International Dimensions of Japanese Insolvency Law

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This paper offers an introduction and overview of the international aspects of Japanese insolvency law. There are three international dimensions to Japan's insolvency law: jurisdiction of Japanese courts; the status of foreign claimants; and recognition and enforcement of foreign proceedings. These dimensions are characterized by a distinctly territorial approach. This inward-looking way of handling insolvency cases is incongruous with developments in the comparative and international law context. It is also at odds with broader globalization trends, some of which are evident in Japan's economic crisis. Analogies to international trade law are useful: the post-Uruguay Round dispute resolution mechanism has insights for the problem of jurisdiction; the famous national treatment principle is a basis for critiquing the status foreign claimants have in Japanese insolvency proceedings; and trade negotiations might be a model for expanding recognition and enforcement of foreign proceedings.

As a corollary, the relationship between the extant insolvency regime and Japanese banks—many of which are internationally active—is explored. Problem banks are at the heart of the economic crisis. Yet, the insolvency law regime has not been applied to failed or failing banks, partly on grounds of the systemic risk that would be triggered by a stay of creditor proceedings. The reluctance to use the regime in bank cases is open to question on a number of grounds. Similarly, the failure to develop a harmonized set of international bank bankruptcy rules to avoid BCCI-type liquidation problems is addressed, and a proposal for proceeding in this direction is offered.

Key words: Japanese insolvency law; International insolvency law; Bank insolvencies

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It is universally accepted that well-functioning economies need well-designed bankruptcy procedures.

—"When Countries Go Bust," The *Economist*, Oct. 3, 1998, at 88.

Introduction

Insolvency is a sober affair. Creditors are unhappy because they know they are unlikely to recover what they lent to the debtor—the proverbial "ten cents on the dollar," if they are lucky. The debtor is miserable, not simply because of its adverse legal position, but also because of the death of its dreams. Shareholders are, in almost all events, wiped out financially. The affair is all the more sober in Japan nowadays. Corporate bankruptcies are at record levels, and these failures—because they translate into ever-greater numbers of unemployed workers—are causing record numbers of personal bankruptcies.[1]

But, bankruptcy is also a fascinating affair—at least intellectually for those not immediately involved in it. And, it is an increasingly international one. Country after country seems to be revising (or, in some cases, starting anew) its legal regime for handling the financial affairs of its debtors. And for good reason. Globalization means, in part, that companies know no boundaries. Their assets and liabilities are spread across geo-political borders, which are significant as far as conventional bankruptcy proceedings are concerned. The obvious concern that arises amidst all of the legal revision in which countries are engaged is how the many bankruptcy regimes, shifting as they may be, relate to one another, or, indeed, whether they relate to one another at all. Was this not the very problem over which central banks fretted when the Bank of Credit and Commerce International (BCCI) collapsed on July 5, 1991? How could the trustee responsible for marshaling BCCI's assets possibly make good on the $10 billion owed creditors when those assets were located in 72 countries? After all, officials in at least some of those countries might—and did—refuse to transfer control over BCCI's local assets, preferring domestic creditors first.

To be sure, when BCCI's Tokyo branch suspended operations on July 5, 1991, a special liquidation proceeding was commenced in Tokyo District Court.[2] The Court appointed a liquidator, who decided to participate in the worldwide pooling arrangements, based in Luxembourg, with the approval of BCCI's creditors. As of July 1998, in accordance with the pooling arrangement, a second dividend payment was made to the creditors. The point is that not every liquidator in every country will behave in as globally-minded a way as the liquidator for BCCI-Tokyo. Even in Japan, the decision was easy given the peculiar circumstances. Creditor claims against BCCI-Tokyo far exceeded the branch's assets (if it is proper to speak of a branch having assets and liabilities separate from those of the parent). Japanese authorities realized creditors would fare better in the global liquidation proceeding than in a "ring-fenced"

1. See Alexandra Harney, *Japan's Woes Drive More to Bankruptcy*, Fin. Times, Aug. 12, 1998, at 7.
2. Liquidation, along with the other types of Japanese insolvency procedures, is discussed in Part Two below.

Japanese one. Thus, Japan's traditional territoriality approach to insolvency issues (discussed in Parts One and Two below) was never severely tested by the BCCI scandal. That test would have come if BCCI-Tokyo had assets far in excess of creditor claims (as was the case with BCCI's New York and California operations, which were ring-fenced by state regulatory authorities).

There is, then, a context to consider—in fact, there are two contexts to consider: the economic context, and the comparative and international legal context. Any discussion of a country's insolvency law, including Japan's, could launch into the details. Lacking the context, however, seeing how and why those details matter is difficult. Context shapes our understanding of law, and this is no less true with respect to insolvency law than any other specialty. To rush into the inner workings of Japan's insolvency law regime would be to neglect consideration of why that regime is important and forego consideration of possible analytical tools for assessing that regime.

What is the economic context in which Japanese insolvency law—as presently constituted, and as proposed—is set?[3] In brief, the economic context is rather desperate. There is not much risk of an overstatement: insolvency law is more important to Japan than at any time in the last half-century. Its importance is not confined to the Japanese. An economically sick Japan is not in America's long run, broader national economic (or, for that matter, security) interests. Whether or not the two nations are partners in the most important bilateral relationship in the world, they are the two largest economies and two of the hegemonic trading powers. Japanese businesses are a source of supply for American consumers; Japanese consumers are a source of demand for American businesses. It is hardly a pretty sight to watch one's clients and customers deteriorate, particularly where the rules designed to address deterioration—insolvency law—are problematic, if not antiquated.

Appreciating Japan's present economic predicament is not the only challenge. How Japanese insolvency law relates to regimes in other countries, and to emerging principles in international insolvency law, cannot be ignored. This comparative and international legal context is the subject of Part One.

In Part Two, Japanese insolvency law itself, and its international dimensions, are assessed. The focus is not limited just to understanding the conventional types of insolvency proceedings, nor should it be. Inevitably, there are creditors located overseas of Japanese companies. Inevitably, there are Japanese debtors with assets and liabilities located overseas. What does Japanese insolvency law say—or not say—about these situations? How does the Japanese regime contrast with the American one? What insights might be provided by other international law fields—most notably, international trade law—to improve the Japanese regime? These points are considered in Part Two.

In Part Three, the special—or ostensibly special—case of banks is considered. How have Japanese bank collapses been handled? What role, if any, has Japanese insolvency law played in resolving these cases? What role ought it to play? What

3. This issue is discussed in detail in Part One of the longer version of this paper published as Bank of Japan IMES Discussion Paper Series 99-E-26 (September 1999).

about the international dimensions of Japanese bank operations? How might a harmonized set of rules for international bank bankruptcies emerge? These matters are discussed in the final Part.

PART ONE: THE COMPARATIVE AND INTERNATIONAL LEGAL CONTEXT[4]

I. Commonalities in Insolvency Laws across Countries

It is a strange fact that in the increasingly inter-disciplinary atmosphere in which scholars now work, or at least laud, all of the macroeconomic diagnoses and remedies are just that—macroeconomic. If legal reform is mentioned, it is only under the general rubric of structural form. Insolvency law in particular is not appreciated as part of the essential landscape of a well-functioning, developed capitalist economy. That must change.

Stripped to its essentials, insolvency law creates a collective procedure for the recovery of debts by creditors.[5] The common feature of all insolvency situations is that there are insufficient funds to pay off all creditors in full. Insolvency law is all about deciding who to pay, in what order to pay, and how much to pay. The collective procedure created is designed to resolve the "who?," "in what order?" and "how much?" questions in an efficient and equitable manner. Of course, efficiency and equity sometimes may be competing policy goals. In the way it pursues those goals, insolvency law says a lot about the attitudes of a country's legal system, and about the relationship between the parts of that system. This specialty has even been dubbed the most important of all commercial legal disciplines.[6]

As country after country revises or, in some cases, writes anew, its bankruptcy law, some common themes are beginning to emerge. Japanese insolvency law can be gauged partly in a comparative legal context, specifically, in relation to these themes. In general, three legal doctrines resonate in all or virtually all modern bankruptcy regimes.[7] First, all actions taken by individual creditors against the debtor are frozen and replaced with rights to claim a portion of the pool. Second, all assets of the bankrupt belong to the asset pool, the debtor's estate, which is made available to pay off creditor claims once the size of the pool has been maximized. Third, creditors are paid on a *pari passu*, or pro rata, basis, out of the pool, each according to their claims.

What policies compel these three doctrines, referred to respectively as the automatic stay, the maximization of the asset pool, and the proportionate payment of claims? Again, efficiency and equity. By automatically staying creditor claims, a "grab race" for assets among creditors is prevented.[8] It may well be that if the debtor's

4. The author gratefully acknowledges the background memorandum, "International Insolvency Laws" (June 1999), by Ms. Preeti Kapoor, GW Law School Class of 2000, which assisted in the preparation of this Part.
5. Philip R. Wood, Principles of International Insolvency 1 (1995).
6. See *id.*
7. See *id.* at 2.
8. See Thomas Jackson, The Logic and Limits of Bankruptcy Law (1986).

asset pool is preserved and strengthened over time, each creditor will wind up with a greater recovery than it otherwise would have obtained through immediate, unilateral and selfish behavior. In other words, fairness means that, relative to all other creditors, no creditor ought to recover out of turn or in an amount greater than the proportionate share of its claims. But, how much, in absolute terms, this recovery amounts to depends very much on the efficiency of the bankruptcy procedure. Observe, then, that efficiency and fairness work in tandem.

II. The Pro-Debtor—Pro-Creditor Continuum

A. Defining "Pro-Debtor" and "Pro-Creditor"

The commonality across borders of the three doctrines and their underlying policy rationales does not necessarily translate into commonality of implementation. Different countries implement the doctrines differently, a not very surprising result. After all, emphases on efficiency and fairness are bound to differ, and there are unique economic circumstances and legal traditions to boot. The styles in which the doctrines appear allow for a conceptual classification along a continuum that focuses on a single question: how pro-debtor or pro-creditor is the country's bankruptcy regime?[9]

The answer says a lot about the kind of capitalist system in a country. Certainly, there is a lot more to differentiating brands of capitalism than insolvency law. Still, it may be said that a pro-debtor regime encourages entrepreneurial risk-taking, while a pro-creditor regime encourages the provision of liquidity to business. Yet, operating at either extreme on the continuum is problematic. Credit may be hard to come by for many firms in a pro-debtor regime, simply because lending institutions fear the all too favorable rules for debtors. Conversely, rules that are skewed too far in favor of creditors hardly create an environment friendly for entrepreneurs.

What is a "pro-debtor" regime? In the most rigorous sense, it is one that dwells on increasing the size of the debtor's estate by destroying creditor and ownership rights.[10] In a pro-debtor jurisdiction, every effort is made to maximize the value of the debtor's assets for ultimate distribution to creditors.[11] The justification for this effort is that debtors and their employees ought to be saved, and if need be, all creditors ought to contribute to this rescue.[12] The argument is that increasing a debtor's estate improves the lot of unsecured creditors in particular.[13] Accordingly, in a pro-debtor jurisdiction, the class of third-party owners is limited, because every effort is made to aggrandize the debtor's estate for the benefit of the debtor and its unsecured creditors.[14]

At the other end of the continuum from "pro-debtor" regimes are "pro-creditor" ones. To affix the label "pro-creditor" on a regime is to connote that creditors

9. See Wood, *supra* note 5, at 3.
10. See *id.*
11. See *id.*
12. See *id.*
13. See *id.*
14. See *id.* at 35.

ought to be able to avoid losses that result from the default of a debtor.[15] Thus, a pro-creditor jurisdiction allows creditors to avail themselves of protection through security interests and set-offs.[16] Otherwise, it is said that the insolvency will create risks for everyone, and perhaps even generate risks for the system itself.[17] Concomitantly, a jurisdiction is pro-creditor if it allows a wide class of third party owners to claim their property held by the bankrupt ahead of other creditors.[18]

B. The "Empirical" Results

How do various countries stack up on this pro-debtor—pro-creditor continuum? On a scale of one to ten, with one being extreme pro-creditor and ten being extreme pro-debtor, the results are depicted in Figure 1. It is worth highlighting that Japan is considered to be roughly in the middle of the continuum. It is also worth emphasizing that, as in any comparative legal analysis, the empirical results are rather general characterizations, subject to criticism on finer details.

Figure 1 The Pro-Debtor—Pro-Creditor Continuum

Most Pro-Creditor

(1) Hong Kong and Singapore
(2) Australia, England, and Ireland
(3) Germany, the Netherlands, Sweden, and Switzerland
(4) Japan, Korea, New Zealand, Norway, and Scotland
(5) Canada and the United States
(6) Austria, Denmark, and South Africa
(7) Italy
(8) Greece, Portugal, Spain, and most Latin American countries
(9) Belgium and Luxembourg
(10) France[19]

Most Pro-Debtor

How are countries placed on this continuum? Seven criteria distinguish the bankruptcy laws of the countries. These are: (1) the scope and efficiency of security interests and title financing; (2) the right of set-off in insolvency situations; (3) contract and lease rescission; (4) the way in which preferential transfers are treated; (5) the strength of the veil of incorporation (e.g., as between corporate parents and subsidiaries); (6) the circumstances of ownership of assets in the possession of the debtor; (7) the existence and nature of corporate rehabilitation statutes (i.e., rescue proceedings).[20]

The first, second, and sixth criteria are straightforward. The broader the scope and efficiency of security interests and title financing, the more pro-creditor the jurisdiction. The stronger the right of set-off, the more pro-creditor the jurisdiction.

15. See *id.* at 3.
16. See *id.*
17. See *id.*
18. See *id.* at 35.
19. See *id.* at 4.
20. See *id.* at 6.

The more rigorous the circumstances of ownership of assets in the debtor's possession, the more pro-creditor the jurisdiction. However, special mention should be made of the third, fourth, fifth, and seventh criteria.

Consider the third criteria. The most common approach to contract and lease rescission found across countries is that the debtor's estate has the power to disclaim, abandon, or reject a contract or a lease, or to call upon the counter-party to perform the contract.[21] A good example is found in Japan's Bankruptcy Law, which contains the power to perform or reject contracts.[22] Similarly, under the American Bankruptcy Code, a trustee has the power to assume or reject any executory contract or unexpired lease, as long as certain conditions exist.[23] However, there are also important exceptions to rules on contract and lease rescission, found (for example) in the United States and the United Kingdom. Suppose that a seller of land in the United States or England becomes insolvent after entering into a contract of sale, but before completion of performance of this contract. Then, the purchaser can insist on transfer and possession of the land upon payment of the price.[24] Thus, the trustee for the seller's estate lacks the power to disclaim the real estate sale contract.

As regards the fourth criterion, all contemporary bankruptcy laws provide a system of preferences for the recapture of assets. In determining whether the corporate insolvency law of a particular jurisdiction is pro-creditor or pro-debtor based on this criterion, it is necessary to examine the extent of creditor protections for general preferences, the protection of the ordinary course of business payments, the validity of security for pre-existing debt and the length of the suspect period.[25] This examination, obviously, is rather involved.

