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## Claw Back Risk on International Debt Collection Between China and Japan

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### **I. Introduction**

We have been collecting debts owned by the Japanese debtor to the foreign creditors on behalf the trade insurance organizations, foreign collection agencies and foreign attorneys for more than 2 decades in Japan.

A claw back risk has become an important issue for the international debts collection in Japan because the number of the bankruptcy of Japanese debtors who own the debts for foreign creditors has increased these days.

Upon the commencement of the bankruptcy procedure, the bankruptcy trustee is appointed and exercises its avoiding power to avoid pre-petition preferential transfer, including the repayment of the debts made by the Japanese debtor to the Chinese creditor.

This risk of the avoidance of the repayment of the debt is called as the claw back risk.

We would like to discuss the legal requirement and consequence of this risk and explain the reasons why we believe the claw back risk in practice seems not high.

### **II. Example**

Let us give you an example.

Recently we have been acting on behalf of the Chinese creditors, through Chinese trade insurance companies, collection agencies and attorneys-at law.

Many of these Chinese creditors are manufactures of clothing and the debtors are the wholesale dealers in Japan.

Because the amounts of debts are sometimes more than US\$1,000,000, we have had to accept the request of the debtors to reduce the amounts of the debts and to make installment payments after carefully reviewing the financial conditions of the debtors.

Due to rising labor cost in China and yen high, the Japanese debtors recently suffer a lot and some file a petition for commencing the bankruptcy procedure after the debtor make all or installment payments.

As the repayment by the Japanese debtor is high and normally does not have very remaining assets, the bankruptcy trustees of the debtors has an incentive to exercise its power to avoid the repayment of the debts.

Please note that the bankruptcy trustee owes its duty to make equitable distribution of estate property to all the debtors and to prevent the debtor from choosing which creditors to repay.

### **III. Bankrupt Trustee's Avoiding Power**

The question here is whether bankruptcy trustee can exercise the avoiding power for our collection of the debts owned by the Japanese debtors to the Chinese creditor, including the trade insurance organization stepping into the shoes of the Chinese creditor by making the payment to its policy holder.

Japanese Bankrupt Act provides various type of avoiding power for bankruptcy trustee (Articles 160 to 162 of the Bankruptcy Act)<sup>1</sup>.

Followings are the short explanation of these avoiding powers.

#### **1. Articles 160 and 161 of the Bankruptcy Act**

##### **A. Article 160 (1) of the Bankruptcy Act**

This provision stipulates the (narrowly-defined) avoidance of fraudulent transfer. As a requirement of this provision, “the act shall not be related to the provision of security or extinction of debt”. In this case, as the debtor made a payment to the client (“the act related to the extinction of debt”), this

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<sup>1</sup> Articles 127 to 127(3) of the Civil Revitalization Act stipulate correspondent provisions.

provision does not apply to this case.

**B. Article 160 (2) of the Bankruptcy Act**

This provision regulates the payment in lieu of cash etc. by the debtor, the value of which is excessive compared to the original amount of the claim. However, as the debtor does not make the payment in lieu of cash, this provision does not apply to this case.

**C. Article 160 (3) of the Bankruptcy Act**

This provision regulates the gratuitous act (including the equivalent paid act) performed by the debtor within 6 months prior to the suspension of the payment. However, as the debtor does not perform a gratuitous act, this provision does not apply to this case.

**D. Article 161 of the Bankruptcy Act**

This provision stipulates that even if the debtor disposes its property at reasonable prices, the disposal of property can be avoided in case where the act falls under the all of followings:

- (a) the act incurs the possibility of concealment by the debtor;
- (b) the debtor had intention to hide the obtained costs at the time of the performance; and
- (c) the opposing party recognized the intention (b) of the debtor.

The payment of this case is not the disposal of property at reasonable price, therefore this provision does not apply to it.

**2. Article 162 of the Bankruptcy Act**

Since the payment of this case meets the requirement of “the act related to the extinction of debt” stipulated in the article 162(1) of the Bankruptcy Act, bankruptcy trustee may avoid the payment as a preferential transfer and may recover it for the benefit of the estate.

Followings are the requirements and effect of avoidance on this category of preference transfer.

**A. Substantial Requirements**

a. Requirements

This provision stipulates avoidance of preferential payment, the act related to the provision of security or extinction of claim, which falls under at least either of the below (a) or (b).

- (a) (a-i) as to the act performed after the debtor became unable to pay the debts: in case where the creditor was aware of the fact that the debtor was unable to pay the debt or suspended the payment, or:

(b) (a-ii) as to the act was performed after the filing of the petition for the commencement of bankruptcy proceedings by the debtor: in case where the creditor was aware of the filing of the petition (Article 162 (1)(i) of the Bankruptcy Act).

(b) in case where the act does not belong to the obligation of the debtor and was performed within 30 days prior to the date when the debtor became insolvent, and the creditor recognized that the act harms the other creditor at the time of the performance (Article 162(1)(ii)).

Regarding the requirements above, “the act related to the extinction of debt” shall include our collection of debts in full or in part during the install payment (after the deduction of the original principal amount) from the Japanese debtors for the Chinese creditors, including the trade insurance organization stepping in to the shoes of the creditors. .

