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Priority of Tax Claims and the Recent Bankruptcy Reforms in Japan

Yasuhei Taniguchi
Senshu University and Matsuo & Kosugi

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Yasuhei Taniguchi[1]

1. Introduction

In all legal systems, tax claims enjoy priority over private claims. However, the degree of such priority varies based on the relative weight the legislature has given tax claims vis-à-vis private claims at the given time. From a historical perspective, the status given tax claims in Japan has undergone interesting changes from the pre-War regime to the post-War period and further to the present time. Different attitudes toward the tax claim typically are made manifest in insolvency proceedings, because a clear system of priority is needed in order to effect an orderly distribution of liquidated assets. As an overview, we can see a constant degradation of the tax claims in the Japanese legislation since the Meiji period culminating in the most recent bankruptcy law reform in 2004. The principle of tax priority is, of course, still retained, but there is a clear trend from absolute priority to relative priority.

2. Historical Overview

When the Meiji Government was established, the tax claim was given the highest priority because tax revenue was the financial foundation of state power. For example, under the pre-War law, even a perfected security right was subordinated to a tax claim which became due within one year of the perfection.[2] Secured creditors were surprised by unexpected tax claims at the time of insolvency of the debtor. Tax priority made the security meaningless. The court also interpreted the principle of tax priority broadly. For example, once a garnishment by the government of a taxpayer's claim to a third debtor had been effected, no set-off was held possible by the third debtor because it would extinguish the claim already secured by the government.[3] Jurisprudence was different when a garnishment was by a private creditor. Another example was that when the collateral of a security right was assigned, the tax claim against the assignee was

[1] Professor of Law, Senshu University and Attorney at Law, Matsuo & Kosugi.

[2] Pre-War National Tax Collection Law, Art. 3.

[3] Nagasaki Appeals Court's decision of March 20, 1915 cited in Yoshikuni et al., Kokuzei Shoshu-ho Shokai (Detailed Commentary of National Tax Collection Law), 13th edition, 11 (1993). The jurisprudence changed to allow such a set-off. Price Adjusting Public Corp. v. Japan, 6 Minshu 518 (Sup. Ct., May 6, 1952).

preferred to the secured creditor of the assignor who was still supposed to have the security right over the assigned collateral.[4]

All these neglects of private interests for the benefit of the tax claim, however, did not invite much criticism because of the socio-economic structure at the time. In early days, there existed only the land tax and the alcohol tax. Throughout the pre-War period, the tax payment was a privilege reserved to wealthy citizens. The economy was dominated by big landowners and a few successful industrialists (Zaibatsu). It is said that the default in tax occurred very rarely. Generally speaking, the tax payers were wealthy enough to be immune from insolvency.

Under this condition, such absolute priority of tax claims was taken for granted for a long time. It was in the 1930s, when Japanese industries had attained a certain level of development and were affected by the world-wide depression, that Professor Sakae Wagatsuma, a rising jurist at the time, pointed out the problem. But it was not enough to initiate a reform. Japan was then involved in continuous wars spurred by a militaristic trend. Degradation of the tax claim became out of the question. It was only after the War that Professor Wagatsuma led a legislative team to amend the law concerning the relationship between taxes and security rights. This was the new National Tax Collection Law of 1959.

The principle of priority of tax claims over private claims is expressed in the famous Article 8 of the new law. It reads, “National tax shall be collected from the totality of the taxpayer’s assets in precedence over all public duties and private obligations unless provisions of this Law otherwise provide.” It also has a set of detailed provisions for the priority between tax claims and private secured claims. Generally speaking, a security right perfected prior to the due date of a tax is given precedence over the tax claim. The law, however, does not have any provision about the status of tax claims in the judicial insolvency proceedings.

3. Development of Bankruptcy Systems

The ultimate arena in which the tax claims and private claims fight for preference is the bankruptcy. Japan’s modern bankruptcy law was enacted in 1922 after the German model. This law provided for absolute priority of tax claims over private claims. Tax claims were given the first priority after the secured claims at the same rank as the claims for the expenses of the bankruptcy liquidation such as the fees of the trustee in bankruptcy. In the pre-War period and even until the 1970s after the War, that priority

[4] Decision of the pre-War highest court, Grand Court of Judicature, June 6, 1903, Minroku 687. The post-War Supreme Court changed this view. Okumura v. Japan, 11 Minshu 1 (Sup. Ct., Jan. 16, 1957). This decision was by the Grand Bench of all 15 Justices because it overruled the precedent of the above mentioned pre-War highest court decision of 1903. But the decision was accompanied by two dissenting opinions and five supplementary opinions, showing how controversial the decision was.

rule did not cause a serious problem because use of the bankruptcy system was very limited.