A fundamental decision that must be made in many corporate insolvency cases, which concerns the fifth criterion, is whether to honor the veil of incorporation. The problem arose in a curious way in the infamous BCCI insolvency. There, BCCI had subsidiaries in some countries, branch offices in other countries, and agencies in still other countries. Standard Anglo-American corporate legal doctrine would have it that a subsidiary is a separate entity from its parent, with its own assets, liabilities, and capital. An agency or branch is, by contrast, part and parcel of the parent. It has no separate balance sheet, and it is not separately capitalized. Accordingly, there ought not to have been any question about the treatment of assets or liabilities in BCCI's subsidiaries versus its agencies or branches. The former were distinct from those of the parent, whereas the latter were not. However, ring-fencing laws of various jurisdictions—New York and California being examples—got in the way of a straight application of corporate law. Local bank regulators applied their banking laws to keep assets and liabilities of agencies and branches—a corporate law incongruity—in their jurisdictions.

As for the continuum, the test to determine whether the corporate veil is honored is whether the law holds persons other than the company personally liable for the

21. *Id*. at 60.
22. See *id*. at 61.
23. See 11 U.S.C. § 365(c).
24. See Wood, *supra* note 5, at 61.
25. See *id*. at 72.

company's debts once the company has become insolvent. If there is absolutely no way to impose such liability, then the veil is respected in the purest sense. In reality, the most pure form exists with respect to the liability of shareholders for the debts of a corporation. There is a broad international consensus that shareholders are not personally liable for the debts of a company beyond the unpaid amount of their shares.[26] As for the liability of directors, respect for the veil is far less pure. A comparative analysis of countries reveals six circumstances in which a director may be held personally liable for the debts of a company: (1) fraudulent trading; (2) wrongful trading; (3) obligations to act when the company is insolvent or has lost most of its capital; (4) negligent management; (5) breach of company law or securities regulation; and (6) miscellaneous liabilities, including tort and breach of general statute.[27] In the United States, much emphasis is placed on the third circumstance, which is also known as the "business judgment rule." The rule demands that a director act honestly and with the best interest of the company in view.[28] Similarly, Japan imposes a due diligence duty on directors.[29] In both countries, the "bottom line" for directors is that they are immune from liability in the event their company "goes bust" so long as they have fulfilled their obligation to act appropriately on behalf of their company.

The seventh criterion used to construct the pro-creditor—pro-debtor continuum is the adoption of corporate rescue proceedings. They are designed to assist debtor companies in distress. Modern forms of corporate rehabilitation laws impose a freeze on creditor proceedings, which, of course, impinges on creditor rights.[30] The justification for the freeze and consequent impingement is that during the delay, the corporate debtor can be rehabilitated (at least partly). Countries differ substantially on eligibility for rehabilitation. Under Japan's Corporate Rehabilitation Law of 1952, access is rather difficult, whereas under Chapter 11 of the United States Bankruptcy Code, rehabilitation proceedings can be commenced rather liberally.[31] Specifically, in Japan, the possibility of corporate reorganization exists only for publicly-held limited companies, but it is effective (if at all) only with respect to the properties of a company that exist in Japan.[32] Reciprocity does not exist; that is to say, corporate reorganization proceedings commenced in a foreign country are not effective with respect to properties situated in Japan.[33] To qualify for corporate reorganization under Japanese law, a corporate debtor must show (1) it cannot pay its debts as they fall due without materially impeding the continuance of its business or (2) absent rehabilitation, the causes of bankruptcy are likely to occur.[34] In contrast, in the United States, the scope of Chapter 11 embraces most business enterprises, whether they are incorporated or unincorporated.[35] It is not necessary for the debtor

26. See *id*. at 160.
27. See *id*. at 142.
28. See *id*. at 149.
29. See *id*.
30. See *id*. at 182.
31. See *id*.
32. See *id*. at 186.
33. See *id*.
34. See *id*. at 188.
35. See *id*. at 187.

to show insolvency or feasibility in order to qualify for Chapter 11, i.e., a solvent corporation can file.[36]

III. The Lack of Comity

The fact that a pro-creditor—pro-debtor continuum exists bespeaks a lack of comity in relation to international bankruptcy law. Why has this come about? An obvious explanation is the sharp division between pro-debtor and pro-creditor bankruptcy policies, as mentioned above. A second explanation is what might be called a "ring-fencing mentality," namely, a desire to ensure local assets are not used to pay foreign taxes or foreign preferred creditors, at least not unless and until local creditors are satisfied. Related to this mentality is another contributing factor: the "xenophobic protection of local creditors."[37] Foreign debtors that have caused loss to local creditors are resented. This resentment translates into distrust of foreign legal systems.[38]

These reasons do not, however, justify the lack of comity that exists in insolvency laws of most countries. It is incongruous with the modern global economy. Multinational corporate debtors hold assets in several different countries. Creditors are scattered around from Toronto to Tokyo. Thus, trustees seeking to marshal the assets of a debtor, in order to distribute them among the creditors in their own country, as well as those domiciled in other countries, necessarily must pay increasing attention to the principle of comity.

IV. Organizing Principles for the International Aspects of a Country's Insolvency Regime

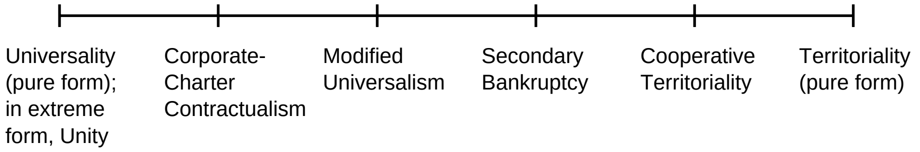
The problem of comity, or the lack thereof, raises an obvious question: are there any principles emerging in the insolvency laws of various countries that might provide for greater respect, indeed, recognition, of foreign insolvency proceedings? Happily, the answer is yes. The world at the end of the twentieth century is not retreating entirely into fortresses, at least not with respect to insolvency law. Two broad principles are emerging in international insolvency law, i.e., in the provisions of local laws dealing with international aspects of bankruptcy. These principles are universality and territoriality.

The dichotomy between universality and territoriality is an ideal type. In practice, there are many combinations and variations of these, for example, modified universalism, secondary bankruptcy, corporate-charter contractualism, and cooperative territoriality.[39] Once again, there is a continuum, depicted in Figure 2, which might be dubbed the "Organizing Principle Continuum." Almost every country falls within

36. See *id.*
37. See *id.* at 227.
38. See *id.*
39. See Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post-Universalist Approach*, 84 Cornell L. Rev. 696 (1999).

one of these variations, with their domestic insolvency laws and recognition policies being a mixture of the two broad principles. It is worth emphasizing, then, that the principles are not confined to any one country or group of countries. They are as worthy of consideration in Japan, for example, as in other country examining its insolvency regime with a view to improvement.

Figure 2 The Organizing Principle Continuum



A. The Pure Form of the Universality Principle

What is the universality principle? Its key premise is that only the courts of the bankrupt company's "home country" should have control and jurisdiction, thus applying the home country's laws to the core issues of the proceeding.[40] It is the ultimate expression of the importance of the location of the debtor, and attempts to rationalize the bankruptcy proceeding based on the answer to a single question: where is the debtor domiciled? In this context, "domicile" refers to the headquarters of the debtor, or its principal place of business. For the universality principle to work well, therefore, a solid test to determine the country in which the headquarters or principal place of business exist is essential.

A country adhering to the universality principle agrees that all of the debtor's assets are to be administered in one insolvency proceeding, regardless of where those assets are located.[41] The single insolvency proceeding in the jurisdiction of the debtor would have full effect in all other countries where the debtor's assets are located.[42] Consequently, the only courts that ought to have jurisdiction to decide whether a debtor is indeed insolvent, and to have control over the assets of a bankrupt multinational firm, are the courts of the debtor's domicile or principal place of business.[43] These courts would apply their own country's insolvency laws to decide whether the best strategy is corporate reorganization or liquidation, and to determine priorities among competing claims of creditors.[44] These courts would control the administration of all assets of the debtor, both local and global, and make the requisite distributions to all creditors worldwide.[45]

The universality principle boasts a few important advantages. The most apparent one is the avoidance of the costs and inefficiencies of having two competing insolvency administrations.[46] There is, moreover, clarity of expectations. All creditors

40. See *id*. at 696.
41. See Andre J. Berends, *UNCITRAL Model Law on Cross-Border Insolvency*, 6 Tulane J. Int'l & Comp. L. 309, 313 (1998).
42. See *id.*
43. See Wood, *supra* note 5, at 228. See also LoPucki, *supra* note 39, at 704.
44. See LoPucki, *supra* note 39, at 705.
45. See *id.*
46. See Wood, *supra* note 5, at 228.

dealing with a domiciliary know that, should the domiciliary "go bust," the laws of the domiciliary will govern the subsequent insolvency proceeding. Indeed, all creditors know they will be treated equally under those laws. Finally, an international "grab race" among creditors is avoided. All of the debtor's property, wherever located, is pooled, and there is a universal restraint on creditor proceedings.[47]

But, the universality principle is not without its drawbacks. Its advantages generally are from the perspective of an uninvolved observer—an antiseptic academic view—or from the perspective of the debtor and creditors located in the debtor's jurisdiction. With regard to the perspective of creditors that are not local, i.e., that are from outside the debtor's jurisdiction—foreign creditors, as it were—the universality principle becomes controversial. First, a country accepting the universality principle must permit foreign laws and courts (i.e., the laws and courts in the debtor's home country) to govern domestic relationships and local assets (i.e., relations between the debtor and creditors outside of the debtor's home country). The results could be unpredictable.[48] After all, how issues will be resolved under one's own law are more or less understood (assuming the issues are not entirely novel). How they may be resolved under another legal regime may be quite unclear, or at least demand a great deal of study of, and experience with, the other regime before a certain comfort level is reached. It might be unreasonable to demand detailed study of the other regime, and it might be intolerable to suffer the trials and tribulations sure to come with experience.

Worse yet, allowing foreign law to govern the affairs of a debtor and creditors, regardless of where the debtor's assets and its creditors are located, may be seen as an infringement on sovereignty. A country that accepts the universality principle, without any restrictions, runs the risk that a foreign liquidator will assume control over assets in the country, and remove them to the debtor's home country.[49] Imagine a debtor that has engendered plenty of resentment among creditors outside (as well as within) its home country. Some of this resentment may be expressed in terms of the language of sovereignty. "How can we allow a foreign liquidator onto our soil to remove assets of the wretched debtor out of our country to pay off others?" will be the bottom-line demand.

Aside from certainty and sovereignty, there are some hard-headed concerns regarding the interests of creditors outside of the jurisdiction whose laws are applied to settle the case. If the universality principle is followed, then how will creditors not located in the debtor's jurisdiction be treated vis-à-vis local creditors? What is hoped for is—to borrow a critical concept from international trade law—national treatment. Local creditors, that is, creditors in the debtor's jurisdiction, ought not to be treated more favorably than foreign creditors.[50] Put conversely, foreign creditors ought to be treated no less favorably than local creditors. If the analogy to international trade law is continued, the idea is not identical treatment. Rather, it is *de jure* and *de facto* equality of treatment.

47. See *id*.
48. See LoPucki, *supra* note 39, at 709.
49. See Berends, *supra* note 41, at 314.
50. See *id*. See also Wood, *supra* note 5, at 228.

Still other hard-headed problems will arise if the universality principle is followed without qualification.[51] How will claims be filed? Will there by any choice of law issues, and if so, how will they be resolved? What differences exist between the priority scheme under the law where the debtor is located and the law of the country accepting the principle? To the extent these questions are not addressed clearly, or are answered in unfamiliar ways, there may be increased resentment against the universality principle.

It is possible, at least in theory, to conceive of a more extreme principle around which a country can organize the international aspects of its insolvency laws than universality. This more extreme version is known as "unity." It may so happen, even if a purely universalistic approach is taken, that some aspects of an insolvency proceeding will be governed by law other than the one in which the proceeding is being held (the home country law). The unity principle demands that all aspects of the proceeding be governed by one single law, that of the country of the opened proceeding, regardless of any ancillary proceedings used.[52] Needless to say, implementation of the unity principle requires an extraordinary degree of cooperation among players in all relevant countries.

B. The Pure Form of the Territoriality Principle

At the opposite end of the continuum from the universality principle is the territoriality principle. It creates a system in which each country has jurisdiction over the portion of the multinational corporate debtor within its borders.[53] Here, then, is the ultimate deferral to the interests of every country involved. If the territoriality principle is applied, then each country in which the debtor has assets "gets a piece of the action."

Specifically, every country where the debtor has assets will administer those assets, but only those assets within its territory and no more. There is no obligation whatsoever for the administration going on in one country to recognize concurrent insolvency proceedings being conducted in other countries. Indeed, quite the contrary, no such recognition is expected. Thus, the effects of an insolvency proceeding do not reach further than the sovereignty of the state where the insolvency proceeding has commenced.[54]

The obvious advantage of applying the territoriality principle is its respect for sovereignty. Related to this advantage is the mitigation of any uncertainty about results under foreign law, because foreign law is immaterial. In addition, there is no concern about creditors from one country (such as the debtor's home country) being preferred over creditors from another country. If there is any discrimination based on national origin, it arises under the law in which the proceeding is taking place, and the locals—through their political representatives—presumably are satisfied with the discrimination (probably because it favors them).

51. See *id.*
52. See Berends, *supra* note 41, at 315.
53. See LoPucki, *supra* note 39, at 696.
54. See Berends, *supra* note 41, at 314.

There also are some obvious disadvantages. First, the principle is atavistic. If debtors and creditors know no boundaries when they give birth to and nourish a business, then why should the law—or laws—suddenly declare those boundaries to mean something when the business is ailing? Second, the principle is inefficient. When the assets of insolvent debtors are located in numerous countries, an insolvency proceeding would have to be undertaken in each country.[55] A disinterested observer would find a single, rationalized procedure to be more logical if the desired goal is to maximize the size of the debtor's estate and pay out claims according to the *pari passu* principle.

C. Modified Universalism

In practice, neither the universality nor the territoriality principle is likely to be observed in pure form. More likely is a hybrid of some sort. Modified universalism is one example, and this principle is evident in the American Bankruptcy Code. Conflicts tend to arise between a debtor's principal place of business, on the one hand, and a foreign country in which the debtor's assets are located, on the other hand. Therefore, it becomes necessary to view the insolvency proceeding first from the perspective of the domicile of the debtor—the so-called "domiciliary," or "principal," or "home" forum—and then to consider the likely reactions of foreign jurisdictions—the ancillary forum—to the operation of the laws of the home forum.[56] This two-step approach is modified universalism. The first step is the universality principle, and the second step is its modification to account for the reality of conflicts.

What will the state of affairs be in the ancillary forum during this two-step process? Either no bankruptcy proceedings will have started, or parallel proceedings will have commenced.[57] Once bankruptcy proceedings have begun in the home forum, the insolvency administrator wishing to gather the debtor's overseas assets must be able to freeze local attachments of those foreign assets, freeze dealings with the assets by the debtor, and compel a turnover of the foreign assets or their proceeds to the home forum for distribution to creditors.[58] This is a tall order, but not an impossible one.

