

# Real Estate Finance in Japan Is Gaining Momentum

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## I. INTRODUCTION

### A. *Economic Recovery and Revival of the Real Estate Markets*

Japan's economy has been recovering for more than five years since January 2002. The banks have overcome the bad loans problem. Domestic and external demand and also the corporate and household sectors are well in balance. Exports continue to increase. Corporate profits increased for the fourth consecutive financial year and profits are expected to rise for fiscal 2006 ending April 2007. Corporate bankruptcies declined to a 14-year low in 2005. Employment and wages have been improving. Private consump-

tion has been on an increasing trend. The latest outlook of the Bank of Japan indicated further growth in fiscal 2006 and fiscal 2007.<sup>1</sup>

Recently, in parts of Japan, there has been an improving trend in land market conditions due to the moderate level of economic recovery. After 15 years of consecutive land price declines in some areas, prices have leveled off or show an increase. Against a backdrop of low interest rates and economic recovery, the demand for residential properties across Japan has increased for three consecutive years. Also as a result of low interest rates, an expansion in the number of market players and developments in active investment, the real estate investment markets have been energized by the introduction of new schemes such as real estate securitization. Furthermore, programs of urban renaissance were developed to improve the profitability and convenience of land in different areas, such as the construction of large-scale office buildings and various customer put-through facilities. Another trend is the declining demand for land by the corporate sector due to structural changes in industry – which include the growth of less land-intensive industries – and changes in the corporate management environment, including the means of funding financial investments.<sup>2</sup>

#### *B. Increasing Foreign Investments*

Japanese capital markets are attractive for foreign financial institutions with a global strategy. Japan has the largest pool of domestic savings (¥ 1,400 trillion or US \$ 12.2 trillion (2003), ¥ 1,424 trillion (2004) or US \$ 12.4) in the world, and is the world's largest refinancing pool, with many of the world's largest institutional investors and banks being domiciled in Japan. Japanese corporations are more active in raising capital from the capital markets than in previous years. Foreign players often bring in sophisticated know-how and high-quality products for which an increasing demand in Japan exists.

The legal framework has been reformed or is in the process of reform in the fields of the judiciary, corporate law, financial law, labor law, and social security. Numerous non-tariff trade barriers have been reduced and the government is actively promoting foreign direct investments and foreign participation in the financial markets. Japan is open and offers opportunities and challenges to well-prepared foreign enterprises.

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1 T. FUKUI, Developments in Japan's economy in 2006 and the outlook for 2007, Summary of a speech by Mr. Toshihiko Fukui, Governor of the Bank of Japan, to the Board of Councillors of *Nippon Keidanren* (Japan Business Federation), Tokyo, 25 December 2006.

2 MINISTRY OF LAND, INFRASTRUCTURE AND TRANSPORT, White Paper on Land and Real Property (2006) 1-1-1.

## II. CHARACTERISTICS OF REAL ESTATE MARKETS IN JAPAN

### A. *General Features and Trends*

Land prices are extremely high in Japan because arable land is extremely rare. Dwelling areas account for only 4.8%.<sup>3</sup> Furthermore, land and buildings are threatened by natural hazards due to many dormant and some active volcanoes, tremors and earthquakes, typhoons, and tsunamis.

Building lots and houses are relatively small due to a high density of the population concentrated in few major urban areas. While the national density is 341/sq km, which can be compared to the Netherlands, the densities of Tokyo-to is 5,517/sq km, of Osaka-fu 4,652/sq km, of Kanagawa-ken 3,515/sq km, and of Hokkaido 73/sq km.

A major feature of the Japanese real estate system is that land is regarded as a separate asset from buildings. Freehold is the only type of property ownership in Japan. There is no equivalent system of leasehold property ownership, but there is a property holding system called "land lease": the right to ownership of a building only, excluding the land. Accordingly, land prices are calculated separately from building prices.

