptcy offenses, obtained assets defrauding a creditor in regard to the debtor's financial conditions within one year before the adjudication, presented a false claim, made a false representation with the court concerning the debtor's financial conditions, and did not comply with any provision of the BC. Destruction, concealment, and transfer of any assets belonging to the estate with intent to hinder a creditor; losing a lot of assets and/or incurring excessive debts due to gambling and/or extravagance; making a preferential transfer knowingly; destruction, falsification, concealment or failure to keep or preserve books of accounts from which his financial condition might be ascertained in violation of applicable laws and similar acts constitute bankruptcy offenses.

Because of recent rapid progress in consumer loans known as sara-kin the petitions for bankruptcy are increasing in number tremendously. The number of the petitions in 1984 was 26,384 while in 1982 and 1979 they were 5,031 and 1,498, respectively. More than 80% of all petitions were filed voluntarily by consumer-debtors to obtain the discharge. When the Anglo-American originated discharge system was added to the German originated Bankruptcy Code, many potential problems were under water. Recently, problems with regard to discharge, exemptions and other matters are coming to the surface. These problems are as follows:
A non-asset case and a nominal-asset case, in which assets are not sufficient even to pay for administrative expenses, are terminated at the same time of adjudication, that is, the termination-at-same-time. As courts are sometimes reluctant to grant discharge, in many cases discharge is granted during the period of six months to one year after the termination. Thus, courts are able to make sure there is no concealed asset to be discovered during this delayed period. Due to lack of adequate proceedings to rehabilitate consumer-debtors, courts tend to recommend consumer-debtors apply a portion of their earnings acquired after the adjudication for payment of debts before the granting of discharge in some cases. However, there is no means to prohibit or prevent individual execution which may be invoked by creditors during such period, i.e. after the termination-at-same-time but before the granting of discharge. This may be a loophole in the law. When considerable amounts of severance pay, lease deposit to be returned from landlord, or cash surrender value of life insurance are expected, some courts may suggest at their discretion that the debtor quit the job, terminate lease of his house or apartment or cancel life insurance contracts and that such proceeds be applied to the debts as a prerequisite to the grant of discharge. These recommendations or suggestions may be complained of by lawyers for debtors on the ground that the following the court suggestions might hinder the fresh start of aggrieved debtors. However, on the other hand, young attorneys are usually frustrated in filing the petition of bankruptcy to get rid of debts on behalf of their clients who are still living in more luxurious apartments than those of young attorneys. Almost all bankruptcy cases for consumer-debtors are handled by young attorneys who are person of a strong sense of justice.

As far as business bankruptcy is concerned, excessive priority given to tax is criticized. Because of this priority, the average rate of distributions made for unsecured creditors was 12.1% in 1975. A trustee is not a tax collector but an attorney at law for the public.

Another procedure to be invoked for liquidation purpose is the extraordinary winding-up procedure provided by the Commercial Code (the "CC"). Upon the petition made by a liquidator elected by a shareholders' meeting, along with a resolution of dissolution of the corporation in distress, the court renders an opening order when the requirements, which include but are not limited to insolvency are met. The court may replace a liquidator for cause. A liquidator administers the case according to the provisions of the CC under the supervision of court. The liquidation plan, which is proposed by the liquidator, must be accepted at a creditors' meeting by a majority of three-fourths in amount of all claims and more than one-half in number of creditors present at the meeting. The court then approves the plan. Notice for the stockholders' meeting, agenda of which is to dissolve the publicly owned corporation and thus indicating the subsequent petition for extraordinary winding-up procedure, may result in a panic. For a closely held small corporation, this procedure is too complicated. Because of these reasons the extraordinary winding-up procedure is of little use.