The insolvency administrator has three main options: (1) it can attempt to collect the debtor's foreign assets locally without local proceedings, possibly through an assignment or power of attorney; (2) it can seek the aid of the local court by getting recognized as a (or the) representative of the debtor; or (3) it can commence bankruptcy proceedings locally, either via an ancillary proceeding or a full proceeding.[59] Under United States law (specifically, Section 304 of the Bankruptcy Code, discussed below), when a multinational debtor or its creditors file a petition of bankruptcy, the court of the forum country appoints a representative for the debtor.[60] The appointed

55. See *id.*
56. See Wood, *supra* note 5, at 230.
57. See *id.*
58. See Wood, *supra* note 5, at 242.
59. See *id.*
60. See 11 U.S.C. § 304(a). For a discussion of this point, see LoPucki, *supra* note 39, at 725-728.

representative takes possession of the debtor's assets and either sells them in a liquidation or uses them for a corporate re-organization. Most bankruptcy regimes, including those in the United States, Canada, and the United Kingdom, claim jurisdiction over the assets of a filing debtor wherever located, including assets located in other nations.[61] Accordingly, under these regimes, the debtor's representative can take possession of assets in other nations, just as a purchaser from the debtor could in the absence of bankruptcy.[62]

In the American Bankruptcy Code, Section 304—a proceeding of interest in the BCCI affair, among many other cases—is the key provision permitting this result. Section 304 authorizes the qualified representatives of foreign bankruptcy estates to seek assistance by filing an ancillary proceeding in the United States.[63] Section 304(a) states:

(a) A case ancillary to a foreign proceeding is commenced by the filing with the bankruptcy court of a petition under this section by a foreign representative.[64]

The debtor or creditors filing the case can determine which country will serve as the main forum.[65] To be sure, the American standard for recognition constrains the choice of a country; however, it still leaves a particular debtor free to choose among several countries.[66] The assistance provided to the foreign representative is evident from Section 304(b):

(b) Subject to the provisions of subsection (c) of this section [discussed below], if a party in interest does not timely controvert the petition, or after trial, *the court* may–
  (1) *enjoin the commencement or continuation of*—
    (A) *any action against*—
      (i) *a debtor with respect to property involved in such foreign proceeding*; or
      (ii) such property; or
    (B) *the enforcement of any judgment against the debtor with respect to such property*, or any act or the commencement or continuation of any judicial proceeding to create or enforce a lien against the property of such estate;
  (2) *order turnover of the property of such estate, or the proceeds of such property, to such foreign representative*; or
  (3) order other appropriate relief.[67]

As is apparent from the italicized language, the assistance provided by Section 304(b) allows the qualified representative to do its job of marshaling assets, including those located in the United States, and paying out claims to creditors around the world.

A touchstone of modified, as distinct from pure, universalism is the ability to refuse cooperation that may prejudice creditors in one country. This refusal is found

61. See LoPucki, *supra* note 39, at 726.
62. See *id.*
63. See 11 U.S.C. § 304.
64. 11 U.S.C. § 304(a).
65. See LoPucki, *supra* note 39, at 726.
66. See *id.*
67. 11 U.S.C. § 304(b) (emphasis added).

in the American Bankruptcy Code in Section 304(c), where one of the important concerns is prejudice against American creditors.[68]

(c) *In determining whether to grant relief under subsection (b) of this section, the court shall be guided by what will best assure an economical and expeditious administration of such estate, consistent with—*
  (1) *just treatment of all holders of claims against or interests in such estate*;
  (2) *protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding*;
  (3) prevention of preferential or fraudulent dispositions of property of such estate;
  (4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title;
  (5) *comity*; and
  (6) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.[69]

Thus, Section 304(c)—reflecting the modified universalist impulse—relieves the courts of the non-forum country (here, American courts) from the unpleasant obligation they would have under pure universalism to sacrifice their own (American) creditors' interests for the benefit of foreigners.[70]

Modified universalism is, then, a pragmatic accommodation. It is not, however, a problem-free one. Among its disadvantages are uncertainties regarding choice of law, because the forum proceeding plus the ancillary proceedings create dozens of extra complex proceedings.[71] In addition, because Section 304 allows the debtor or creditor filing the petition to choose among countries to determine the forum proceeding, the process becomes particularly subject to strategic manipulation.[72]

D. Secondary Bankruptcy

Secondary bankruptcy is yet another principle around which a country can organize the international aspects of its insolvency regime. Under this principle, bankruptcy proceedings go forward simultaneously in each country in which the debtor has a substantial presence.[73] As is true under modified universalism, under secondary bankruptcy, the proceeding in the debtor's home country is the "main" proceeding. The courts of all other relevant nations are expected to surrender assets of the debtor for distribution.[74] (The converse situation is not true, i.e., should there be any overage of assets in the main proceeding, there does not seem to be any expectation that they would be distributed pro rata in the secondary proceedings, discussed below. At the same time, such a distribution is not expressly ruled out.)

However, secondary bankruptcy proceedings are implemented. In contrast to an ancillary proceeding, which only assists the main proceeding, a secondary bankruptcy

68. See LoPucki, *supra* note 39, at 728.
69. 11 U.S.C. § 304(c) (emphasis added).
70. See LoPucki, *supra* note 39, at 728.
71. See *id*. at 729.
72. See *id*. at 730.
73. See *id*. at 732-733.
74. See *id*.

proceeding is the same proceeding that would be filed even if no foreign proceedings were pending.[75] In a secondary bankruptcy proceeding, the court reorganizes or liquidates the debtor's local assets and makes the necessary distributions to protect creditors entitled to priority under local law.[76] Thereafter, the court transfers any remaining proceeds of the debtor's local assets to the estate in the main case, whereupon they are available for distribution according to the priority rules of the home country.[77]

Plainly, secondary bankruptcy is a hybrid of universalism and territoriality, because part of the debtor's assets (those in countries outside the home forum) are distributed according to local priorities. This smacks of the territoriality principle. The fact that any remainder is distributed according to home country priorities bespeaks the influence of the universality principle. Equally plain is that secondary bankruptcy is somewhat closer to the territoriality principle than modified universalism. Modified universalism does not call for the protection of local creditors before turning over assets to a foreign trustee, whereas that is the hallmark of secondary bankruptcy.

E. Corporate-Charter Contractualism

Professor Rasmussen has offered yet another hybrid principle on the continuum between universality and territoriality. He emphasizes the ability of firms to specify in their corporate charters the country that would administer their bankruptcies.[78] The courts of all jurisdictions would be bound to enforce those charters, save for instances in which the results would be "unreasonable and unjust."[79] Indeed, the debtor would not only be able to select a country, but could also determine the system for cooperation among countries.[80] The debtor's choice would be limited in only one major respect: the debtor could not direct one country to apply the bankruptcy law of another country.[81]

The emphasis on what the debtor says in its corporate charter accounts for the name of this hybrid, and there are some obvious advantages. First and foremost, there is respect for what in conflicts of law is called "party autonomy." Organizers of a corporation get to select the law in which they incorporate, and that law governs all of their corporate affairs. Why should they be any less free to select the law that will govern their firm's liquidation or re-organization? Moreover, there is no harm to creditors. Any prospective creditor can see from the charter what law will govern an insolvency proceeding. If a prospective creditor does not like the law, then it can forsake the debtor. Finally, there is the advantage of a unified proceeding under a single law. In this respect, corporate-charter contractualism veers towards universality on the universality—territoriality continuum, albeit as a result of private rather than public decision making.

75. See *id.*
76. See *id.*
77. See *id.*
78. See *id.* at 737.
79. See *id.*
80. See *id.*
81. See *id.*

While free marketeers thus may be inclined to corporate-charter contractualism, there are some concerns. First, sovereignty may rear its head. Will every country really agree that a private company's choice of law should override what might be regarded as a sovereign decision, namely, the decision of what law to apply in insolvency? Second, might there be room for strategic behavior by debtors? They can scour the globe looking for the most pro-debtor law on the available pro-debtor—pro-creditor continuum. Third, is there a possibility of a "race to the bottom"? That is, could powerful multinational corporations bully less potent sovereign governments into enacting all-too-pro-debtor insolvency laws as a condition for foreign direct investment in those countries? All of these concerns are reason for some pause with respect to the *laissez-faire* orientation of corporate contractualism.

F. Cooperative Territoriality

Cooperative territoriality, another hybrid principle for the international aspects of a country's insolvency law, recognizes other countries' rights of territoriality. In this respect, it lies closer to the territoriality end of the universality—territoriality continuum. Under the cooperative territoriality principle, bankruptcy courts in one country will administer the assets of a multinational debtor within the borders of that country as a separate estate.[82] If a debtor has significant assets in several countries, then several independent bankruptcy cases might occur. None of these cases will be considered "main," "ancillary," or "secondary."[83] In effect, they all will be of equal stature.

What rationale underlies cooperative territoriality? To answer this question, it is useful to recall that the main aim of pure universalism, facilitating a worldwide re-organization or worldwide sale of the debtor's assets, can be implemented only if the home country exercises jurisdiction over the entire group of assets and claims.[84] This "group" jurisdiction is intensely problematic in reality, because it broadens bankruptcy jurisdiction beyond acceptable limits. Cooperative territoriality attempts to solve this problem by "severing" the firm (that is, its links to assets and liabilities overseas) at the national border. The principle thus creates an incentive for multinational corporations to compartmentalize their operations by country, thereby further reducing the damage.[85] However, exactly how cooperative territoriality solves this problem in particular cases is not entirely clear.

V. The Problem of Recognition

The universality—territoriality continuum does more than provide a range of principles around which a country can organize the international aspects of its bankruptcy laws. It highlights the fundamental problem of recognition, that is, whether one country will give legal effect to insolvency proceedings conducted in

82. See *id.* at 744.
83. See *id.*
84. See *id.*
85. See *id.*

another country. It is not unduly optimistic to see an increasing tendency internationally to recognize the right of a foreign administrator from the home forum of the debtor to collect local assets, as well as an increasing tendency to recognize the automatic stay of creditor executions (though this freeze sometimes takes effect only after local recognition proceedings have begun).[86]

Having said this, the fact remains that most countries now allow concurrent proceedings to be opened, whether they be ancillary or full. Thus, in practice, the unilateral efforts of a foreign trustee typically are overtaken rather quickly by local proceedings that "guillotine" any further attachments.[87] The effect of these local proceedings is to allow the local jurisdiction to give effect to its own bankruptcy laws. Under those laws, the issues become (1) choosing what law applies, (2) deciding whether local creditors are paid first, and (3) determining whether the local forum will turn over local assets to the foreign forum that may, in turn, go to pay creditors in a different order from that contemplated under local law, or that may go to finance a foreign rehabilitation proceeding as opposed to a final bankruptcy.[88] The central issue in all this is whether the local jurisdiction recognizes foreign insolvency proceedings and, if so, the extent of such recognition. Recognition may be mandatory, discretionary, or selective (i.e., with respect to certain issues).[89] Other forms of recognition include retroactive recognition, nonretroactive recognition, and recognition limited to asset collection.[90]

As intimated above, recognition is a question of degree. That is to say, once again, there is a continuum, a "Recognition Continuum," depicted in Figure 3. At one extreme is complete recognition. It amounts to the faithful execution of the universality—or, better yet, the unity—principle. There appear to be few (if any) countries at this extreme.

At the other end of the continuum is total non-recognition. Here, the territoriality principle is followed. This extreme means that, in the absence of a treaty, a country does not recognize a bankruptcy proceeding in the principal foreign forum, and hence does not give it any local effect over local assets.[91] The result is that the administrator in the home forum has no status to collect assets in the country. At the risk of a pejorative connotation, the country is the ultimate "obstructionist." Examples include Argentina, Austria, Denmark, and Norway. None of these countries recognizes foreign bankruptcies, so a foreign trustee is powerless to collect local assets.[92]

Figure 3 The Recognition Continuum

86. See Wood, *supra* note 5, at 242.
87. See *id.*
88. See *id.* at 243.
89. See *id.*
90. See *id.*
91. See *id.*
92. See *id.*

Japanese insolvency regime is, without doubt, at or near the total non-recognition end of the continuum. A bankruptcy procedure commenced outside Japan is not effective with respect to the properties of the debtor located in Japan.[93] That is, no recognition exists at present, a deficiency discussed in more detail in Part Two below. Indeed, Japan's Bankruptcy Law does not contain any mechanism for recognizing a foreign bankruptcy procedure.[94] But, there is some relaxation of this territorial policy, as evidenced below.

In between these extremes are full or partial recognition. In this vast middle, the insolvency proceeding in the domiciliary forum achieves a measure of recognition in other countries with respect to freezes on execution and collection, with or without local recognition proceedings.[95] The United States stands in between these extremes. In a case where a debtor is subject to a foreign bankruptcy proceeding outside the United States, and foreign creditors want to place assets located in the United States under the control of a foreign insolvency representative, there are three possible options: (1) no proceeding in the United States; (2) a concurrent bankruptcy proceeding in the United States; or (3) an ancillary proceeding in the United States.[96] Under the first option, there is immediate recognition without the necessity of any court proceedings. In other words, the foreign forum recognizes the bankruptcy proceeding in the forum without any formal recognition proceeding in the foreign forum. This option is mostly taken by the American Bankruptcy Code.[97] The recognition entitles the foreign insolvency representative to collect local assets, and it freezes creditor attachments of local assets and the powers of the debtor to dispose of local property.[98]

At bottom, the most practical problem with respect to the international effect of insolvency proceedings is whether, and to what extent, each relevant country is willing to cooperate with a principal foreign proceeding or to allow for the intra-territorial effect of multiple foreign proceedings.[99] There is a reform movement emerging in international insolvency law toward greater cooperation in international insolvencies.[100] The end point may be universality, though the world is nowhere near that point yet. Ancillary proceedings conducted under the auspices of Section 304 of the American Bankruptcy Code are a hopeful sign in this reform movement. Other examples come from Europe, through possible conventions and new domestic laws, and the International Bar Association, which has prepared a model act. Yet another positive example is found in Japan, which is making efforts to relax its territoriality policy and creating preliminary drafts of a reform law and a bilateral treaty.[101]

93. See *id*. at 268-269.
94. See *id*.
95. See *id*. at 244.
96. See *id*. at 259-260.
97. See *id*.
98. See *id*.
99. See Shoichi Tagashira, *Intraterritorial Effects of Foreign Insolvency Proceedings: An Analysis of "Ancillary" Proceedings in the United States and Japan*, 29 TEXAS INT'L L.J. 1 (1994).
100. See Tagashira, *supra* note 99, at 3.
101. See *id*.

The reforms on the table or drawing board for cooperation in international insolvency cases vary from country to country. The two main methods for implementation have been through domestic law reform and/or focusing on international conventions/treaties. Whatever method is used, what is required is deliberate cooperation with foreign laws within a country's own legal and economic policy. A simple waiver of jurisdiction or submission to foreign laws is not enough.[102] As discussed more fully in Part Two below, in Japan, the key barrier to increased international cooperation is its current legislative policy of territoriality.[103]

VI. The UNCITRAL Model for International Insolvency Law

Perhaps the most hopeful sign of all as regards greater international cooperation on the problem of recognition comes from the United Nations Commission on International Trade Law (UNCITRAL). On May 30, 1997, UNCITRAL adopted the text of a Model Law on Cross-Border Insolvency.[104] To be sure, a model law had to be used instead of a convention, because a convention would hold no effect if it were not ratified, and it seemed unlikely that a large number of countries would ratify such a convention.[105] Why? Harmonization of insolvency law across borders is difficult, because this area of law is akin to a symphony. Just as a symphony is made up of many different kinds of musical instruments that must work perfectly together, insolvency law consists of many parts—contracts, corporate law, civil procedure, etc.—that must fit together. Any attempt to unify insolvency law thus entails a gargantuan effort: the unification of many other bodies of law. This task is perhaps too ambitious for the present.

Nevertheless, the Model Law is an impressive achievement. In the long run, it may be a stepping stone toward harmonization, toward a single "world law" on insolvency. Just as creditors of American railway companies in the late nineteenth and early twentieth century were scattered across state lines, as were the assets that they looked to for satisfaction, creditors of modern corporations in the global economy, and the assets of those firms, are scattered across national boundaries. And, just as railway creditors as a whole could be better off by a federal bankruptcy statute that inhibited destructive grab races, multinational corporate creditors can be better off by a unified insolvency law that preserves the highest value of the debtor's estate for re-organization or liquidation.