Land prices are normally determined by market comparisons utilizing land price indices prepared by the Japanese government, while building prices are normally determined in the market through a cost approach. However, due to the continued land price declines during the last 15 years and the spread of real property securitization, property prices are beginning to be determined by reflecting the income from the subject properties, where real property assets are considered as a whole, using the income approach: net income divided by yield, minus building cost.<sup>4</sup>

The population is aging rapidly, which is a blessing for the respectable elderly people as well as for the entire Japanese society due to a long average life expectation. Since this goes hand in hand with a declining birth rate, the total number of people is already decreasing. The demographic development will have an impact on future land prices, the utilization of land, and the kind of dwellings and finance techniques that are needed in the future.

### B. *Basic Policies and Legal Regulations*

#### 1. *Public Law*

The Japanese constitution<sup>5</sup> confirms in Art. 29 the right to own or to hold property as a basic human right. This right is limited by legal regulations binding it to its social functions and responsibility.

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3 The statistical data was retrieved from THE ASAHI SHINBUN, Japan Almanac 2006, 80.

4 MINISTRY OF LAND, INFRASTRUCTURE AND TRANSPORT (*supra* note 2) Introduction.

5 *Nihon-koku kenpō*, 3 November, 1946, in effect since May 3, 1947.

In a small country such as Japan, land is recognized as a limited resource and a basic necessity of life that is common to all the people. Thus the use of land enters the public domain and as such is subject to public restrictions. The Basic Land Act<sup>6</sup> does not include specific restrictions, but proclaims abstract ideas and basic concepts. It is a policy guideline addressed to the central government, local authorities, business enterprises, and the general public. These are the four fundamental principles: (1) Social welfare has priority in land use. (2) Land must be used properly according to the various environmental, social, economic, and cultural conditions in each area. It must comply with land use planning which was established to maintain a reasonable and rational use of land. (3) Speculative development should not be permitted because it causes land prices to inflate higher than their actual value. This would contravene the role of land and property to enhance social welfare. (4) Owners will be taxed accordingly if the value of their land has increased as a result of changes in the socio-economic conditions of the area (Artt. 2-5 Basic Land Act).

There are no special rules for investment by foreigners into real estate in Japan except certain requirements of notification under the Foreign Exchange and Foreign Trade Control Act.<sup>7</sup> In line with the absence of special regulations for ownership of real estate by foreigners, there are also no requirements for permits of ownership by foreigners. Consequently, Japan is also not party to any specific treaty concerning investments of foreigners in real estate in Japan.<sup>8</sup>

The legal conditions of expropriation are regulated in the Land Expropriation Law,<sup>9</sup> which contains an exhaustive enumeration of all cases of expropriation under the laws of Japan in its Art. 3. Such cases are basically in line with similar regulations in Germany, namely roads, waterways, energy, and other requirements of city planning or area planning. Art. 4 of the Land Expropriation Law confirms that any expropriation under this or any other law must be based on the “special need” for such real estate. Beyond compensation for the value of the land (by cash or by substitute), the expropriator also has to compensate the owner as well as any related person, such as a lessee, for any damage suffered due to the expropriation, while such compensation shall in general be undertaken separately (Artt. 68, 69 Land Expropriation Law). Consequently, the cost of interruption and deterioration of a business due to expropriation are also in general to be covered by the expropriator.

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6 *Tochi kihon-hô*, Law No. 84/1989, as amended by Law No. 160/1999.

7 *Gaikoku kawase oyobi gaikoku bôeki-hô*, Law No. 228/1949, as amended by Law No. 66/2006.

8 However, Japan has ratified investment treaties with Egypt, Sri Lanka, Bangladesh, Pakistan, China, Hong Kong, Russia, South Korea, and Vietnam. The term “investment” in Japan’s investment treaties generally includes “immovable property.” In addition, Japan has concluded free trade agreements (FTAs) and economic partnership agreements (EPAs).

9 *Tochi shuyô-hô*, Law No. 219/1951, as last amended by Law No. 53/2006.

Important statutes belonging to construction and housing include the Construction Industry Law,<sup>10</sup> the Building Standard Law,<sup>11</sup> and the Real Estate Evaluation Law,<sup>12</sup> to name just a very few.