5. Rehabilitation:

A debtor in financial distress has four options to invoke rehabilitation procedures. Preventive composition under the Composition Act (the "CA") serves not only rehabilitation purposes but also liquidation purposes. Both a natural person and a legal entity, including but not limited to a corporation, may file the petition. Foreigners in Japan are eligible the same way as straight bankruptcy. The preventive composition under the CA, however, is the most popular device for the business rehabilitation of corporation of regular size. No creditor may file the petition. The preventive composition is
viewed as honest debtor relief so that the opening of proceeding and/or the judicial sanction of composition-plan may be refused on the ground that the debtor was judged not bona fide at the court's discretion. The stay-order, which may be issued by the court immediately after the petition, in fact tranquilizes a panic and prevents the individual collection efforts pursued by creditors. But some courts are reluctant to issue the stay-order for fear of possible abuse of it. The examiner who is appointed by the court investigates the composition-plan proposed by the debtor along with the petition. The composition-plan usually provides for the deductions of debts and extensions of credits. In contrast to German and Italian law, neither minimum ratio of distribution nor limitation to extension is required. When the court finds the plan is feasible and in the best interest of creditors with reference to the examiner's advice, it may render an opening-decree. The opening decree prevents the levying of further attachments and voids the prior attachments, but does not prevent or stay any foreclosure of security interest. A composition-trustee is appointed by court while the examiner remains in his position. The debtor continues in possession but needs consent only for engagements outside the ordinary course of business; however, the court may further restrict his power. He is under the triple supervision of trustee, examiner and court while the case is pending. Filing of claims takes place only for determining voting rights. Foreign creditors may file their claims, if Japanese can do so in their own countries. When a claim is contested, the court determines the voting right of the claimant. Secured creditors are not affected by the plan. They neither present claims nor vote, unless they surrender their security or only for the excess beyond the security value. They participate to the extent they are not secured. Individual granting of delays or deductions by secured creditors is solicited but not forced. No power to force secured creditors is one of the defects of the composition, because they may have huge amount of claims and the debtor may not be able to operate his business without the properties by which the claims are secured. After the notice for a creditors' meeting is made, the debtor may amend the composition-plan only in favor of creditors. A meeting is held at which the vote is taken. The plan is accepted when the majority of creditors present at the meeting holding three quarters of the allowed claims consent, subject to subsequent court sanction to make the plan effective. If no appeal is filed within a specified period or the appellate court dismisses the appeal, the case will be closed. Even dissenting creditors are bound by the provisions of the plan. The court must refuse authorization if the requirements are not observed. In the context of court approval, the equality requirement is of particular importance. In case of nonperformance of the payment in accordance with the provisions of the plan, an individual creditor may rescind his concession or the court may rescind the composition upon the request of the majority of creditors holding three quarters in amount and more than one-half in number of all claims. Rescission leads to the declaration of bankruptcy, which must be made by court ex officio. These devices are of little use because the rescinding creditor may recoup the restored portion of his claim only after all the payments under the plan have been executed and no dividend may be distributed in the following straight bankruptcy. The preventive composition is criticized on the ground that debtors neglect to pay in accordance with the provisions of the plan. In my personal opinion, however, the debtors do not neglect to pay, but cannot pay for the lack of profit. Failed businessmen tend to repeat failure the same way as a bad driver repeats car accidents frequently or a thief repeats often his unique business. Because the composition-plan must be proposed at an early stage of the cessation of payments, it tends to provide generous treatments for claims to tranquilize the excited creditors and lead to default.
The second alternative is the composition for termination of bankruptcy under the BC. It may also serve liquidation and is invoked by a consumer-debtor who might not afford the discharge. But only an adjudicated bankrupt is eligible to the composition for termination. The procedure for termination of bankruptcy is similar to that of the preventive composition, except for continuation of debtor's possession and appointments of composition-trustee and examiner. Instead, a trustee for bankruptcy keeps his position until the closing of the case.

The third alternative is Corporate Composition proceeding under the Commercial Code (the “CC”) for which only kabushikigaiša or a company limited (hereinafter referred as “corporate-debtor”) is eligible. Upon the petition by a director, or a creditor holding a certain amount of claim, or a shareholder holding a certain amount of stock, the court usually renders a stay-order. The court may appoint an inspector to investigate the possibility of rehabilitation of the corporate-debtor and to investigate the other opening requirements. After the investigation if the court finds that the requirements are fulfilled, the court renders the opening-decree. The opening-decree prevents the levying of further attachments and voids the prior attachments. The court may appoint a trustee, otherwise, the corporate-debtor continues to be in possession. The court may also appoint a supervisor, a collaborator and/or an inspector. The composition-plan drafted by the corporate-debtor or the trustee must be presented within the designated period by court which is usually six months following the opening. The supervisor or the collaborator, if appointed, assists the corporate-debtor in drafting the plan. The composition-plan provides for the deductions of debts and extensions of credits in the same way as preventive or final composition. The corporate-debtor or the trustee, assisted by the collaborator if appointed, solicits creditors to accept the proposed plan. When almost all creditors agree to the plan, then the court issues an order to execute the plan. The corporate-debtor or the trustee performs the installment payments according to the provisions of the plan under supervision of the court. They give a monthly report to the court, if required. When almost all the payments provided for in the plan have been made, the court closes the case. Dissenting creditors are not bound by the plan. However they are not able to collect money substantially, because the corporate-debtor is prohibited from making any payment not in accordance with the provisions of the plan and such creditors are prevented from taking any execution proceedings while the case is pending. In some cases, the plan provides for long term installments as long as seven years during which the case is pending. No provisions for filing or verifying claims or meeting of creditors exists in the CC, because of no use for majority doctrine. Although the opening of the case does not prevent a foreclosure of a security interest, the court may prevent or suspend individual foreclosure of a security interest temporarily within a certain period designated by the court to help the corporate-debtor to negotiate with the secured creditor. When the addition of the provisions for the Corporate Composition procedure to CC was made, to some extent, reference probably might have been made to the Deed of Arrangement in England. The defect of this procedure is that there is no means to compel stubborn minority creditors.