For a long time, bankruptcy carried stigma in Japanese society. For every good citizen and corporation, bankruptcy was something to be avoided by all means. The bankruptcy system in its original form was designed as an institution through which creditors could get pro-rata dividends out of the proceeds of the assets of the bankrupt. It also provided certain protection of the bankrupt because it shielded the debtor from the pressure of creditors. For this reason, the law made it possible for the debtor to file a petition for bankruptcy (voluntary bankruptcy). In reality, however, virtually all bankruptcy petitions were filed by creditors. It was inconceivable for a Japanese debtor to file a petition for his own bankruptcy. It was, therefore, common for a petition filed by a creditor to be withdrawn before the court officially entered a declaration of bankruptcy. This shows that the petition was used as a means of threat to force a debtor to pay the debt. Because of an imminent great stigma, the debtor made all possible effort to pay the debt. His prize was a withdrawal of the petition given by the creditor.

The post-War amendment to the Bankruptcy Law of 1922 tried to change the character of the bankruptcy system in accordance with the American ideals. The amendment took place in 1952, the last year of the allied occupation of Japan. It adopted discharge in bankruptcy for the first time as a bankruptcy law within the civil law camp. Discharge from unpaid debt became available to individual debtors. Although this reform certainly made voluntary petitions more likely, in fact they did not increase at all. As late as 1972, 1,002 petitions were withdrawn while 1,250 petitions were filed nation-wide during the year. These petitions were presumably mostly by creditors and 80% were withdrawn. Many creditors must have received a payment in full or in part thanks to the threatening effect of a petition. Some creditors were perhaps willing to withdraw even if the threat proved ineffective because they could not expect any meaningful dividends in most cases. This is an interesting example of a case where a legal change was not followed by a social change when the society was not receptive of such a change.

Another change brought about in 1952 was the enactment of the Corporate Reorganization Law patterned after the American Bankruptcy Code Chapter X of the time. The new system was designed to rescue large businesses for the sake of the national and local economy. This new institution met a similar fate for some time, because the Japanese large corporations were not inclined to voluntarily ask for relief from the court, another cultural aspect of the Japanese society at the time. Contrary to the legislative intention, the system was rather used by small enterprises as an alternative for the pre-existing and less effective system of the composition (wagi) under the Composition Law of 1922.

The whole picture, however, started to change in the 1980s. The driving force was the rapid development of consumer credit. It started with easy use of credit cards and developed into easy availability of loans at money lenders with high interest rates. Increasing popularity of consumer credit naturally resulted in many financial failures beginning as early as the 1970s. Because of the stigma of bankruptcy, voluntary filings of bankruptcy did not increase markedly. It was only in the 1980s that members of the Osaka bar began an organized effort to send these consumers to the court for bankruptcy and discharge. That organized effort soon spread out to Tokyo and other areas. The number of bankruptcy filings, which had stayed at less than 2,000 a year nation-wide, rose to 26,384 in 1984. These filings were mostly voluntary. As a result, very few filings were now withdrawn. As far as the consumers were concerned, the stigma of bankruptcy seemed to have finally disappeared by the end of the 1980s. Interestingly, the same trend was later found in the business community. At the time when voluntary filing became commonplace, business firms were still reluctant to resort to the court for bankruptcy. But they soon became willing to do so as an ultimate solution to the problem. Lawyers also developed the necessary expertise in this area by the mid-1990s. Bankruptcy filings, including both consumer and business cases, increased steadily and exceeded 250,000 in 2003. In this year, there were 251,800 bankruptcy petitions out of which 242,849 were by individuals (including 492 individual business failure cases), 250,983 were voluntary and 229,158 were no-assets cases.[5]

Although the number is of no comparison with the astronomical figure of the American counterpart, it is easy to imagine the magnitude of the burden suddenly imposed on the judges in charge of bankruptcy cases. There were two perceived problems arising from the phenomenal increase of bankruptcy filings both by individuals and by corporations. The one was about how to process discharges efficiently and properly. The other concerned the desirability of a special system for rehabilitation of small failed businesses.