102. See *id.*
103. See *id.*
104. See Berends, *supra* note 41, at 312. Work on the Model Law commenced in 1995, and it is commendable that UNCITRAL was able to complete this important project within a relatively short time frame. It is beyond the scope of this paper to entertain a dilated discussion of the Model Law. In any event, there are several excellent reviews of its provisions. See, e.g., Harold Burman & Jay Lawrence Westbrook, *Introductory Note—United Nations Commission on International Trade Law: Model Law on Cross Border Insolvency*, 36 INT'L LEGAL MATERIALS 1386 (1997); UNCITRAL, *Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency*, U.N. Doc. A/CN.9/442 (May 1997), reprinted in 1998 BASIC DOCS. OF INT'L ECON. L. AD LEXIS 26 (1998); Ron Harmer, *The UNCITRAL Model Law on Cross-Border Insolvency*, 6 INT'L INSOLVENCY REV. 145 (1997). The Model Law itself is published at 36 INT'L LEGAL MATERIALS 1389 (1997).
105. See Berends, *supra* note 41, at 319.

In the nearer term, the Model Law has persuasive power. Countries can look to it as a paragon embodying internationally agreed-upon principles when they contemplate revising or drafting anew their own insolvency regimes. To the extent countries do indeed use the Model Law, confidence among investors, traders, and banks may be enhanced. After all, if bankruptcies cannot be resolved under the same set of rules around the world, then the second-best solution is that they be resolved in as consistent and transparent a manner as possible regardless of the forum in which cases happen to be brought.

The basic purpose of the UNCITRAL Model Law is to provide an effective mechanism for dealing with cases of cross-border insolvency.[106] This Law is based on nine principles, which are as follows:

First: The court of the enacting State shall recognize only one foreign proceeding as a foreign main proceeding.

Second: The recognition of a foreign proceeding shall not restrict the right to commence a local proceeding.

Third: A local proceeding shall prevail over the effects of a foreign proceeding and over relief granted to a foreign representative, regardless of whether the local proceeding was opened prior to or after the recognition of a foreign proceeding.

Fourth: When there are two or more proceedings, there shall be cooperation and coordination.

Fifth: A foreign proceeding shall be recognized as a foreign main proceeding if the foreign proceeding is opened in the State where the debtor maintains the center of his main interests. A foreign proceeding shall be recognized as a foreign non-main proceeding if the foreign proceeding is opened in a State where the debtor has an establishment.

Sixth: Upon recognition of a foreign proceeding as a foreign main proceeding, some types of relief will come into effect automatically. They will be in effect until modified or terminated by the court. Upon recognition of a foreign proceeding as a foreign main proceeding, some other types of relief may be granted by the court, but they will not come into effect automatically. Upon recognition of a foreign proceeding as a foreign non-main proceeding, relief can only come into effect if it is granted by the court.

Seventh: Coordination may include granting relief to the foreign representative. In granting relief to a foreign representative of a foreign non-main proceeding, the court must be satisfied that the relief relates to assets falling under the authority of the foreign representative.

Eighth: Creditors shall be allowed to file claims in any proceeding. Payments to creditors from multiple proceedings shall be equalized.[107]

106. See id. at 323.

107. This is the so-called "Hotchpot" rule, which derives from English insolvency law. It is set forth in Article 32 of the Model Law. The idea is that if a creditor recovers X percent in one foreign proceeding (e.g., in the United States), and then tries to recover more in a second foreign proceeding (e.g., in Japan), the court in the second foreign proceeding (Japan) will bar any further recovery for this creditor until other creditors in the second proceeding have gotten X percent. The rule is a move away from territoriality. Under a pure territorial

Ninth: If there are surplus proceeds of a local non-main proceeding, they shall be transferred to the main proceeding.[108]

It should be apparent from these core principles that the Model Law is based on a minimalist philosophy: nothing in the Law should prevent legislators from giving more rights to foreign creditors than to local creditors.[109] (This minimalist approach does no damage to the national treatment analogy from international trade law mentioned earlier. National treatment under Article III of the General Agreement on Tariffs and Trade (GATT) does not bar better treatment for imported goods than for like domestic products.) It should also be apparent that, while the Model Law clearly rejects territorialism, it is not perfect in its adherence to the universality principle. Points one and four–six steer in that direction, but the second and third do not.

In other words, the Model Law is somewhat of a "mixed bag," perhaps reflecting the pragmatic accommodation required to get a consensus among UNCITRAL delegates. Under the Model Law, recognition of a foreign proceeding and any relief granted are given effect either automatically or through a court order.[110] Concurrent proceedings may take a variety of forms. The court of the enacting State is required to decide whether it will recognize a foreign proceeding as a foreign main proceeding or as a foreign non-main proceeding.[111] Any concurrent proceeding is governed by three rules. First, the effects of a foreign proceeding must always be adjusted to the effects of a local proceeding. Second, the effects of a foreign non-main proceeding must always be adjusted to the effects of a foreign main proceeding. Third, the effects of more than one non-main proceeding must be adjusted to each other.[112] These adjustments are possibly the best illustration of the pragmatic bargain the Model Law seems to strike.

To what extent are countries—in particular, Japan and the United States—likely to adopt the Model Law?[113] Japan is not likely to adopt the Model Law as a whole, provision-by-provision. The wording of, and concepts embedded in, the Model Law are appropriate for an Anglo-American common law system. They do not fit so easily into the Japanese legal system. Thus, not surprisingly, two bills were introduced during the 105th session of the United States Congress that would have incorporated the Model Law almost *verbatim* into the American Bankruptcy Code.[114] The bills would have created a new Chapter 15 to the Code for the provisions of the Model

approach, the court (e.g., in Japan) could not take account of any collection by the creditor in a foreign insolvency proceeding (e.g., in the United States). After all, other insolvency proceedings are neither recognized nor enforced. See *UNCITRAL, supra* note 104, at 64.

108. See Berends, *supra* note 41, at 321-322.

109. See *id*. at 344.

110. *Id*. at 349-350.

111. *Id*. at 385.

112. *Id*. at 387.

113. The author is grateful to Professor Junichi Matsushita, Faculty of Law, Gakushuin University. He patiently explained the problems of Model Law implementation at a meeting on 12 July 1999, and kindly provided a copy of his excellent paper on the Model Law. See Junichi Matsushita, *UNCITRAL Model Law and the Comprehensive Reform of Japanese Insolvency Laws* (March 1999) (unpublished manuscript, submitted for publication).

114. See generally Don Wallace, Jr. & Harold S. Burman, *U.N. Colloquium on the Top International Commercial Law Topics for the Late 1990s*, INT'L L. NEWS 15 (summer 1998) (discussing the Model Law and its prospects for implementation in the United States).

Law. Unfortunately, both bills were defeated, though not because of any controversy over the Model Law. Rather, issues surrounding consumer bankruptcy and Chapter 13 sent the bills down. However, very similar legislation has been introduced in the 106th Congress, and it seems inevitable that the United States will—sooner or later—incorporate the Model Law into its Bankruptcy Code.

As for Japan, there appears to be a strong momentum to integrate the essential parts of the Model Law into the insolvency regime.[115] Fitting these parts into the regime is the challenge. More than just a change of wording is necessary. For instance, the Model Law contains provisions that impart discretionary power to judges. Yet, concerning the authority to create a remedy, judicial discretion is more constrained in Japan than in the United States, and even than in France or Germany. As an example, Article 21 of the Model Law states that "the court may, at the request of the foreign representative, grant any appropriate relief, including:" and then lists seven possibilities, (a) through (g), where (a) through (f) are measures that are expressly spelled out, and (g) states "granting any additional relief that may be available to [*insert the title of a person or body administering a reorganization or liquidation under the law of the enacting State*] under the laws of this State." This provision would not fit within the Japanese legal context because of the discretion it imparts to judges. The larger point, then, is that Japanese officials and legal scholars will have to import the Model Law only after carefully examining each and every provision at the border and making adjustments—additions, deletions, and the like—to fit in the Japanese legal context.

PART TWO: JAPANESE INSOLVENCY LAW AND ITS INTERNATIONAL DIMENSIONS[116]

I. Causes of Bankruptcy

Presently, the Bankruptcy Law recognizes three causes of bankruptcy: (1) insolvency; (2) suspension of payment; and (3) an excess of liabilities over assets (i.e., a balance sheet test).[117] These causes operate regardless of any international dimensions to a case. That is, it does not matter whether the debtor has assets overseas—the same causal tests are applied. This conclusion is not expressly stated at any point, but the absence of a provision to the contrary suggests it is a reasonable inference to draw.

115. The "First Questionnaire" ("*Kentou-Jikou*") publicized in December 1997 by the Advisory Committee for the Reform of Insolvency Laws, Civil Bureau of the Ministry of Justice, raises various issues relating to international insolvency, including the scheme of recognition of foreign main proceedings.

116. The author gratefully acknowledges the background memoranda, "Japanese Insolvency Law" (June 15, 1999), by Ms. Kris Hansen, GW Law School Class of 2000, and "International Insolvency Laws," by Ms. Preeti Kapoor, GW Law School Class of 2000, which assisted in the preparation of this Part.

117. See Tasuku Matsuo, *Bankruptcy*, in Doing Business in Japan ch. XIV at 7-6 (Zentaro Kitagawa ed., 1998). Legally strictly speaking, suspension of payment itself is not a cause of bankruptcy, but when a debtor has suspended payment, a legal presumption arises that he is unable to pay his debts. This presumption can be rebutted by the debtor in order to avoid an adjudication of bankruptcy. See *id*. at 7-8 and Bankruptcy Law, *infra* note 122, at Art. 126, ¶ 2. Composition Law, *infra* note 123, at Art. 12, ¶ 1 provides for the same rule.

Use of the word "insolvency" as a cause is a bit confusing. It means an obligor cannot cover its indebtedness.[118] Accordingly, the primary purpose of an insolvency proceeding is to provide the greatest distribution to creditors.[119] The term "insolvency" thus must be understood in context. It is often used interchangeably with the word "bankruptcy," and indeed has been employed in this manner throughout this paper. However, when thinking of the causes of bankruptcy under Japanese law, it is "bankruptcy" that is the generic term, and "insolvency" is simply one of three sub-categories. Of these three causes, insolvency is by far the most important, and the focus below shall be on this cause with respect to corporate debtors.

II. Types Of Insolvency Proceedings

It is often said that there are five different types of insolvency proceedings under Japanese law.[120] It is, thereafter, commonly indicated that two of the five are liquidation proceedings, while the remaining three (corporate reorganization, company arrangement, and composition) involve rehabilitation of the debtor, i.e., corporate reorganization.[121] The idea of "five" types can be confusing for an outsider. The point is that since 1922, Japan has enacted four statutes that relate to bankruptcy. They are the (1) Bankruptcy Law of 1922,[122] (2) Composition Law of 1922,[123] (3) Commercial Code of 1938,[124] and (4) Corporate Reorganization Law of 1952 (enacted during the Occupation, and bearing the influence of the American Bankruptcy Code as it then existed).[125] (As noted later, the Commercial Code includes two chapters, one providing for special liquidation and one for reorganization (specifically, company arrangements)). The dates of these sources of law ought to be underscored. There have been no major changes to the legal regime in nearly half a century (with the exception of special legislation in 1996, discussed below, designed for failed banks). This fact, in itself, is stunning given the changing fortunes of the Japanese economy and developments in the global economy in the post-Second World War era.

The point is that to say there are five different types of insolvency proceedings in Japan masks the fact that there are really four different sources of law—three statutes (the Bankruptcy Law, Composition Law, and Corporate Reorganization Law) plus the Commercial Code—that govern insolvency proceedings. As for the conceptually distinct question of how many types of proceedings exist, the answer—five[126]—is

118. See *id*. at 7-7.
119. See Makoto Ito, *Report for Japan*, in Cross-Border Insolvency: National and Comparative Studies 178 (Ian F. Fletcher ed. 1992).
120. See, e.g., Junichi Matsushita, *Present and Future Status of Japanese International Insolvency Law*, 33 TEX. INT'L L.J. 71, 72 (1998); Ito, *supra* note 119, at 178.
121. See *id*.
122. See Hasanho [Bankruptcy Law], Law No. 71 of 25 April 1922, translated in 2 EHS L. BUL. SERIES LU (1986).
123. See Wagiho [Composition Law], Law No. 72 of 25 April 1922, translated in 2 EHS L. BUL. SERIES LV (1988).
124. See Shoho [Commercial Code], Law No. 48 of 1899, amended by Law No. 72 of 1938, translated in 2 EHS L. BUL. SERIES JA (1995). See also Law No. 73, 3 May 1911.
125. See Kaishakoseiho [Corporate Reorganization Law], Law No. 172 of 7 June 1952, translated in 2 EHS L. BUL. SERIES LZ (1996).
126. See Ito, *supra* note 119, at 178.

depicted in Table 1. These types are likely to be equally applicable regardless of any international dimensions to the case at hand, i.e., while there may be serious intra- or extra-territorial issues at stake (as discussed later), the availability of these procedures does not usually turn on the international dimensions to the case. This conclusion is nowhere stated expressly. Rather, the inference is drawn from the silence of Japan's legal regime on the point.

Table 1: Conventional Categorization of Japanese Insolvency Proceedings

Broad Classification: Liquidation or Rehabilitation?	***Specific Procedure?***	***Source of Law Governing the Procedure?***	***Who is Eligible to Use the Procedure?***
Liquidation	Bankruptcy	Bankruptcy Law	Any kind of debtor (natural or legal person)
Liquidation	Special liquidation	Commercial Code	Only a stock corporation
Rehabilitation	Corporate reorganization	Corporate Reorganization Law	Only a stock corporation
Rehabilitation	Composition	Composition Law	Any kind of debtor (natural or legal person)
Rehabilitation	Reorganization (of a company), also known as company arrangement	Commercial Code	Only a stock corporation

Clearly, the five procedural devices are divided into two broad categories, liquidation and rehabilitation. There are two types of liquidation procedures, one set forth under the Bankruptcy Law, known simply as bankruptcy, and a so-called special liquidation procedure created by the Commercial Code. There are, in addition, three types of reorganization procedures: corporate reorganization under the Corporate Reorganization Law; composition (including compulsory composition) under the Composition Law; and reorganization of a company under the Commercial Code, which is also known as a company arrangement.

Significantly, not every debtor is eligible for every kind of procedure. Only the bankruptcy and composition procedures can be applied to all debtors, whether natural or legal persons.[127] Corporate reorganization, special liquidation, and the reorganization of a company under the Commercial Code are avenues reserved for stock companies. These avenues are, of course, available to any company located in Japan, regardless of its place of incorporation.[128] To put the point differently, corporate debtors can avail themselves of all five procedures. Debtors other than stock companies are confined to either liquidation through bankruptcy or rehabilitation through composition.

As explained earlier, when a Japanese corporate debtor goes bankrupt by reason of insolvency, as defined above, any of the five legal proceedings may occur. How

127. See *id*.
128. See Patrick Shea & Kaori Miyake, *Insolvency-Related Reorganization Procedures in Japan: The Four Cornerstones*, 14 U.C.L.A. PAC. BASIN L.J. 244 no. 3 (1996).

exactly do these procedures work? The four most significant possibilities—corporate reorganization, company arrangements, compositions, and liquidation through bankruptcy are summarized in Table 2.