Recently, private financing initiatives in accordance with the Law for the Development of Public Facilities Using Private Capital (PFI Law)<sup>13</sup> are gaining importance, especially in the development of infrastructure projects.

## 2. *Private Law*

Important real estate laws include the Civil Code<sup>14</sup> (Book II on real rights and Artt. 601–621 Civil Code regarding lease contracts), the Immovable Property Registration Law,<sup>15</sup> the Law Concerning Unit Ownership, etc. of Buildings,<sup>16</sup> and the Land Lease and House Lease Law.<sup>17</sup>

## III. INVESTMENT LAW

### A. *Overview*

There is no comprehensive statute that governs the regulation of real estate funds (collective investment schemes) in Japan, but there is a wide array of statutes and ordinances for various aspects of the fund industry.

Real estate funds privately placed in Japan are often set up as a partnership between the fund operator and the investors (partnership structure) or, perhaps more frequently, as a corporation with undisclosed association under the Commercial Code (*tokumei kumiai*)<sup>18</sup> or TK structure), while real estate funds publicly offered are set up as investment corporations or listed REITs. This chapter will briefly describe the typical non-regulated private fund structures (B.). Then we will turn to regulated structures under the Real Estate-Specific Joint Business Law (RESJBL)<sup>19</sup> (C.) and the legal framework

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10 *Kensetsu-gyô-hô*, Law No. 100/1949, as last amended by Law No. 92/2006.

11 *Kenchiku gijun-hô*, Law No. 201/1950, as last amended by Law No. 92/2006.

12 *Fudôsan no kantei hyôka ni kansuru hôritsu*, Law No. 152/1963, as last amended by Law No. 83/2005.

13 *Minkan shikin-tô no katsuyô ni yoru kôkyô shisetsu-tô no seibi-tô no sokushin ni kansuru hôritsu*, Law No. 117/1999, as last amended by Law No. 53/2006.

14 *Minpô*, Law No. 89/1896 and No. 9/1898, as last amended by Law No. 50/2006.

15 *Fudôsan tôki-hô*, Law No. 123/2004, as last amended by Law No. 29/2006, which amended all the Law No. 24/1899.

16 *Tatemono no kubun shoyû-tô ni kansuru hôritsu*, Law No. 69/1959, as last amended by Law No. 50/2006.

17 *Shakuchi shakuya-hô*, Law No. 90/1991, as last amended by Law No. 153/1999.

18 “*Tokumei kumiai*” is an undisclosed association under Artt. 535-542 Commercial Code.

19 *Fudôsan tokutei kyôdô jigyô-hô*, Law No. 77/1994, as last amended by Law No. 65/2006.

for publicly placed structures under the Law Concerning Investment Trusts and Trust Corporations (ITICL)<sup>20</sup> (D.).

### B. *Non-regulated Real Estate Funds*

The requirements and restrictions of the RESJBL can be avoided when real estate has been placed into trust and the trust beneficiary rights are the assets of the real estate fund. In addition, there are a number of other reasons why non-regulated real estate funds are popular.

#### 1. *Partnership Structure*

In order for the fund not to be subject to double taxation at the fund level and at the investor level, capital contributions to a fund that are eligible for pass-through treatment are frequently used. If a civil code partnership (*nin'i kumiai* or NK)<sup>21</sup> is used, then pass-through treatment similar to that of an undisclosed association is available. However, the assets (*e.g.*, the trust beneficiary rights) of a civil code partnership are jointly owned by the partners. The partners have a strong influence on management and representation of the fund and are personally liable for misconduct or losses of the fund.

In an LLP (*yûgen sekinin jigyô kumiai*),<sup>22</sup> the partners' liability for the partnership's debts is limited to the extent of their individual capital contributions.

#### 2. *Undisclosed Association Structure*

In the typical TK structure,<sup>23</sup> investors conclude undisclosed association agreements and make cash contributions (TK investment) to a real estate fund. The real estate fund is typically set up as a legal entity. The real estate fund will use the contributions and non-recourse loans<sup>24</sup> from financial institutions to purchase real estate trust beneficiary rights as investments and manage or sell them. The underlying real estate assets are placed in trust with a trust bank by the originator and leased to tenants. The originator as the trust beneficiary transfers the beneficiary interest to the real estate fund. The proceeds of the beneficiary interest will be distributed to TK investors after deduction of expenses, etc. and according to the terms of the undisclosed association agreements.