Because the discharge was not automatic, judges had to examine each application for discharge in order to determine whether a discharge should be allowed under the prescribed requirements such as absence of fraud. Many individual debtors were not free of some kind of fault and blame and were still earning regular income. A solution other than an outright discharge was considered more desirable, but the system of the composition existing since 1922 was totally inadequate.

For corporate failures in the 1990s, there were three systems available for rehabilitation of a business, these being the just-mentioned composition, the corporate arrangement existing since 1938 only for stock corporations in a financial difficulty, and the post-War corporate reorganization. Composition and corporate arrangement were both ineffective for various reasons. Corporate reorganization was designed for rescuing large listed corporations and not suitable for handling small or midsized business failures.

[5] Unlike the US system, the Japanese law requires a ruling to commence the bankruptcy proceedings. When there are no assets to be distributed among the allowed creditors, the court commences the proceedings and at the same time closes the case (simultaneous termination). This is a necessary step to proceed to the next step of the discharge because only a bankrupt can obtain a discharge by filing a separate application for discharge.

Composition, although available for both individuals and corporations, was for various reasons not effective in bringing about a real rehabilitation.

As a result of a great legislative effort in the mid-1990s, the Civil Rehabilitation Law was promulgated in 1999 to deal mainly with business failures, as well as failures of non-business entities such as hospitals, schools, and religious organizations. In 2001, chapters dealing with individuals' financial failures were added to this new law. The composition and the corporate arrangement were abolished at the same time. Continuing legislative work completed a total revision of the Corporate Reorganization Law in 2002 and culminated in 2004 in a complete revision of the Bankruptcy Law. Thus, today, the Japanese insolvency system is supported by a triad of the Bankruptcy Law, the Civil Rehabilitation Law, and the Corporate Reorganization Law.

4. Treatment of Tax Claims

By the time the legislative agenda was set in the 1990s for a series of new legislation, the problems of tax claims in bankruptcy had become patently clear. The Japanese tax law was completely rewritten during the allied occupation under the strong influence of American tax law. The occupation authority "democratized" the Japanese economic system by dissolving the "Zaibatsu" and by making millions of tenant farmers land-owner farmers (the post-War land reform). The pre-War tax system, which depended largely on wealthy individuals and monopolistic corporations, was converted to a system in which most citizens and corporations had to pay tax according to their income. Thus income tax and corporate tax became the main sources of national revenue, while property tax was made local tax.

These structural changes of the economy and the traditional super priority of tax claims created a new challenge to the administration of insolvency proceedings. The Bankruptcy Law of 1922 provided that all tax claims arising from before the commencement of bankruptcy proceedings be treated as so-called "assets claims."[6] The concept of assets claims is originally German (*Masseanspruch*) and typically applies to the expenses incurred for administering the bankruptcy proceedings, such as remuneration of the trustee, expenses for the sale of assets, and so on. The assets claims typically arise after the commencement of bankruptcy and are payable in full when due. All claims that have arisen before the commencement are treated as bankruptcy claims, which are payable only through pro-rata dividends, normally a miniscule portion of the original claim. Tax claims that have already arisen before the commencement of bankruptcy are bankruptcy claims by nature, but the law specifically upgraded them to the rank of assets claims so that taxes would be paid from the assets as much as possible.

[6] Treatment of tax claims arising after the bankruptcy varies. Property tax from the bankrupt assets is, of course, an assets claim. Income tax imposed on the income arising from the individual bankrupt's activities after bankruptcy is outside of the bankruptcy proceedings and must be paid individually.

As of 1922 and throughout the pre-War time thereafter, this rule did not cause much problem and therefore no criticism of the system was voiced. As a matter of theory, the priority of tax claims was well established in the pre-War absolutist political environment. On top of that, tax payers were mostly wealthy individuals and large corporations who were most unlikely to subject themselves to a bankruptcy. Therefore, there was little possibility of any real conflict emerging. The situation changed under the new post-War tax law and the increasing economic activities in the period that followed. Whenever a bankruptcy occurred, there tended to be a severe rivalry between the private claims and the tax claims. The courts became increasingly involved in litigation involving the alleged priority of tax claims in bankruptcy.