Table 2 Principal Features of Japanese Insolvency Proceedings

Type of Proceeding	*Causes of Bankruptcy that Trigger the Proceeding*	*Scope of the Stay on Creditor Action*	*Status of Management of the Debtor*	*Plan*
Corporate Reorganization	(1) Company cannot pay its debts, or (2) bankruptcy is likely.	Stay blocks actions by secured creditors.	Trustee must displace management of the debtor.	Reorganization plan must be fair and equitable. Creditors, share-holders, and the court must approve the plan. "Cram down" is possible.
Company Arrangement	Can be com-menced at a very early stage, namely, it is prob-able that (1) the company is unable to pay its debts, or (2) that the com-pany's liabilities exceed its assets.	Stay blocks actions by secured creditors at the discretion of the court.	Trustee does not displace company management except in extreme circumstances.	No legal criteria for elements of the plan. However, plan must be approved by all creditors. Approval of court is not necessary.
Composition	Any of the three causes of bank-ruptcy, i.e., (1) debtor is unable to pay its debts, (2) debtor has suspended payment of its debts, or (3) debtor's liabilities exceed its assets.	Stay does not block actions by secured creditors.	Company's management is not displaced.	Plan must be fair and equitable. Plan must be approved by unsecured creditors and court.
Liquidation under Bankruptcy Law	Same as composition, above.	Stay does not block actions by secured creditors	Trustee must displace manage-ment of debtor.	Not applicable.

III. International Dimensions—And Some Perspectives from International Trade Law[129]

One of the grave concerns about Japan's insolvency law regime is its lack of inter-national dimensions, hence the incongruity: Japan is the world's second largest economy, Japanese corporations boast an empire of business interests around the

129. The author is grateful to Professor Junichi Matsushita, Faculty of Law, Gakushuin University. Professor Matsushita patiently explained many aspects of the international dimensions of Japanese insolvency law, and the reform of Japan's insolvency regime, at a meeting on 12 July 1999. He also kindly shared a copy of his excellent paper that deals with these issues. See Junichi Matsushita, *Current Japanese Insolvency Law and the Comprehensive Reform Project* (April 1999) (unpublished manuscript, submitted for publication).

world, and yet the regime says precious little about how to handle international aspects of an insolvency case. It is as if the insolvency regime were written in for the most inward-looking days of the Tokugawa Period and never updated to account for the changing reality of globalization. This is not to say the regime is utterly silent. There are a few sounds, three in particular: jurisdiction; the status of claims; and the recognition of foreign insolvency proceedings.

Before listening to the sounds, it is worth trying to organize what there is to hear. International dimensions of any country's insolvency law regime may be divided into two categories: intra-territorial effects, and extra-territorial effects. The first category concerns the effect of a foreign insolvency proceeding within a country, for example, the effect in Japan of a bankruptcy case adjudicated in the United States. Recognition and enforcement is the obvious element in this category. Will decisions made by the bankruptcy court in the United States be recognized as legally valid in Japan, and enforced by a Japanese court as such?

The category of extra-territorial effects is the mirror image of the first category. At issue is the effect overseas of an insolvency proceeding in a particular country. For example, what effect would an insolvency proceeding in Japan have on the United States? In particular, will a Japanese trustee be able to collect assets of the debtor in overseas jurisdictions like the United States? Into this category, then, falls the matter of jurisdiction. Also, the status of foreign claims may be considered an intra-territorial matter, because at issue is whether foreign creditors will be able to make claims in the proceedings of another country. Obviously, whether an effect is "intra-" or "extra-" territorial depends on the perspective used. In the second example, the effect on the United States of a Japanese insolvency proceeding is extra-territorial from Japan's perspective, but intra-territorial from the American perspective.

A. Jurisdiction—And GATT-WTO Dispute Resolution

Does a court have the power to hear the case? That is the necessary starting point for any insolvency proceeding, whether or not the debtor's affairs have cross-border dimensions. Aside from the few mentioned below, there are no direct provisions on international insolvency jurisdiction in Japan. To be sure, there are guidelines contained in Sections 105 and 107 of the Bankruptcy Law, and Section 6 of the Corporate Reorganization Law,[130] that reflect relevant venue rules. Under these rules, a district court in Japan is the proper venue for a foreign debtor.[131] However, these venue rules still do not get at the fundamental extra-territorial question of jurisdiction.

In the absence of specific jurisdictional rules on international insolvency matters, general jurisdictional principles are used. The gist of them is that a Japanese district court must have either ordinary or complementary jurisdiction in order to preside over an insolvency proceeding.[132] Ordinary jurisdiction exists if a debtor has a center of business within the district in which the court sits, or in the case of an individual debtor, if that district is the debtor's domicile.[133] For example, if a foreign corporate

130. See Tagashira, *supra* note 99, at 9.
131. See *id*.
132. See Ito, *supra* note 119, at 179.
133. See *id*.

debtor has one or more offices in Japan, then the district court in which the debtor's main Japanese office is located would have exclusive jurisdiction over the case.[134] If the court lacks ordinary jurisdiction, then it will analyze whether the location of the debtor's assets give rise to complementary jurisdiction.[135] In other words, complimentary jurisdiction is a fall-back: the court does not have the power to hear the case based on the debtor's "headquarters," but perhaps it might have the power based on asset location. Assets which the court will look at include real estate, personal property, claims, and even intangible rights such as intellectual property rights (patents, trademarks, and copyrights).[136]

Japanese courts apply these jurisdictional criteria to both foreign and domestic debtors.[137] The territoriality principle, discussed in Part One, governs the exercise of jurisdiction over a debtor's assets located abroad.[138] This principle—to which Japan subscribes—bars a Japanese court in which commencement of an insolvency proceeding is sought from exercising jurisdiction over a debtor's assets located outside Japan. The textual bases for the lack of any extra-territorial jurisdiction are Articles 3 of the Bankruptcy Law and Article 4 of the Corporate Reorganization Law. The result is, of course, that overseas assets may be the target of execution by an individual creditor, or they may remain under the control of the debtor,[139] and thus out of the reach of creditors participating in the Japanese proceeding.

Obviously, Japanese creditors are sure to be dismayed if the debtor's overseas assets are considerable but could not be used to satisfy their claims. (If the depositor or creditor is a claimant against the Japanese branch of a foreign bank, such as BCCI-Tokyo, then that depositor or creditor may be even more disappointed. Under Japanese law, accounts of a branch which, in turn, are held at the branch's parent (for example, in New York) are not considered to be located in Japan.[140]) Why, then, does Japan's insolvency regime take this approach?

> The rationale for the territoriality principle includes some of the following propositions:
> First, bankruptcy is a collective and comprehensive execution on the debtor's assets; thus, its effect must be limited within the geographical boundary of the state's sovereign power. Second, it would be impractical to apply the universal principle because there is no system of cooperation relating to insolvency between Japan and other countries. Third, the territorial principle would lighten the burden of trustees and facilitate proceedings.[141]

134. See Tagashira, *supra* note 99, at 9.
135. See *id*.
136. See *id*.
137. See *id*.
138. See Ito, *supra* note 119, at 180.
139. See *id*.
140. What property of the debtor is considered to be located in Japan and, therefore, subject to the insolvency proceeding in Japan? Any claim that can be enforced under the Code of Civil Procedure (Law No. 109 of 1996) is said to be located in Japan. See Bankruptcy Law, *supra* note 122, at Art. 3(3); Corporate Reorganization Law, *supra* note 125, at Art. 4(3).
141. Matsushita, *supra* note 120, at 73.

However, none of these propositions is compelling. Internationally-minded academics like to believe—statutory authority notwithstanding—that insolvency administrators do have extra-territorial authority over a debtor's assets. Thus, not surprisingly, the territoriality principle is widely, and not unfairly, criticized.

The first and third arguments are the easiest to dispose of. The first argument—that bankruptcy is a collective matter and, therefore, its effect must be limited geographically—is a *non sequitur*. It is precisely because bankruptcy is a collective matter, coupled with the debtor's far-flung assets, that demand a single, rationalized resolution that is deliberately ignorant of national boundaries.

As for the third argument, bankruptcy is not about the convenience of trustees. It is about satisfying creditors in an efficient and fair manner, and perhaps also allowing the possibility of a "fresh start" for the debtor so as not to create crushing disincentives for risk-taking in a capitalist market economy. Even if application of the territorial principle makes the trustee's life easier, it does not improve the quality of that life. The trustee works with a geographically-limited asset pool, but faces a mountain of creditor claims. Would not the trustee be better off in international insolvency cases if it could satisfy a larger percentage of each claim, and a larger percentage of claims overall, through cooperative participation in a universal regime?

The second argument—that there is presently no universal bankruptcy resolution scheme—is not really an argument at all. It is merely a translation of reality into an excuse for the *status quo*. This is not to imply that present reality is thoroughly regrettable. Some Japanese courts appear to be departing from the "traditional territoriality doctrine with respect to the extra-territorial effect of Japanese insolvency proceedings."[142] Yet, for the most part, territoriality is still the rule in Japan. The point is that it may well be time to consider the creation of a global insolvency resolution system, whereas the second argument is defeatist.

A good model for a universalistic international insolvency regime comes from an allied field of international law, namely, international trade law. On January 1, 1995, the World Trade Organization (WTO) was born, and with it the Uruguay Round *Understanding on the Rules and Procedures Governing the Settlement of Disputes (DSU)* entered into force.[143] The *DSU* marked a shift from the old-style system of resolving disputes under the General Agreement on Tariffs and Trade (GATT). That system was characterized by ad hoc mechanisms created through power-based political negotiations. The system lacked legal rigor: there were few fixed time deadlines for the procedural steps of a case, and the procedural steps themselves were not well defined. The system was plagued by the same problem that haunts international insolvency cases: a key player could decide not to participate. In the pre-Uruguay Round dispute resolution system, that meant that either party—the complainant or respondent—could block formation of a dispute resolution panel, block adoption of a panel report (assuming it agreed to the formation of the panel), and decline to

142. Ito, *supra* note 119, at 181.

143. For detailed discussions of the *DSU*, as well as other aspects of the Uruguay Round, see Raj Bhala & Kevin Kennedy, *World Trade Law* intro. (1998, with *1999 Supplement*), Raj Bhala, *International Trade Law: Cases and Materials* ch. 2 (1996), and David A. Gantz, *Dispute Settlement Under the NAFTA and the WTO: Choice of Forum Opportunities and Risks for the NAFTA Parties*, 14 Am. Univ. Int'l L. Rev. 1025, 1049-57 (1999).

implement the recommendations of the panel. Trustees around the world are in the same position as the pre-Uruguay Round complainant or respondent: they can decline to participate in a sensible, worldwide proceeding.

Fortunately, during the Uruguay Round, the world trading community understood that a shift to a consistent, rules-based dispute resolution process was in order. The *DSU* contains tight deadlines for every step of the dispute resolution process, and these steps are spelled out with care. No party can block formation of a panel or adoption of a panel report (or, in the event the report is appealed, of the WTO Appellate Body's report). If the losing party in a case does not comply with the recommendations of the panel (or Appellate Body), then it must pay compensation to the winning party, or suffer retaliation. Thus, dispute resolution in international trade now has the certainty, predictability, and enforceability—in a word, the "teeth"—that international insolvency law lacks. It is not a starry-eyed overstatement to say that the *DSU* represents the most sophisticated mechanism for resolving international disputes that humankind has yet devised. To be sure, it has its warts, but warts and all it stands as an achievement of which those involved in international insolvency reform would do well to take note.

Until they do, the world shall remain beset with the possibility of simultaneous bankruptcy proceedings in multiple jurisdictions, "with the debtor's estate in each one consisting only of the assets available within that country."[144] This possibility is not only inconvenient, it is also costly for the parties involved.[145] Additionally, multiple proceedings in different countries may give rise to potentially conflicting decisions and evasive action by savvy creditors.[146]

B. The Status of Foreign Claims—And National Treatment

The status of foreign claims is the second sound of international insolvency that resonates, albeit softly, in the Japanese regime. It is an overstatement, though not an uncommon one, to say that Japanese courts do not discriminate between foreign and local claims in insolvency proceedings, hence the status of the foreign claim is the same as that of the local claims.[147] In international trade law terms, the court affords foreign creditors "reciprocity." Article 2 of Japan's Bankruptcy Law outlines the principle for the treatment of foreign individuals and companies, providing that "an alien or foreign corporation [i.e., the creditor, be it an individual or corporation from overseas] shall have the same status as a Japanese national or Japanese corporation in regard to bankruptcy, provided however, that this shall apply only when Japanese nationals or Japanese corporations have the same status under the native laws of the alien or the foreign corporation."[148] In addition, Article 485 of Japan's Commercial Code and Article 51 of its Banking Law allow for the commencement of proceedings

144. See Chin Kim & Jimmy C. Smith, *International Insolvencies: An English-American Comparison with an Analysis of Proposed Solutions*, 26 GEO. WASH. J. INT'L L. & ECON. 1, 3 (1992).
145. See *id.*
146. See *id.* at 4.
147. See Ito, *supra* note 119, at 181.
148. Bankruptcy Law, *supra* note 122, at Art. 2. See also Tagashira, *supra* note 99, at 6 (discussing varying interpretations of this reciprocity principle).

against the assets located in Japan of a foreign corporation or bank, respectively. It appears that foreign creditors can file their claims in such proceedings (though whether the debtor, if it is a foreign bank, will be treated as a single or separate entity may be open to question), assuming they can meet the applicable proof-of-claim requirements. In other words, as regards status, foreign claims have an intra-territorial effect insofar as they can be pressed in Japan.

Perhaps Article 2 of the Bankruptcy Law can be justified on pragmatic grounds. It can be argued that because insolvency proceedings are a part of Japan's economic system, Article 2 should be available to all foreigners engaged in economic activity in Japan, and thereby include foreign entities.[149] Yet, foreign assets are beyond the powers of a Japanese trustee. There is no choice but to leave them exposed to collection efforts by individual creditors.[150] The result may be unequal treatment among creditors and, in reorganization cases, an obstacle to the debtor's reorganization,[151] but so be it.

This sort of justification—which is, in effect, the territoriality principle at work—would be at odds with Japan's overseas interests. When adhered to by another country, that other country denies effect to insolvency proceedings in Japan that seek to block the collection actions of individual creditors abroad (a "general staying effect"). That is, it prevents a Japanese proceeding from stopping creditor actions against properties in that country. The result is that the efforts of the Japanese trustee to maximize the size of the debtor's estate (in a global sense), and obtain the best possible pay-out for the broadest array of creditors, are frustrated. Only if the other country does not adhere to pure territoriality will Japan's proceedings stand a chance of being recognized. Section 304 of the American Bankruptcy Code is an example. This Section admits eligibility of Japanese trustees; they can file ancillary proceedings.[152]

It also must be stressed that reciprocity is not nearly as progressive a principle as—to borrow another international trade law concept—national treatment. At first blush, it seems quite appropriate that Japanese courts treat foreign and domestic creditors equally, and it is. The problem is that the treatment is conditional on the courts in the home countries of the foreign creditors offering Japanese creditors the same treatment (i.e., not discriminating against Japanese creditors in favor of their own local ones).[153] This demand is not the hallmark of an advanced approach—at least as judged from the perspective of GATT principles. To be sure, in international trade negotiations, concessions are made on the basis of reciprocity. Nowhere, however, in the GATT national treatment provision (Article III) is there a demand for reciprocity. All WTO Members are expected not to discriminate against

149. Tagashira, *supra* note 99, at 5.
150. See *id.*
151. See *id.*
152. See *id.*
153. It is assumed here that the stricter interpretation of reciprocity under Article 2 of the Bankruptcy Law—that Japanese creditors must be treated under a foreign insolvency law in the same way that they would be treated under Japanese law—is not applicable. This interpretation would render some foreigners entirely ineligible for Japanese bankruptcy proceedings, on the grounds that their law does not treat Japanese creditors as they would be treated by Japan's law. The interpretation above is less strict, namely, that Japanese creditors not be discriminated against under foreign law, regardless of the nature of that foreign law. See generally Tagashira, *supra* note 99, at 6 (discussing these interpretations).

imports vis-à-vis like domestic problems. (Likewise, there is no such demand in the famous Article I, concerning most-favored nation (MFN) treatment. Every WTO Member is obliged to treat the imports of every other Member equally.) Were Japan to stake out an aggressive universalistic approach to international insolvency law, it would drop the reciprocity condition and treat foreign creditors as well as Japanese creditors, regardless of the treatment of Japanese creditors in foreign insolvency proceedings. Apparently, this principle already has been discarded in the Corporate Reorganization Law.