Debtor’s “unable to pay the debt” hereby means that the debtor is generally and continuously unable to pay the debts already due because of the lack of the ability to pay (Article 2(11) of the Bankruptcy Act).

Whether the debtor lacks the ability to pay the debt is determined by the debtor’s assets, creditworthiness and income from its labor, on the whole<sup>23</sup>.

Since it is not apparent whether the debtor is unable to repay the debts, the bankruptcy trustee has the difficulty to show the knowledge of the creditor or its collection agent, like us.

To avoid the difficult to show the actual knowledge, the Bankruptcy Act provides the other requirement called the debtor’s suspension of the payment.

The debtor’s suspension of payment here means that the act by the debtor to show that the debtor is generally and continuously unable to pay the debt already due because of the lack of ability to pay the debt<sup>4</sup>.

Prime example of the debtor’s suspension of payment is default of the payment obligation of the promissory note twice within 6 months, which results in suspension of bank transaction.

The debtor’s unable to pay the debt is presumed if the debtor’s suspension of payment occurs

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<sup>2</sup> “Commentary of the Bankruptcy Act” (Seirin Shoin, 2007) p. 21

<sup>3</sup> Tokyo High Court Decision on July 5, 1958

<sup>4</sup> Makoto Ito “Bankruptcy Act and Civil Revitalization Act” (Yuhikaku, 2007) p.77

(Article 162(3) of the Bankruptcy Act).

The creditor or the collection agent like us, in general, have little chance to notice the debtor's unable to pay the debt or suspension to pay the debt as the creditor or we normally request repayment of the debts without reviewing the financial situations of the debtor.

In the settlement of the debts, however, the debtors and we discuss extensively prior to the reduction of the amounts of the debts or allow the installment payment by received financial statements or tax return from the debtor.

In the process, we sometimes notice the financial crisis of the debtor which can be fallen into the categories of the debtor's unable to pay the debt or suspension to pay the debt under the Bankruptcy Act.

Please note that the act performed within 1 year prior to the date of filing for the commencement of the bankruptcy proceedings cannot be avoided on grounds that the act was performed after the suspension of payment or the debtor recognizes the suspension of the payment (Article 166 of the Bankruptcy Act).

Accordingly the bankruptcy trustee may avoid the repayment of the debtor within a year from the date of filing of commencement of the bankruptcy proceedings as long as the creditor or the agent of the creditor knew that the debtor's unable to pay the debts or the suspension of the payment of the debt through the settlement negotiation.

This is the claw back risk.

## **B. Procedural Requirements**

The bankruptcy trustee exercises avoiding power by demanding or avoidance without court or filing litigation against the debtor (Article 173(1) of the Bankruptcy Act).

The adverse party of the exercise of avoiding power shall be either beneficiary or subsequent acquirer, including the creditor of the debts paid by the debtor, and the debtor does not become the adverse party<sup>5</sup>.

The avoiding power is unable to be exercised after 2 years from the date of commencement of the

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<sup>5</sup> Kazuhiko Yamamoto et al. "General Observation of the Bankruptcy Act" (Kobundo, 2006) p. 277

bankruptcy proceedings<sup>6</sup> or 20 years from the date of preferential performance (Article 176 of the Bankruptcy Act and Article 139 of the Civil Revitalization Act).

### **C. Effect of Avoidance**

Exercise of avoiding power “restores the bankrupt estate to its original state” (Article 167(1) of the Bankruptcy Act).

Upon the bankruptcy trustee exercising its avoiding power, the repayment by the Japanese debtor to Chinese creditor (through its collection agent) becomes null and void. The bankruptcy trustee therefore becomes able to request the creditor to return the payment made by the debtor<sup>7</sup>.

Upon the avoidance of the repayment of the debt, the debt once repaid is revived and creditor may claim the debts to the debtor (bankruptcy trustee). The creditor, however be repaid equally to the other creditor from the equitable distribution of estate property through bankruptcy proceedings (Article 194 of the Bankruptcy Act).

In other words, the repayment amount of the debts to the creditor decreases considerably.

## **IV. Difficulty to Exercise Avoiding Power towards Foreign Creditors**

### **1. Necessity of exercise of avoiding power through litigation**

It is quite hard for the bankruptcy trustee to exercise avoiding power towards foreign creditors, such as creditors in China.

Although avoiding power can be exercised outside the court procedure as explained above, it is difficult to assume foreign creditors return the repayment amount without litigation despite the fact the bankruptcy trustee is appointed by the court. Then, the bankruptcy trustee has to file a law suit against the creditors in China.

### **2. Filing a lawsuit in Japan**

In most cases we file a bankruptcy petition on behalf of the debtor as the company or individuals located in Tokyo. We therefore file a petition for the bankruptcy to the Tokyo district court (Articles 4(1), 5(1) and 6 of the Bankruptcy Act).

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<sup>6</sup> There is few bankruptcy procedure longs for more than two years and even the procedure takes long time it is quite rare that the trustee could not find the transfer to be avoided for two years. Of course, the case where the trustee neglects the necessity of exercise of avoiding power cannot be justified.