These cases started appearing as the use of insolvency proceedings in the court became more common than before. Two 1970 Supreme Court decisions are significant in that they showed the Court's inclination to attenuate the priority of the tax claim. In one of these cases, a question arose how to treat the tax claim when the assets were not large enough to pay in full even all of the assets claims. The Bankruptcy Law at that time provided that each of the assets claims had an equal share in the distribution of the remaining assets. Therefore, the court below (appellate court) decided that the claim of the trustee in bankruptcy for the fee had no priority over other assets claims including a tax claim and ordered a pro rata payment. The Supreme Court reversed. It held that despite the statutory mandate for an equal distribution among various assets claimants a tax claim should be subordinated to the trustee's claim for the fee.[7] The rationale was that the costs for maintaining the bankruptcy proceeding must be paid first by all means. This principle is now incorporated in the new Bankruptcy Law of 2004.[8]

Another earlier 1970 decision concerned the question whether the tax office can initiate tax collection proceedings against bankruptcy assets. The Bankruptcy Law provided that collection proceedings that had already started before the commencement of bankruptcy could be continued. Possible interpretation of this provision was that the tax office could start collection anew after bankruptcy. The Supreme Court interpreted the provision so that a new action for collection was not allowed once the bankruptcy had been started.[9] This principle has also been incorporated in the new Bankruptcy Law.[10]

During the real estate craze of the 1980s, a novel issue was brought to the Supreme Court. The price of land in large cities skyrocketed during this period. In order

[7] Shimada v. Japan, 24 Minshu 1667 (Sup. Ct., Oct. 30, 1970).

[8] Bankruptcy Law Art. 152 II.

[9] Trustee Kataoka v. Fukushima Tax Office Chief, 24 Minshu 879 (Sup. Ct., July 16, 1970).

[10] Bankruptcy Law Art. 43 I. Views were divided under the former Law, however, as to whether assets claims other than the tax claims could be collected forcibly through execution. The new Law now explicitly prohibits it. Id. Art. 42 I.

to suppress the rising land price, which was largely caused by the practice of speculative "land churning" (selling land for a higher price shortly after buying it), the tax law was amended to impose a heavy tax on income obtained by a sale of land within five years of its purchase. A serious question arose when the trustee in bankruptcy had to sell a piece of land that belonged to the bankruptcy assets and it happened to be within five years of its purchase by the bankrupt. The amount of tax imposed was so large that it would have had to be paid from the proceeds of other assets, despite the fact that the sale by the trustee could not be called a "land churning." In effect, that tax claim had to be satisfied at a great sacrifice of other ordinary claimants when the assets were large enough to fully satisfy all the assets claims. The problem was particularly acute when the land in question was encumbered by mortgages in full. In such a case, the proceeds from the land were all taken by the mortgagee and, therefore, the heavy tax would in effect have to be paid by ordinary creditors.

The issue centered on the interpretation of the statutory language that the tax claim arising from the bankruptcy assets was an assets claim. The first and second instance courts decided that there was a taxable profit whether or not it was taken by a mortgagee. The Supreme Court reversed by holding that when the profit made by a "land churning" was fully taken by the mortgagee and did not remain in the bankruptcy assets there would be no taxable profit.[11] This holding relieved the heavy tax burden imposed on the administration of bankruptcy at least when important pieces of real property were subject to heavy mortgages, as usually they were.

This Supreme Court decision also included another significant holding concerning the status of pre-payable corporate tax. When a corporation is being liquidated, the corporate tax is due only on the remaining assets to be distributed among the shareholders. Because the liquidation process may take years, the pre-payable corporate tax arises each taxable year although the prepaid taxes will be adjusted finally at the conclusion of the liquidation. Because bankruptcy is a process of liquidation, a question arose about the nature of such pre-payable corporate tax to be imposed on the interim corporate income in the course of bankruptcy. The Supreme Court held that, in view of the fact that the prepaid tax would most likely be refunded at the conclusion of the bankruptcy proceedings, the pre-payable tax should not be treated as an assets claim. Thus, the Court reversed the judgment below on this point.[12]

In 1997, two Supreme Court decisions were rendered on a similar issue in favor of the trustee in bankruptcy. Secured creditors are free to enforce a security interest by

[11] Okazaki Senko K.K. v. Japan, 41 Minshu 329 (Sup. Ct., April 21, 1987).