The last option is Corporate Reorganization procedure provided for by the Corporate Reorganization Act which was enacted with reference to Chapter X of the Chandler Act of 1938 of Bankruptcy Act of 1898 of the United States of America, combining traditional ways included in the BC and CA of Japan. However, as Japanese economic circumstances and traditional laws are different from those in the US, in practice proceedings under this procedure is vary considerably from those in the US. First of all we have no organization similar to the SEC in Japan. Only kabushikigaisha company limited (herein-
after referred as “debtor-corporation”) is eligible for corporate reorganization procedure. Foreign corporations are eligible as well. Immediately after filing of the petition of the debtor-corporation in difficulty, the court issues a stay-order usually and appoints a disinterested person as an interim trustee or examiner or supervisor. Creditors and stockholders holding a certain amount of claims or interests may request the opening of the corporate reorganization procedure. After the investigation made by the interim trustee or the examiner, the court renders an opening-decree if there is a reasonable prospect for rehabilitation and other requirements are met. The court must appoint one or more trustees to take over the estate regardless of the aggregate amount of claims or the size of the debtor-corporation. The trustee is authorized to operate the debtor’s business, while officers and directors of the debtor-corporation are deprived of control of the assets and the power of management without any exception. After the opening-decree is made, all creditors including secured creditors, creditors with liens and tax authorities, are prevented from invoking any execution proceeding, including the levying of further attachments, garnishments and foreclosures, and any prior proceeding which is pending at the time of commencement of the case is voided. The trustee is vested with the powers to avoid fraudulent conveyances and preferential transfers similar to those in straight bankruptcy, but this does not apply to the composition proceedings. Appraisal of all assets is made based on a going-concern value basis with some exceptions. Court sets the time limit for filing claims with the clerk of court. A verification meeting of creditors follows in which the claims are verified. Secured creditors must file their claims. Otherwise they lose their claims and are expelled from the case. Secured status is determined based on the going-concern value of the property in which the secured creditor has an interest. The holder of contested claims must sue the trustee in order for a contested claim to be allowed. Sometimes the extent of secured status is a subject of serious controversy. Foreign claims have equal status with domestic claims. The trustee has the option to perform or reject executory contracts. However, a collective bargaining agreement is not an executory contract. The trustee must file a reorganization-plan within a certain period designated by court. The time limit is usually one year after the date of opening-decree, provided the continuation of this period might be granted for cause. The plan must be feasible, fair and equitable. The plan must provide for equal treatments of claims in the same class, and be in the best interests of all parties in interest. As stated formerly, the amount of unsecured claims is huge. Moreover in general the debtor corporation or reorganized corporation is not able to issue new securities, which have substantial value, in satisfaction of claims, if any. Therefore usually the plan provides for the deductions of debts and extensions of credits for both unsecured and secured claims. In many cases the duration of installment payments ranges from five to seven years, and the ratio of deductions ranges from 50% to 70% for unsecured claims. Secured claims are paid over a longer period than the unsecured by annual installments in full without interest. By European or American standard, many Japanese corporations may be deemed undercapitalized. Although case law adopts a relative priority rule in applying the fair and equitable rule instead of absolute priority doctrine, equity security holders are usually deprived of their interests in debtor corporations without any compensation because of insolvency in almost all cases. As a consequence, new stocks of re-organized debtor with nominal value are applied to a partial payment to creditors with a large amount of claims in many cases, unless a new sponsor assumes the business of the debtor corporation. The plan may provide for the formation of a new company or the transfer of the debtor’s assets to another, or other means, if any, appropriate to rehabilitate the debtor. The plan may also provide
for the orderly liquidation of the debtor-corporation. At one or two creditors' meetings the proposed plan is examined and accepted or rejected. Interested parties are divided into separate classes consisting of parties with substantially the same interest. The vote is taken in the meeting. The plan is accepted for unsecured creditors when the creditors with two-thirds of allowed claims in amount accepted it. To be accepted for secured creditors, the majority of creditors holding three quarters is needed. This will apply to a plan which provides for extensions only. On the other hand, if the plan includes provisions that impair the claims with security or liens by any other means, including deductions, the majority of four-fifths is required. No plan can be proposed providing for the impairment of tax claims by means other than the extension of less than three years without consent of the authorities with the tax claims thus impaired. The court approves the plan accepted when other requirements are fulfilled.

The court may approve the plan overriding the nonacceptance by any class by adding provisions which give to parties belonging to such class adequate protection, including for realization or retention by them of the liquidation value of their claims against the estate. The court retains its jurisdiction over the reorganized debtor and does not close the case until almost all installment payments have been performed, which should be made over several years. The plan might be modified for cause, subject to the acceptance by the parties in interest affected as well as to court approval. The trustee files monthly reports with the court. It is a unique feature in Japan that courts retain jurisdiction for such a long time.

Theoretically, Corporate Reorganization procedure under CRA is intended for the reorganization of larger corporations having publicly held securities outstanding. In fact, however, many small corporations file the petition for the opening of the reorganization. This shows that readjustments of secured debts and liabilities for tax are necessary not only for big corporations but also for privately owned corporations. Once the reorganization is launched, the officers, directors and owners of debtor-corporations are expelled forever. The attorney at law is a protector for a troubled client, but not a hanging judge.

Each proceeding for rehabilitation has its merits and demerits as well. It seems important to install the proceedings combining their merits. Reformation of these laws has not been discussed in the Diet yet.

by Shinjiro Takagi