See “Commentary of the Bankruptcy Act” p.720.

<sup>7</sup> Kazuhiko Yamamoto et al. “General Observation of the Bankruptcy Act” (Kobundo, 2006) p. 278

As the case to demand for the avoidance shall be under the jurisdiction of the bankruptcy court (Article 173(2) of the Bankruptcy Act), the court of jurisdiction shall be the Tokyo District Court.

### **3. Service of complaint**

Upon the demand of the avoidance by the bankruptcy trustee, the opposing party (creditor)'s attendance is required (Article 174(2) and (3) of the Bankruptcy Act).

Also, the bankruptcy trustee shall file the complaint for the court (Article 133(1) of the Civil Procedure Act) and service of complaint is required upon the filing by the bankruptcy trustee (Article 138 (1) of the Civil Procedure Act). As the service of complaint against a legal entity shall be done for its representative (Articles 37 and 102(1) of Civil Procedure Act), and the complaint shall be delivered to the address of the person who shall receive the service (Article 103(1) of the Civil Procedure Act), the complaint shall be served to China where the address of the representative of the client is located.

### **4. Service of complaint for foreign country**

Service of complaint in foreign countries shall be done by a judge through the local proper authorities or the ambassador, minister or counsel of Japan located in the local country (Article 108 of the Civil Procedure Act).

In this case, as both Japan and China has ratified the Convention of 15 November 1965 on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters, complaint shall be served according to the Convention. More concretely, "judicial...documents" concerning "civil case" (Article 1 of the Convention) includes complaint<sup>8</sup>, therefore the complaint for the avoidance of repayment shall be served to the representative of the client who has its address in China based on the Convention.

### **5. Oversea enforceability of Japanese judgment**

As analyzed above, since the substantial and procedural requirements of avoidance are likely to be met in this case, if the complaint is served to the creditor in China, the avoidance lawsuit shall belong to the bankruptcy court and the complaint is approved unless the creditor appears on the court date (Article 159(1) and (3) of the Civil Procedure Code).

However, even if the complaint of avoidance is approved, the bankruptcy trustee shall enforce the

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<sup>8</sup> Saichi Akimoto "International Civil Procedure Code" (Kokushokan, 1994) p. 859

judgment in order to recollect the repayment from creditor.

To recover the paid amount, enforcement of the judgment obtained in Japan by the court of China is required. Civil Procedure Code of China stipulates the requirements for the court of China to accept and enforce the legally effective judgment and arbitration made by a foreign court<sup>9</sup> (Articles 278 and 279 of the Civil Procedure Code of China). More precisely, the requirements are (1) acceptance and enforcement of the judgment are approved by international treaties China concludes or joins, or principle of mutual benefit, and (2) the decision and arbitration complies with the basic principle of the laws of China, national sovereignty, safety and public interest.

Japan and China, however, have not concluded the convention concerning the acceptance and enforcement of the judgment and related international treaty, neither. In addition, principle of mutual benefit is not recognized between Japan and China, therefore the court of China is not likely to accept and enforce the judgment made by the court of Japan.

## **6. Filing a suit in China**

Although the Article 173 of the Bankruptcy Act stipulates the bankruptcy court has jurisdiction of lawsuit and ruling concerning avoidance, the bankruptcy trustee would not seemed to file a law suit against the Chinese creditor in Japan as the judgment of the Japanese court cannot be enforced in China.

Because of the language and qualification, most of Japanese bankruptcy trustee (most of them are Japanese attorney qualified only in Japan) cannot suit the creditor in China. The bankruptcy trustee is therefore required to appoint Chinese attorney to file a law suit in China. The litigation in China to avoid the repayment of the debts by Japanese debtor to the Chinese creditor is not easy for Chinese attorney because of the language and knowledge of the bankruptcy law of Japan.

Thus, unlike our office with worldwide network of claim collection, most of the bankruptcy trustees have difficulty, if it is not impossible, to find appropriate Chinese attorney who may exercises avoiding power and operate claim collection in China. Even in the case where they can appoint Chinese attorney, whether filing a suite in China or not depends on the consideration by the bankruptcy trustee in each case.

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<sup>9</sup> Comparison table of the Civil Procedure Code of China (before and after the revision)  
<http://www.jetro.go.jp/world/asia/cn/ip/law/pdf/opinion/20111029.pdf>



## **V. Conclusion**

Upon the collection of the debts owned by the Japanese debtors to the foreign creditor, the claw back risk or the risk of nullification of the repayment by the Japanese debtor to the foreign creditor is not high as the foreign creditor in general does not know the financial situation of the debtor.

There is, however, a claw back risk if the foreign creditor, through its collection agent in Japan, negotiates with the repayment schedule by reviewing the financial statements of the debtor and recognizes the financial crisis of the Japanese debtor.

In practice, however, the claw back risk for the Chinese debtor is not high as the judgment against the Chinese debtor in Japan is not enforceable in China and the bankruptcy trustee of Japan, in general, would have difficulty to find an appropriate Chinese attorney to exercise the avoidance power granted to the bankruptcy trustee under Japanese law against the Chinese Creditor through the litigation in China.

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