[12] Id. In this case, the issue of whether the trustee must file a tax return for the interim pre-payable tax was not at issue. This issue was later decided for the affirmative by the Supreme Court. Trustee Mori v. Yokohama Naka Tax Office Chief, 803 Hanrei Taimuzu 65, 1439 Hanrei Jiho 120 (Sup. Ct., Oct. 20, 1992). However, it is not yet clear how such a pre-payable tax is actually to be paid. There is a strong view that it should be treated as a deferred claim after the normal claims.

attaching the relevant collateral even when the debtor has been subject to bankruptcy proceedings. Tax claims, being assets claims as discussed above, can be collected from the proceeds of the collateral realized in the enforcement proceedings (equivalent of mortgage foreclosure) by the tax office's filing a demand for dividends in such proceedings. Priority of the tax claim vis-à-vis the secured creditor is determined by the provisions of the National Tax Collection Law. If the tax in question becomes due before the secured interest is perfected, the tax claim is paid first from the proceeds.[13] If not, the tax is paid after the secured creditor is paid in full. In any event, when a tax claim was entitled to payment, the question arose whether the money could be directly paid to the tax authority or should be first paid to the trustee who was supposed to pay the money eventually to the tax authority as a payment of assets claim. The Supreme Court held that the money must be paid to the trustee.[14]

A similar question arises when a tax office attaches a piece of property for collection of a tax and the taxpayer becomes bankrupt. As explained above, the law permits continuation of the tax collection process. Another tax office may intervene to file a demand for payment of another tax before the collection is completed. The priority between the original tax and the intervening tax is determined by the provisions of the Tax Collection Law which provides the priorities among various tax claims. The Supreme Court held here again that the amount of money the intervening tax office is entitled to should be paid to the trustee.[15]

These two holdings may seem too technical. But from the standpoint of the trustee in bankruptcy, there is a practical importance. It is true that the money in question in these cases must eventually be paid by the trustee to the intervening tax office. What is good for the trustee in this holding is that the trustee is given certain freedom and discretion about the timing of the payment to the tax office. There is also the possibility of an agreement with the tax office for payment by installments. In any event, some cash with the trustee always eases his or her activities. The Supreme Court in effect sided with helping the trustee rather than with serving the tax office.

5. Legislative Innovations

The 1922 Bankruptcy Law remained unchanged in its treatment of tax claims until 2004. As explained earlier, the composition and the corporate arrangement were also functioning along with the (straight) bankruptcy. The status of tax claims in these two judicial proceedings is worth mentioning here. The Composition Law, enacted in

[13] National Tax Collection Law Arts. 15 to 25 provide for priorities between the tax claims and various security interests.

[14] Trustee Muratsuji v. Japan, 51 Minshu 4172 (sup. Ct., Nov. 28, 1997).

[15] Kobe Tax Office Chief v. Trustee Tanabe, 946 Hanrei Taimuzu 102, 1628 Hanrei Jiho 21 (Sup. Ct., Dec., 18, 1997).

1922 at the same time as Bankruptcy Law, did nothing to alter the position of the tax claims. The same applies to the corporate arrangement introduced in 1938. It was by the American-styled Corporate Reorganization Law of 1952 that the Japanese insolvency legislation tried to attenuate the force of tax claims in favor of a smooth and effective enforcement of the insolvency proceedings. The 1952 Corporate Reorganization Law recognized the functional equivalent of the assets claims in the name of the “claims for common interest.” However, only limited categories of tax claims were listed there, such as the employee’s withheld taxes which have been taken from the real taxpayers (wage earners) and must simply be handed over to the tax authority by the employer. Tax claims arising from the activities after the reorganization is started naturally belong to this category. All other taxes already due before the commencement of reorganization are subject to the reorganization along with preexisting private claims. Although many differences exist in the treatment of tax claims from that of unsecured private claims, the basic principles are the same. Tax claims may be modified by a reorganization plan if approved by the court. The new Corporate reorganization Law of 2002 did not change this basic feature.