Would such a change to the Bankruptcy Law be criticized as naive, as "giving up something for nothing"? Perhaps, particularly by Japanese creditors that have obligations outstanding to debtors in countries that do not treat foreign creditors akin to domestic creditors. But those creditors ought to enter into such obligations with their "eyes open." If they fear the possibility of a local insolvency proceeding and attendant discrimination, then they can put a price tag on their fear: they can increase the cost of credit they are extending to the debtor. Moreover, it is important not to view the matter from the narrow perspective of Japanese creditors. There is a larger context to consider, namely, the reaction of the international business and legal community. Foreign creditors would applaud the move. They might interpret it as signaling a more favorable business climate, and react by extending more credit, or credit on easier terms, to Japanese debtors. No doubt Japanese debtors would welcome the increased liquidity. As for the international legal community, might it not see Japan as staking out leadership on international insolvency reform?

C. Recognition of Foreign Insolvency Proceedings—And International Trade Negotiations

Given the grip of the territoriality principle on Japan's insolvency law regime, it ought not to come as a surprise to learn that Japanese courts neither recognize nor give effect to foreign insolvency proceedings or judgments with respect to property situated in Japan. In other words, these proceedings and judgments have no intra-territorial effect. Article 3(2) of the Bankruptcy Law puts it plainly: "a bankruptcy adjudged in a foreign country shall not be effective with respect to properties existing in Japan."[154] Other Japanese insolvency statutes have similar territoriality provisions.[155]

Fortunately, Japanese courts have not turned a deaf ear to the rising chorus of criticism of the territoriality principle and its deployment in Japan. For example, in 1981, the Tokyo High Court held that the territorial provisions of the Bankruptcy Law were simply intended to limit the general staying effect of foreign proceedings, and did not deny a foreign trustee's rights to manage the debtor's assets in Japan.[156] Some scholars have interpreted this holding to mean that foreign insolvency proceedings

154. Bankruptcy Law, *supra* note 122, at Art. 3.
155. See, e.g., Composition Law, *supra* note 123, at Art. 11 (1922); Corporate Reorganization Law, *supra* note 125, at Art. 4.
156. See Tagashira, *supra* note 99, at 9. In the case, a Swiss trustee was allowed to litigate the rights of a foreign debtor, a Swiss corporation, in Japan. A Japanese creditor had arrested a registered trademark of the Swiss corporation. In the ensuing Swiss bankruptcy proceeding, the trustee sought to cancel the action of the Japanese creditor (the arrest). The Tokyo High Court agreed the trustee had "a right to manage the debtor's assets in Japan." *Id.* at 9; See also Judgment of 30 January 1981, Tokyo Kosai [Tokyo High Court], 32 Kaminshu 10, 12.

can be effective in Japan, provided that they meet several requirements for recognition.[157] Perhaps, then, Japanese courts are "tending to relax the strict attitude toward foreign proceedings."[158]

> Article 3 paragraph 2 of the Bankruptcy Law provides only that foreign bankruptcy adjudication does not automatically have an effect, in particular effect of collective execution, to the debtor's property. It does not necessarily mean that the court must ignore the foreign bankruptcy itself or must deny the right of the foreign administrator to manage and dispose of the debtor's property which is granted by the law of the foreign country.[159]

Accordingly, under certain circumstances, Japanese courts may allow a foreign trustee to administer the debtor's assets located in Japan. What are those circumstances? Simply put, there must be no Japanese creditors seeking to attach the same assets.[160] Obviously, there is always a strong chance of a long line of Japanese creditors knocking at the debtor's door. Moreover, "it is still difficult or at least unknown [if the trustee] may vacate such attachment, which is either caused by a local creditor or foreign creditor, by way of the recognition of the foreign insolvency proceeding."[161]

It is, therefore, perhaps harsh but by no means unfair to characterize Japan's approach toward foreign insolvency as noncooperative, and certainly distinct from that of the United States. Section 304 of the American Bankruptcy Code is an effort at international cooperation. The absence of an analogous provision in Japanese law reflects a territoriality policy that has deep historical roots. The initial intent of that policy was to protect Japanese creditors from being forced to attend foreign proceedings.[162] As long as they did not have to participate in these proceedings, they would be spared the costs associated with presenting evidence and defenses to meet or rebut issues of proof. Thus, the thinking was that foreign proceedings ought not to have an effect on a debtor's assets in Japan. Accordingly, almost a century ago, Japan's former highest court, the Grand Court of Judicature, denied effect to an order of discharge issued by a Hawaiian court.[163] The Grand Court reasoned that the essence of a bankruptcy proceeding is its power of compulsory execution, thus its effects should be limited to the territory within which it is enforceable, in this case, only within the United States.[164]

In sum, the best that can be said is that in general, "as long as there is no concern about the protection of local creditors, it does not contravene the provision [Article 3(2)] to be flexible with respect to the extent of the power of a foreign administrator."[165] This general statement hardly can be regarded as acceptable. First,

157. See, e.g., Tagashira, *supra* note 99, at 9.
158. Ito, *supra* note 119, at 182.
159. Matsushita, *supra* note 120, at 76-77.
160. See Ito, *supra* note 119, at 183.
161. *Id*.
162. See Tagashira, *supra* note 99, at 8.
163. See *id*.
164. See *id*.
165. Matsushita, *supra* note 120, at 79.

ad hoc behavior by judges is far less satisfying than decisive action by the Diet. As a theoretical matter, this sort of judicial activism might be viewed as unacceptable—judicial over-reaching, as it were. As a practical matter, it is hardly predictable. How a particular judge will behave is uncertain. Even if a judge does accord recognition to a foreign insolvency proceeding, that decision does not technically rise to the level of a formal source of law, in a *stare decisis* sense, given that Japan is a civil law country.

Worse yet, Article 3(2) reflects a "me first" attitude, a perspective of both thinking and acting locally rather than globally. Even reciprocity—whereby Japanese courts offered recognition and enforcement to foreign insolvency proceedings in those countries that did the same for Japanese proceedings—would be a more internationally-minded approach. How might such a reciprocity regime come about?

Here again, recourse may be had to an international trade law analogy. As intimated earlier, concessions in negotiations over tariff and non-tariff barriers typically can be made when a country that is the principal supplier of the product at issue commences discussions with one or more countries to which it exports that product. In other words, discussions are conducted on a bilateral basis, or in a small group. In return for opening its market to products that matter to its negotiating partner (or partners), the principal supplier wins a reduction in barriers against its product. Eventually, the countries involved may expand the product list they discuss, and agree to an across-the-board reduction in barriers.

There would appear to be little holding Japan back from commencing negotiations with its largest trading partners with a view to developing an agreement on the recognition and enforcement of foreign insolvency proceedings. Indeed, Japan seems already to have the substantive legal framework that might be a starting point. Article 118 of the Code of Civil Procedure provides that a foreign judgment will be recognized as valid in Japan if (1) the jurisdiction of the foreign court is recognized under Japanese law or an applicable treaty, (2) the defendant received personal service of process or appeared voluntarily, (3) the foreign judgment does not contravene public order or good morals in Japan, and (4) reciprocity is guaranteed as regards the recognition of Japanese judgments. Similarly, under Article 24 of the 1979 Law of Civil Execution,[166] Japanese courts will enforce a foreign judgment if these four conditions are met, and that judgment is final. Possibly, these conditions could be the "talking points" in the early stages of negotiations toward recognition and enforcement criteria for an international framework.

Logistically, how might the negotiations proceed? One possibility would be for Japan to begin talks with the countries in which Japanese companies have the most assets, and from which creditors have the most obligations due in Japan. The presumptive candidates would be the United States, the members of the European Union, Canada, and various Southeast Asian countries. The negotiations could be conducted bilaterally, with the aim of an agreement stating that Japan will recognize and give effect to an insolvency proceeding in the other country, and the other country will do likewise for Japanese proceedings. After a critical mass of bilateral agreements is obtained, Japan could move to "multilateralize" the process

166. See Law No. 4 of 1979.

by calling for a treaty among countries. The signatories would offer recognition and enforcement to each other, much like each WTO Member accepts the schedules of concessions of every other Member. Japan, of course, would stand out as a leader in international insolvency reform.

Is this scenario chimerical? Perhaps not. Consider an example involving the United States and Japan. How might these two nations form a mutually desirable structure for dealing with ancillary proceedings?[167] Radical change in its current legal framework, particularly the abandonment of the territoriality principle, is a possibility discussed below. But, suppose that does not occur, or at any rate, not in the near future. Japan, then, is compelled to explore possible cooperation modalities with foreign insolvency proceeding within the current legislative framework.[168] After all, in the United States, Section 304 helps fit the American Bankruptcy Code in the context of the overall system of international insolvency cooperation,[169] but Japan has no such provision. Nor does it have a bilateral treaty with the United States calling for recognition and enforcement.[170] Thus, between the world's two largest economies, the specter of concurrent insolvency proceedings looms large.[171] Indeed, depending on the nature of a debtor's affairs, concurrent full proceedings may be commenced in more than just Japan and the United States. Japan's adherence to the territoriality principle, together with its lack of a special ancillary procedure, virtually assures this result.

A possible solution in the Japanese-American context is cooperation through *ad hoc* agreements between bankruptcy officials from each country.[172] When concurrent proceedings do erupt, the officials in both proceedings, as well as the debtor, could conclude an agreement that "constitutes a bilateral treaty" for that specific international reorganization case. To be sure, as discussed earlier, Japanese insolvency law places a trustee under court supervision and requires the trustee to obtain court approval before taking important actions, including entering into a settlement. Therefore, an *ad hoc* agreement of the kind suggested would raise three issues.[173]

First, is the trustee even allowed to strike such a bargain? Second, must the trustee enter into such an agreement whenever it is possible to do so? Third, what criteria should the supervising court apply to decide whether to approve the so-called bilateral treaty? The first two questions are the easiest to answer. Presently, Japanese law neither prevents a trustee from attempting to harmonize with a foreign proceeding, nor does it oblige the trustee to do so.[174] The third question remains one open for debate. Arguably, the "bottom-line" criterion is whether the deal will result in the maximization of the size and value of the debtor's estate, and whether it represents the most fair and equitable settlement for the broadest array of creditors and shareholders.

167. See Tagashira, *supra* note 99, at 23.
168. See *id.*
169. See *id.*
170. See *id.*
171. See *id.*
172. See *id.* at 35.
173. See *id.*
174. See *id.* at 36.

IV. Whispers of Reform: Ending Territoriality?

The above discussion suggests that jurisdiction, status, and effects all remain critical problems demanding attention. The Japanese approach to these international insolvency issues, as embedded in current law, is distinctly territorial. It is, therefore, out of step with developments at UNCITRAL—namely, the Model Law. It is also incongruous with the potential role of Japanese corporations, both financial and non-financial, as major players in the global economy. What, then, is to be done?

One starting point is to focus on how to construct a proceeding that is ancillary to a main (or principal) proceeding conducted in another country. In the United States, courts often apply comity to foreign insolvency proceedings, hence international cooperation is a consistent policy in American bankruptcy law.[175] To argue that foreign proceedings should receive automatic "full faith and credit" is to argue for a major change in Japan's current regime.[176] Yet, there are whispers that such change might be afoot.

Japan's reform work on its insolvency laws began in 1996.[177] As part of this reform effort, an advisory committee is scheduled to complete preparation of a draft of the new laws by 2001 or 2002.[178] The committee faces three main issues: (1) consumer bankruptcy, in particular, the requirement and effect of discharge; (2) a simple and effective rehabilitation proceeding for corporations, especially small and medium-sized businesses; and (3) international insolvency.[179] As to the third challenge, there exists a Preliminary Draft of the International Bankruptcy Related Provisions in the Japanese Insolvency Proceedings. This Draft was prepared by leading Japanese scholars. Thankfully, it proposes to abolish the territorial principle in favor of a universality. Indeed, no one doubts that the principle must be abandoned; the only question is the extent of the abandonment. One proposal, which is set forth in Section 4 of the Preliminary Draft, adopts

> a recognition approach, wherein the decision of a foreign court opening a foreign proceeding is recognized and the legal effects of the decision are supposed to be determined basically by the foreign law. This approach is probably patterned after the recognition of foreign judgments. In contrast, the U.S. Bankruptcy code adopts an "ancillary proceeding approach [11 U.S.C. § 304(a)], wherein relief available to a foreign representative is provided in the U.S. law independent from foreign law.[180]

Additionally, Section 6 of the Preliminary Draft abolishes the reciprocity principle and provides for unconditional equal treatment of foreigners.[181]

175. See *id.*
176. See *id.*
177. See Matsushita, *supra* note 120, at 72.
178. See *id.*
179. See *id.*
180. *Id.* at 80.
181. See *id.* at 87.

Unfortunately, these sorts of proposals might not go far enough in calling for intra-territoriality, i.e., the recognition in Japan of foreign insolvency proceedings. For example, the Preliminary Draft abandons the territoriality principle only when certain circumstances are satisfied. The first such circumstance is the existence of ordinary jurisdiction. As explained earlier, ordinary jurisdiction exists where a debtor has its principal office in Japan; complementary jurisdiction exists if the debtor has its principal office in another country, but has property in Japan.[182] Under the Preliminary Draft, a foreign proceeding under ordinary jurisdiction would be given effect in Japan upon recognition by a Japanese court, as long as it meets certain criteria.[183] Upon recognition, a foreign proceeding would become effective retroactively as of its commencement.[184]

Another requirement that would have to be fulfilled to avoid invocation of the territoriality principle would be fair treatment of the rights of all interested parties.[185] How would this be determined? The Preliminary Draft sets forth a series of factors for a Japanese court to apply in order to decide whether all interested parties will receive fair treatment in a foreign insolvency proceeding:

> whether the proceeding is under the control of courts or other competent authority; whether both individual proceedings by creditors toward the debtor's assets and transfers by the debtor are restricted after the commencement of the insolvency proceeding; whether there is a process for addressing fraudulent and preferential transfers; whether the estate is distributed on a pro rata basis without discrimination based on nationality or residency; and whether creditors are properly notified on important matters.[186]

The rationale for giving intra-territorial effect to foreign insolvency proceedings is to protect local creditors by minimizing the expense of presenting proof, evidence, and defenses abroad. However, "simple delay or greater expense in litigating abroad is insufficient proof of prejudice...otherwise, almost all foreign insolvency proceedings would fail to have any effect in Japan."[187]

Further requirements still would have to be met to avoid invocation of the territoriality principle and the consequent denial of recognition to a foreign insolvency proceeding.[188] They include an assurance that the interests of local creditors would be protected. They also include a determination that there is no substantial discrepancy in the system for determining priorities of rights as between Japanese and foreign law. Finally, the Preliminary Draft would require accordance with Japanese public policy.

While each one of these criteria for the recognition of foreign insolvency proceedings may be defensible on its own, taken together they might be troublesome.

182. See Tagashira, *supra* note 99, at 10.
183. See *id.* at 11.
184. See *id.*
185. See Matsushita, *supra* note 120, at 81.
186. *Id.* at 82.
187. *Id.*
188. See *id.* at 81-82.

They would codify and institutionalize judicial discretion as to whether to grant recognition.[189] Japanese legislators need to consider whether Japanese district courts can exercise these discretionary powers without significant delay or excessive burden on judges. In addition, the criteria do not distinguish between liquidation and reorganization proceedings. Providing for appropriate cooperation in liquidation proceedings cannot suffice; attention must be given to reorganization proceedings.

Despite these concerns, the sorts of changes called for in the Preliminary Draft are at least hopeful signs that Japan is moving away from territorialism. In fact, two other related proposals that give cause for hope are worthy of mention. First, the Preliminary Draft suggests an amendment to Japanese insolvency law concerning how to handle concurrent proceedings. Specifically,

> Section 5 of the Preliminary Draft deals with concurrent proceedings. Adjustment of distribution in paragraph (1) [of Section 5] is an internationally accepted rule, and the right of a foreign administrator to file for a Japanese insolvency proceeding in paragraph (2) seems to be a corollary of the recent case law allowing a foreign administrator to act on behalf of the debtor in Japan.[190]

Additionally, Section 5, paragraph (2) states that a recognized foreign main proceeding shall override an antecedent domestic proceeding, and that a foreign administrator will manage the debtor's assets. Clearly, this amendment would materially alter Japanese law. But, until it is effective, the traditional principles of territoriality and reciprocity will apply.

Second, in December 1999, the Diet enacted a new law on so-called "debt adjustment proceedings," informally known as the Debtor Rehabilitation Law. The new legislation is scheduled to take effect in the spring of 2000 and replace the Composition Law of 1922. The new law contains both extra- and intra-territoriality features. A Japanese trustee will have jurisdiction to collect assets of a debtor located overseas, and some recognition will be granted to foreign insolvency proceedings. If the new law is implemented, it will represent an important step away from territorialism.

PART THREE: BANK INSOLVENCIES AND THEIR INTERNATIONAL DIMENSIONS[191]

I. How Have Banks Been Dealt With?

The discussion in Parts One and Two is a general one in that it concerns debtors without making much of a distinction between banks and nonbanks. But, what about the case when the debtor is a bank? Is this a special case? Should it be?

189. See Tagashira, *supra* note 99, at 37.
190. See Matsushita, *supra* note 120, at 86-87.
191. For a discussion of some of the issues dealt with herein, see Hiroshi Nakaso, *Recent Banking Sector Reforms in Japan*, FED. RES. BANK OF N.Y. POLICY REV. 1 (July 1999).

Currently, the woes of the Japanese banking system have been a significant aspect of the country's overall economic crisis. Estimates of the amount of nonperforming loans on the books of Japanese banks vary, including estimates in tens of trillions of yen (i.e., tens of billions of U.S. dollars). Already, approximately 60 problem banks have failed (and perhaps more may follow). An obvious question that arises is what law applies to bank bankruptcy? Put more generally, how, in practice, have bank bankruptcies been handled, and how should they be handled? These are the sorts of issues discussed, in a preliminary way, in this Part. After all, any attempt at a thorough overview of the international dimensions of Japanese insolvency law cannot end without mentioning banks, particularly internationally active banks, as debtors.

A brief excursion into Japanese banking law and recent banking history provides the answers. Japan's Deposit Insurance Law was enacted in 1971,[192] with major reforms made to the Law in 1986, 1996, and 1998. (The 1996 and 1998 changes are of particular importance, because they were designed to deal with the current economic crisis.) After the 1986 change, under Japan's "safety net," two strategies were available to deal with failing or failed commercial banks. The first strategy, known as a "payoff," resulted in the protection of depositors up to a threshold. By law, each depositor (whether Japanese or not) was (and still is) protected up to ¥10 million. After that, whether a depositor incurred a loss, and in what amount, were matters determined during the liquidation process, i.e., they depended on the remaining value of the liquidated bank. However, the payoff strategy has not yet been applied in any case, because of the fear of systemic risk it might engender, particularly given the circumstances of the financial sector.

The second strategy was "financial assistance" by the Deposit Insurance Corporation. A loss incurred by a failed bank was covered by a money transfer from that Corporation. For example, if a bank had lost ¥100 million worth of assets over its capital, then the Corporation simply covered this loss with a transfer of ¥100 million for the bank's liability. In this way, depositors and other creditors of the bank were protected.

However, there was a limit on the amount the Deposit Insurance Corporation could transfer in any one case, known as the "pay-off cost limit." That limit was defined as the amount that would have been incurred by the Corporation had the failed bank opted for a pay-off, which, in formulaic terms, was as follows:

$$\begin{array}{l}\text{Pay-off}\\ \text{cost}\\ \text{limit}\end{array} = (\text{Insured deposits}) - (\text{Remaining value of assets}) \times \frac{(\text{Insured deposits})}{\left(\begin{array}{c}\text{Insured deposits}\\ \text{plus non-insured}\\ \text{deposits and other}\\ \text{obligations}\end{array}\right)}$$

Consider an example. Suppose insured deposits are ¥120 million, the remaining value of assets is ¥100 million, and non-insured deposits and other obligations are ¥80 million. Then, the pay-off cost limit would be

192. See Law No. 34 of 1971.

$$120 - 100 \times \frac{(120)}{(120 + 80)}$$

i.e., ¥60 million. If the bank had lost ¥100 million over its capital, then there would be a "hole" of ¥40 million (the ¥100 million loss minus the ¥60 million pay-off cost limit) that the Corporation could not "plug" through or by means of financial assistance. For application of financial assistance to such a case, the "hole" would have to be plugged by third parties—e.g., solvent financial institutions from which "voluntary contributions" would be requested by financial authorities.

This approach was used frequently in the early and mid-1990s, including in the cases of Toyo Shinkin Bank and the Cosmo Credit Corporation, in 1992 and 1996 respectively.[193] In the Toyo Shinkin Bank case, the Deposit Insurance Corporation provided a grant of ¥20 billion to Sanwa Bank, which served as a relieving financial institution, i.e., it took over the business of Toyo Shinkin Bank. In the case of Cosmo Credit Corporation, the Deposit Insurance Corporation provided a grant of ¥125 trillion to Tokyo Kyodo Bank, which served as the relieving financial institution.

It is important to understand the policy logic underlying this approach. Suppose banking officials believe application of the pay-off strategy would cause social unrest (not an unreasonable belief, because the Japanese public has not experienced losses from bank failures in the post-Second World War era). Their response is to collect the funds necessary to plug the hole from solvent banks. Thus, banking officials are in the position of going to financial institutions and informally requesting contributions from them. The financial institutions agree insofar as they see a collective interest in maintaining financial stability.

During the early and mid-1990s, this hybrid strategy of financial assistance plus "contribution" worked for the first few cases. But, as Japanese banks continued to fail, remaining solvent institutions began to grumble—and rightly so—about contributing funds, particularly for banks with which they did not have close relations. Contribution, then, no longer was an option for bank regulators. Yet, official policy remained that all depositors should be covered fully. To be sure, the government deliberately ensured that shareholders lost their money, i.e., shareholders were penalized—again, rightly so. But, depositors and other general creditors had to be kept whole in the interest of financial system stability and social harmony.

What spawned the 1996 reform of the Deposit Insurance Law was the death of contribution as a viable option for dealing with failed or failing banks. The 1996 legislation established a temporary period, until March 2001, during which all losses of depositors and other general creditors would be covered without asking remaining solvent banks to contribute to plug holes beyond the pay-off cost limit. In effect, the pay-off cost limit was removed. This legal reform was thought to be a big step forward, but the crisis continued. In particular, the "Autumn crisis," referring to the fall of 1997, which included the failure of Hokkaido Takushoku, once an

193. See DEPOSIT INSURANCE CORPORATION OF JAPAN, ANNUAL REPORT 41 1997 (July 1998) (discussing extension of financial assistance).

internationally active bank, and Yamaichi Securities. Some other banks went down thereafter or faced the possibility of a bank run. In retrospect, it was during this period that Japanese politicians, and the public at large, really came to understand that there was a crisis in their midst.

There was, consequently, no other place for banks to turn than public coffers. However, after the 1995-96 crisis involving housing loan corporations (*jusen*), in which approximately ¥680 billion of taxpayer funds were used, talk of using public funds to bail out the banking system was "taboo." The Autumn 1997 crisis ended the taboo. In the spring of 1998, a framework for capital injection was established. The framework authorized the use of up to ¥13 trillion of public funds to replenish the capital of Japanese banks. A capital injection of ¥1.8 trillion into the 21 major Japanese banks was applied in March 1998.

The injection seemed to work. April and May of 1998 were relatively quiet months in Japanese financial markets. However, the illusion was shattered when, in the summer of 1998, problems at the Long Term Credit Bank (LTCB) of Japan surfaced. LTCB failed in the autumn. It was the largest and most serious failure in Japan's distinguished banking history. LTCB had assets of ¥26 trillion—far in excess of Hokkaido Takushoku. It was internationally active. The outstanding notional principal of derivatives transactions in which LTCB was engaged was an incomparable sum: ¥50 trillion. A substantial proportion of the financial institutions involved in such transactions with LTCB were foreign. Bank regulators in Japan and around the world naturally feared the systemic risk implications of LTCB going bust in a disorderly way.

In October 1998, as a result of the intensive Diet discussions, new legislation designed to deal with the disposal of failed or failing banks was enacted—the "Law concerning Emergency Measures for the Reconstruction of the Functions of the Financial System," also known simply as the "Revitalization Law." The Law provides a useful framework within which authorities can deal with a failed or failing bank, without necessarily finding beforehand a sound bank to assist in the resolution (e.g., through an assisted merger or takeover). The framework includes a Financial Reconstruction Commission (FRC). The FRC (rather than the judiciary through an insolvency proceeding) is empowered to order the administration of failed or failing banks by a financial reorganization administrator. Also, the framework permits the temporary nationalization (formally known as "special public management") of failed or failing banks, and allows for the setting up of bridge banks. Within the framework, failed or failing banks can continue to provide their financial services while meeting their liabilities.

Experience (as at the time of this writing) with the Revitalization Law is limited but growing. There have been two cases of temporary nationalization—LTCB and the Nippon Credit Bank. There have been eight cases of administrations by financial reorganization administrators, three involving banks and five involving credit cooperatives. One noteworthy feature of this experience is the absence of any dreadful implications for international aspects of insolvency law. For example, after the temporary nationalization of LTCB, the Bank of Japan expressly declared that all of LTCB's liabilities—whether on- or off-balance sheet—would be made good, and backed the declaration with a pledge to provide the funds necessary to assure international financial markets that LTCB would make good on all of its obligations. The Ministry of Finance and Prime Minister offered similar statements. The assurances worked: none of LTCB's counter-parties, domestic or foreign, declared a default, and a potential systemic crisis was averted.

A second noteworthy feature is how a strategy for dealing with a failed or failing bank is selected. If a bank is on the verge of suspending the repayment of deposits, then the FRC can appoint an administrator to ensure the bank's condition does not become any more precarious. That administrator will take control of the bank's assets and look to either merge the institution with a healthy bank, or have it taken over by a healthy bank. If no acceptable partner exists, then the Deposit Insurance Corporation can establish a temporary public bridge bank (a subsidiary that is 100-percent owned by the Corporation) to serve as a rescue vehicle, which must complete its work (e.g., arranging a merger or take-over, or dissolving the problem bank) within one (or, with extensions, three) year(s). As for temporary nationalization, the FRC may arrange this if the problem bank is on the verge of suspending repayment of deposits and there is a danger of serious damage to the financial system if the bank were to cease operating, or of an adverse effect on international financial markets. In a temporary nationalization, the Deposit Insurance Corporation takes control of the problem bank by purchasing its shares (at a price based on the bank's net worth) and appointing a new management. The operation of the bank continues pursuant to a plan approved by the FRC. Work must finish by March 2001, the outcome being either a take-over by a healthy partner or transfer of shares to another institution. How, then, in practice, is the choice made between appointment of an administrator versus temporary nationalization? A custom and practice seems to be developing: a bank whose failure would have large systemic risk implications will be dealt with through temporary nationalization; a bank that could go under without such disruption will be dealt with by the financial reorganization administrator.

Perhaps the most important part of the framework set up by the Revitalization Law concerns the comprehensive safety net, which had already developed into a considerable one.[194] The revamped safety net protects all depositors and creditors of any bank to the full extent (that is, 100 percent of the value) of their claims. The revamped safety net is temporary. There is a sunset provision in the Law that calls for an end to the protection in March 2001. Arguments have been made to extend this sunset date on the ground that Japan's financial system will still be fragile in March 2001.

II. The Irrelevance of the Insolvency Law Regime?

So, where does the excursion leave off in terms of the relevance of the Japanese insolvency regime to failed or failing Japanese banks? In theory, any of the five

194. For a detailed discussion of the Japanese experience with deposit insurance and failing banks, see Curtis J. Milhaupt, *Japan's Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design*, Bank of Japan IMES Discussion Paper Series 99-E-8 (March 1999).

Japanese bankruptcy laws could apply to a failed bank. In addition, in 1996, special legislation was enacted that created procedures for the reorganization and bankruptcy of financial institutions. This legislation, formally known as the "Law to Provide Special Procedures for Reorganizing Financial Institutions," or simply the "Special Reorganization Law," had three key features.

First, it enabled cooperative-type insured banks (e.g., *shinkin* banks, labor banks and credit co-ops) to resort to reorganization proceedings that are practically identical to the standard corporate reorganization procedure discussed below. Absent this change, the legal scheme for corporate reorganization could apply only to stock corporations. Second, the law empowered the Deposit Insurance Corporation of Japan to act as an agent for depositors of a failed financial institution in a bankruptcy or reorganization proceeding. The idea is to ensure that reorganizations do not get bogged down owing to a large number of depositors in the bank being reorganized. The Corporation can draw up a single list of depositors and submit it to the supervising court, and this list replaces the filing of proof of claims by each depositor. The Corporation also can act on behalf of depositors and vote on the reorganization plan. Third, the law granted supervisory authorities the ability to file a petition for bankruptcy or reorganization with respect to any failed financial institution under their supervision.

As is often the case, theory is one thing, the facts are another. While Japan's present legal regime for insolvency is, in theory, applicable to banks, a reasonable guess is that the Bankruptcy Law and the Corporate Reorganization Law would be the most likely candidates to govern a bank insolvency case. Guessing is all that is possible. Japan has virtually no experience with bank insolvency after the Second World War. As the above excursion shows, bank failures invariably have been resolved through out-of-court means, namely, an assisted merger or takeover with the help of the Deposit Insurance Corporation. In every one of these resolutions, the failed bank was able to meet all of its liabilities. Thus, the insolvency regime never had to be tested by a bank. Rather, the laws applied included the Deposit Insurance Law, the Revitalization Law, and the others mentioned above, along with the general Banking Law. In short, there simply is no leading case to hand on the international aspects of the insolvency of a Japanese bank.