Radical restriction of the traditional priority of tax claims in corporate reorganization was justified by the socio-economic purpose of the newly introduced scheme for rescuing large industries whose demise might cause a serious damage to the national or local economy. It was also by the Corporate Reorganization Law that for the first time in modern Japanese legal history a serious restriction upon security rights was introduced. The very purpose of the security rights is to guard the creditor from the risk of insolvency of the debtor. Once the reorganization is commenced, however, the secured creditors are no longer allowed to enforce the security but subject to the reorganization plan through which their original right may be cut and altered, although their preferred position must be respected. This radical nature of the corporate reorganization is reflected in the treatment of the tax claims.

The Civil Rehabilitation Law of 1999 was enacted in an attempt to create a simplified and lighter version of corporate reorganization for smaller enterprises. Since the socio-economic and political need for rescuing the failed business was not the primary goal here and rather a versatile swiftness was preferred, there is no special treatment of tax claims. The priority claims such as wages and taxes are excluded from alteration by a rehabilitation plan to be formed by a majority vote of creditors. Therefore, the taxes must be paid as they are due by the debtor. Under the influence of the American Chapter XI bankruptcy, the so-called DIP (debtor in possession) is the norm although the court may appoint an administrator if necessary. If a heavy tax obligation makes rehabilitation impossible, the case must simply be converted to straight bankruptcy. In short, the tax claims are not affected by the civil rehabilitation proceedings except that they may face the risk of straight bankruptcy. When this occurs, the tax claims now face certain curtailment introduced by the 2004 Bankruptcy Law.

The Bankruptcy Law of 1922 was totally rewritten to conclude the series of insolvency law reforms started in the late 1990s. As a result, a large degree of uniformity was achieved among the three existing insolvency systems, namely bankruptcy under the Bankruptcy Law, civil rehabilitation under the Civil Rehabilitation Law and corporate reorganization under the Corporate Reorganization Law. For example, the law of avoidance is common in these three systems.[16] The new Bankruptcy Law changed the status of tax claims as follows:

Tax claims are no longer unconditionally assets claims in totality. Only tax claims that have remained uncollected for less than one year after the due date can be treated as assets claims, that is, can be paid in full by the trustee as long as sufficient assets exists.[17] If the tax office delays the collection for more than one year, the privilege as an assets claim is lost. This is a compromise solution. When a tax becomes due and remains unpaid, the tax office may start an action to collect it But in practice, the tax office is not quick to take a forcible measure but tries to persuade the taxpayer to pay voluntarily. Even if a seizure is made, the seized property is not immediately sold. This is out of consideration for reputation and efficiency.

Although the tax claim has been degraded from the rank of assets claim, it still enjoys being a priority bankruptcy claim. The difference between an assets claim and a priority claim is that an assets claim can be paid by the trustee when due and normally in full whereas a priority bankruptcy claim can only be paid dividends. Dividends payment is slow and may not be in full even for priority claims. It is said that the tax authority in the drafting stage of the new law agreed to make this much concession in view of the age-old criticism of the absolute priority enjoyed for so long.

The relative priority given to the tax claim by the new law can be better understood when compared with the position of the wage claims. Wages had been long treated merely as a priority claim, that is, subordinate to the assets claims as far as the unpaid wage claims due before the commencement of bankruptcy. Wage claims arising after the commencement are assets claims. As a result, it has often occurred that wages were not paid because tax had taken too much. From a policy point of view, such differential treatment was not justified. Therefore, the 2004 new Bankruptcy Law raised the unpaid wages for up to three months prior to the commencement of bankruptcy to the rank of assets claim.[18]

[16] This is hopefully the first legislative step toward a single larger “Insolvency Law” rather than the present compartmentalization of laws.

[17] Bankruptcy Law of 2004, Art. 148I3.

[18] Id., Art 149I.

6. Conclusion

Insolvency law must determine the order of priority among various interests involved in a financial breakdown of an individual or a corporation. It must then provide each interest with an appropriate position. The order of priority shifts as the dominant ideology and social/political policy shift. From the Meiji period until the present, Japanese society has undergone great change. Although the tax revenue still has a persisting importance, other policy interests gained a competing importance. Recent changes in the comparative positions of the tax claim and the wage claim is a good example although, in my view, the change came too late.