Why is there such a discrepancy between the law that is theoretically applicable to bank bankruptcies, on the one hand, and the actual manner in which these messes have been cleaned up, on the other? In a word, politics, though not in a pejorative sense. Rather, somewhere, sometime, by someone, a political decision was taken—or perhaps more accurately, a policy evolved—that a bank bankruptcy would be unacceptable for two reasons.

First, as is clear from the above discussion of Japanese insolvency law, a stay of creditor action against the debtor operates once proceedings of whatever type are commenced (though only in a corporate reorganization does the stay cover secured creditors). Banks typically have a tremendous number of outstanding obligations—deposit liabilities, inter-bank loans, foreign exchange and over-the-counter (OTC) derivatives contracts, wire transfer and other settlement transactions, letters of credit and other trade finance vehicles, to name just a few. The counter-parties in almost all such transactions are unsecured creditors. Thus, their unilateral efforts to obtain satisfaction against the assets of a bankrupt bank would be stayed upon commencement of a rehabilitation or liquidation proceeding under Japanese law. In other words, a stay pursuant to insolvency law would mean the cessation of all bank functions for a certain period of time.[195] How would these counter-parties react to the inability of the debtor bank to make good on its obligations?

Inevitably, the counter-parties would declare the debtor in default. Suppose the creditor banks were relying on payments from the debtor bank as their source to finance their own obligations to other financial institutions. The creditor banks now would be in a perilous position. They might not be able to make good on their own obligations, which, in turn, would cause their financial institution creditors to call a default, and put the liquidity positions of these creditors in jeopardy. This chain reaction of defaults is, of course, systemic risk. The bottom-line fear, then, about resorting to insolvency law to resolve a troubled bank case is that the stay of creditor action will trigger a systemic risk nightmare. Better, then, for government and central bank authorities to step in and resolve the matter through extra-insolvency law means than to sit idly by while entity after entity in the financial system tumbles like dominoes. As the above excursion shows, Japanese authorities did just this. In all cases of bank failure, bank functions were continued.[196]

The second reason for eschewing insolvency law where the debtor is a bank follows logically from the first. Systemic risk, if it materializes, has broader social implications. The Japanese public has no experience after the Second World War with losses from bank failures. Imagine the panic that could spread among the populace if they lost their precious savings, or even a portion thereof, in banks that had closed their doors. They would be powerless in the face of the judicially-condoned stay. In the end, after months or years of insolvency proceedings, they might collect little or nothing. The panic among depositors in the failed bank would likely spread to depositors in otherwise solvent banks. A flow of withdrawals would follow from banks around Japan, putting severe liquidity pressures on these banks. The irrational (initially, anyway) but unstoppable behavior of depositors would exacerbate the systemic risk chain already set in motion by the string of defaults called by financial institution creditors. Indeed, the combined operation of defaults and withdrawals would reinforce each other and, in the end, be too much to bear.

Thus, as long as the minimization of systemic risk and social unrest remain the dominant political concerns among Japanese authorities, the country's five-part

195. Article 59 of the Bankruptcy Law and Article 103 of the Corporate Reorganization Law empower a trustee to assume or reject executory contracts. Some of the financial contracts in which a bank debtor is likely to have engaged may be subject to bilateral or multilateral netting arrangements. The subject of netting is beyond the scope of this paper. Suffice it to say that the famous November 1990 Bank for International Settlements report—commonly known as the "Lamfalussy" Report—requires that netting has a well-founded legal basis in the event of insolvency. Japan's Law Concerning Close-out Netting (Law No. 108 of 1998) is designed to provide this basis for close-out netting arrangements on specified financial transactions, including OTC derivatives.

196. Interestingly, the banking functions of Hokkaido Takushoku were continued for one year after its failure. The continuation was made possible by special loans from the Bank of Japan, also known as "Article 38 loans," the outstanding amount of which peaked at ¥2.6 trillion. ("Article 38" refers to the applicable section of the Bank of Japan Law.) The Bank of Japan later covered the Hokkaido Takushoku loans by proceeds from the sale of assets of the failed bank, and with funds provided by the Deposit Insurance Corporation.

insolvency law regime will be relevant to banks as debtors only in theory. Resolving bank failures speedily will remain the ken of specialists. For banks, the practical import of the "regular" or "normal" insolvency regime will be that it will be applied to them as creditors of failed nonfinancial institutions.

III. Should Insolvency Law Be Irrelevant?

Perhaps the conventional wisdom about the need for a separate regime for bank failures should be re-examined. That is, should authorities allow the insolvency regime to do its work with a failed bank? After all, concerns about systemic risk and social unrest are not testable hypotheses. Rather, they are testable, but at potentially great costs. Thus, in the hands of government and central bank officials, they are almost axioms rather than hypotheses.

Most authorities would be likely to decry any attempt to apply the "regular" insolvency rules to banks. In the one instance where the Corporate Reorganization Law was used, Sanyo Securities, the results, they would say, were disastrous. To be sure, Sanyo was not a commercial bank but a securities firm, but no matter. The systemic risk fears materialized. The automatic stay triggered by use of the Reorganization Law led a small financial institution counter-party of Sanyo to call a default on an indebtedness of several million yen owed by Sanyo to the counter-party. The inter-bank market participants reacted to the default by slashing their credit lines to each other. (Sanyo, of course, could receive new lending after the legal proceeding had commenced only with court permission, but most creditors would be unlikely to offer up new funds in such circumstances). The result was a shrinkage in inter-bank market transactions among other institutions. The subsequent reorganization process has not proceeded smoothly, and Sanyo might be liquidated. The authorities would likely add—not unreasonably—that what matters is not whether bank bankruptcies are resolved in a court house under the same set of rules that apply to nonbank debtors. Rather, what matters is whether bank bankruptcies are resolved in a consistent manner using transparent rules.

Arguably, however, the Sanyo case ought not to inhibit discussion of whether to continue on the road of treating bank debtors specially. Why, indeed, should there be a separate set of rules designed uniquely for bank insolvency cases? There are arguments that counsel against special provisions for banks as debtors in these cases. If special rules are to be had, then they will be more legitimate if these arguments are successfully met.

First, it would hardly be elegant to add yet another set of insolvency rules to the regime. The sources of law are in need of rationalization and simplification. Adding a new set of rules risks transforming an already complex and opaque body of law into a positively byzantine one. If an analogy to international trade may be permitted, GATT Article X stresses the importance of transparency in a trade regime. The theory is that transparency is a hallmark of the rule of law: all similarly-situated players, regardless of national origin, ought to have equal opportunity to learn of the existence of, and understand, the rules. Whether Japan's insolvency regime could be called "transparent," particularly if a new body of bank bankruptcy rules were implemented, is an open question.

Second, special insolvency rules for banks beg an important question: are banks special? In an early 1980s piece published by the Federal Reserve Bank of Minneapolis entitled *Are Banks Special?*, former Federal Reserve Bank of New York President E. Gerald Corrigan answered this question in the affirmative by saying that banks are the mechanism for transmitting monetary policy and are the essential ingredients in the payments system. Mr. Corrigan's argument may or may not be right. Arguably, financial institutions other than commercial banks play important roles (securities firms are primary dealers in open market operations conducted by the Federal Reserve Bank of New York, and payments can be made through a variety of services offered by these firms). But, assuming his argument holds true, does it translate into a justification for unique insolvency rules for banks? Somehow, the case has to be made that Japan's five insolvency laws work well for non-financial institutions, but cannot be made to work for banks. Perhaps the argument might go along the lines of the systemic risk associated with the failure of a major financial institution. Here, however, it would be wise to specify the causal chain—the "parade of horribles"—carefully, not just in the skeletal form as above. Simply waving the words "systemic risk" in the air, as bank regulators have been wont to do, will not suffice. Equally important will be to show why the same severe repercussions would not occur were a major non-financial corporation to go under. After all, could not the failure of the likes of IBM, Microsoft, Disney, or General Motors—or their Japanese analogs—initiate a market panic?

If the case for a separate bank insolvency law cannot be made—and whether it has been made persuasively as yet is arguable—then there is a third argument against enacting legislation on insolvency just for banks. In a word, favoritism. The Japanese polity may well view such legislation as favoring banks over non-banks. The segment of the polity that may be especially vocal on this point are non-banks. Despite *keiretsu* relationships, managers of non-financial firms, as well as their shareholders, could hardly be expected to agree that their firms should remain subject to one set of insolvency rules, while banks get the benefit of a new, more debtor-friendly, set of rules.

There is yet one more argument counseling against special bankruptcy rules for banks: moral hazard. If those special rules amount to bailing out banks, then what incentive exists for bankers to avoid the same foolhardy behavior in the future that got them in trouble in the past? It is perhaps too early to view the history of the Japanese response to the banking crisis as a bailout that has created a moral hazard problem, though in the end that may prove to be the correct judgment. Doubtless officials would respond to any such suggestion that they were supporting the financial system, not bailing out individual banks. As for the managers at the banks, they were tossed out, and shareholders were penalized to boot. But, again, the facts—after enough time has passed to allow for a less biased perspective—might suggest otherwise.

Despite all of the arguments that might be made against a separate bank insolvency regime, the issue seems resolved for now. For banks as debtors, the insolvency law regime simply is not relevant in practice. For banks as creditors, given the economic straits in which Japan finds itself, the regime is as relevant as ever.

IV. A Treaty on International Bank Insolvency?

Why an international bank bankruptcy law has not been written is somewhat of a mystery. Perhaps there is simply a lack of vision and leadership among relevant international and domestic institutions, a deficit that ought not to be excused easily in the wake of the BCCI clean up. Part of the explanation may be that there is an overhang of territorialism from the discussions of international insolvency in the non-bank context. Part of the explanation for the mystery may be that there is no genuine consensus about the need for a separate set of bank bankruptcy rules. Whatever the reason, there ought to be no dispute that BCCI-type liquidation problems should be, in some reasonable way, avoided. The obvious way to do so would be for countries to band together on a multilateral treaty that would cover international bank bankruptcies.

To keep matters simple, the treaty could apply to "international banks," defined as banks (1) whose assets (both on- and off-balance sheet) are worth at least a certain threshold amount (say, for example, US$500 million) and (2) which have assets (again, both on- and off-balance sheet) in two or more countries. The treaty would be implemented into the local law of each signatory country, perhaps on a self-executing basis. Under the treaty, once the home-country regulator of a bank decided to close a particular bank, a single closure proceeding would take place under the auspices of a Multilateral Insolvency Facility (MIF). One candidate for the MIF would be the International Monetary Fund (IMF), given its extensive membership. Another candidate would be the World Bank which, after all, offers a facility for the international settlement of investor disputes (ICSID). A third candidate might be the Bank for International Settlements (BIS), though it would suffer from a less diverse membership and thus could not encompass as many international bank debtor scenarios. (That problem could be dealt with through patchwork efforts by treaty countries to make suitable arrangements with non-treaty countries, and the result could be a rather complex quilt.)

Under the multilateral treaty, all creditor claims brought in a local court of a treaty country would be stayed automatically by virtue of the country's treaty obligations. The court would inform all potential claimants that they are to file proof of claim with the MIF. The MIF would resolve the bank bankruptcy under the rules set forth in the treaty. These rules would include a unified set of priorities and criteria for the determination of fraudulent conveyances. Under the treaty, the MIF would marshal the worldwide assets of the failed international bank and pay out claimants in accordance with treaty rules. The MIF could call upon the assistance of relevant local authorities, including central banks, which would be obliged to help.

Perhaps this sort of treaty would entail too much of a loss of sovereignty for individual countries. They might have an attachment to their local laws on bank bankruptcy and might not be able to come to a unified agreement. Negotiations might, for example, break down on priority orderings among creditors of a failed international bank. Likewise, if the treaty covered bank reorganizations as well as liquidations, then countries simply might not like the idea of the MIF having the power to replace managers of local banks. Accordingly, a second, somewhat less ambitious, treaty might be possible.

In this "fall-back" scenario, creditors of a failed bank would present their claims against the assets of a failed international bank (as defined above) under the local applicable law. This law would not be displaced by the treaty. Actual execution of claims would be stayed, however, again by operation of a treaty. Courts in the various countries where the claims are brought would be responsible for developing a list of creditors that have proven their claims, and the order of priority among these creditors, under local law. Each court would then transmit this list to an international authority—again, perhaps the IMF, World Bank, or BIS. That authority would then give effect to the lists. That is, it would marshal assets, and pay out creditors as the assets permit in the order of priority determined by the local courts. The authority would have the power to resolve conflicts among priorities. However, absent inconsistencies would not contain a unified set of priorities. Likewise, fraudulent conveyance issues would be left to local courts. The authority would be empowered to resolve inconsistent adjudications in local courts about whether a transfer from the debtor-bank antecedent to the insolvency was a fraudulent conveyance.

In effect, this second type of treaty would be an institutionalization of some (but not all) of the *ad hoc* procedures that emerged in the BCCI affair. The authority would implement decisions already made by local courts under local law, which the treaty would give effect to and provide rules for resolving conflicts. In contrast, under the first type of treaty, the MIF would conduct the insolvency proceeding under treaty law.

The first treaty proposed would be a clear manifestation of the universality principle. The second treaty would reflect modified universalism. Both aim at the speedy and fair resolution of failures of large banks that are internationally active. Perhaps the political prospects for actually negotiating a multilateral treaty of either type seem dim. However, nay-sayers must remember that international law has progressed towards unified dispute resolution schemes, not just in the sphere of trade, but also in the areas of commercial arbitration and criminal law. The successful efforts in these fields may be cause for some hope in the international bank insolvency area.

SUMMARY: REFORM IN CONTEXT

Few, if any, observers doubt that international cooperation in the international insolvency law field is desirable and necessary. Yet, so formidable are the obstacles to formulating an ideal unitary system that the notion seems a bit quixotic.[197] Different national policies and mechanisms are the primary obstacles. Political will to overcome them—a will as strong as that observed in the international trade law arena during the 1986-93 Uruguay Round—does not yet seem to exist among insolvency officials around the world.

Section 304 of the American Bankruptcy Code is a case in point. Ancillary proceedings conducted thereunder are considered to be one of the boldest and most innovative attempts toward universality in the history of international insolvency

197. See Tagashira, *supra* note 99, at 37.

law.[198] Yet, under these proceedings, foreign laws can be compared primarily for the purpose of protecting local creditors.[199] To achieve complete universality, the United States, along with all other countries, would have to unify their priority schemes, as well as the rest of their substantive and procedural insolvency laws. If this point can be made about American insolvency law, then *a fortiori* it applies to the Japanese context. The extent of international cooperation under current Japanese law is depressingly limited. To deal with a central reality of the global economy of the new millennium—multinational debtors with assets and liabilities scattered across the globe without regard to geo-political boundaries—a complete overhaul of Japan's insolvency law regime is needed. With its diverse sources and inward-looking nature, the regime now seems akin to a fragmented hard drive. A single, outward-looking regime is needed.

Fortunately, work toward this end has started. The exact details and drafting of new insolvency rules are best left to the experts now involved in the reform project. Insolvency law reform in Japan ought to account for trends in the international insolvency arena. Possibly, it also ought to put to rest the nagging matter of the status of banks as debtors. Thankfully, pure or nearly pure territoriality, a principle which characterizes Japan's insolvency regime, has seen its best days. Twenty-first century thinking, as exemplified by the UNCITRAL Model Law and, by way of analogy, the Uruguay Round trade agreements, points toward universalism.

198. See *id*. at 37.
199. See *id*.