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20 *Tôshi shintaku oyobi tôshi hôjin ni kansuru hôritsu*, No. 198/1951, as last amended by Law No. 65/2006.

21 Artt. 667-688 Civil Code.

22 *Yûgen sekinin jigyô kumiai keiyaku ni kansuru hôritsu* [Law Concerning the Limited Liability Business Partnership Agreement] Law No. 40/2005.

23 See ASSOCIATION FOR REAL ESTATE SECURITIZATION (ARES), *Real Estate Securitization Handbook 2005*, 63/64.

24 A "non-recourse loan" is a secured loan (debt) that is secured by a pledge of collateral, typically real property, but for which the borrower is not personally liable.

The TK investment can be treated as an equity investment, provided that this is made clear in the contract. Distribution of profit or the return of capital can occur as desired, and distributed profit can be recorded as an expense when the operator calculates taxable income.

### *C. Real Estate-Specific Joint Business*

#### *1. Purpose of the RESJBL*

When a residential lot or a building is the subject of an investment contract, the RESJBL is applicable. Thus it is necessary for the business operator to be licensed under the RESJBL.

The purpose of the RESJBL is to implement a license system for those who operate a joint business specialized in real estate transactions, to define duties and obligations which they must perform in executing their operations, and to take necessary measures to prevent any participants in the business from damage which they may receive. The goal is to ensure a proper management of the business and thereby protect the benefits of the participants in the business, and further to contribute to the sound development of joint businesses specialized in real estate transactions (Art. 1 RESJBL).

In other words, the Real Estate-Specific Joint Business Law regulates businesses that syndicate the earnings of real estate to investors who invested their assets or monies into a real estate business operated by contracted real estate or other specialists who conduct the business by pooling assets under *nin'i kumiai* (NK) agreements, *tokumei kumiai* (TK) agreements, or leasing or similar agreements. The law was enacted to regulate these businesses in order to protect investors.<sup>25</sup>

#### *2. Civil Code Partnership Structure*

The property developer or owner transfers the real estate by dividing the ownership into several interests and selling those interests to investors. The investors buy the interests in real estate and contribute that interest, in kind, into a partnership. The partnership agreement is concluded between all investors and the business operator. The common purpose of this partnership is to jointly operate the business of leasing the real estate asset such as an office building, condominium, etc. Based on the partnership agreement, the business operator is entrusted with the management and operation of the partnership's property. The business operator leases the property to tenants to generate income. The business operator distributes the earnings (or losses) generated by the operation of the real estate to the business participants.<sup>26</sup> In case of losses, the investors' liability is not limited.

The partnership is treated as a pass-through entity for Japanese tax purposes.

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<sup>25</sup> ARES (*supra* note 23) 36.

<sup>26</sup> ARES, *ibid.*, 41.

### 3. *Undisclosed Association Structure*

The investors conclude undisclosed association agreements with the business operator and make contributions in cash to the joint business. The business operator uses those funds to purchase real estate and operates it as a real estate leasing business. The earnings (or losses) from the property are distributed to the business participants. The business operator is vested with the ownership and the right to operate the real estate. Unlike the civil code partnership structure, the investor's liability is limited to its initial investment.<sup>27</sup>

The business operator is taxed as a corporation, but the profit allocated to each business participant is deducted as expenses of the operator. Profit allocated to the business participant is included in the taxable income of each business participant.

### 4. *Lease Structure*

The property developer or owner sells the real estate's common interests to multiple investors who become business participants, and transfers the ownership to each business participant. Simultaneously, the business operator concludes a lease agreement or lease contracting agreement with the business participants for the real estate the investors acquired (sell and lease back), and the business participants receive rental income distributions.<sup>28</sup>

As the business participants own the real estate under the tax law, it is handled as real estate income.

After a certain period of time, the real estate is sold as a single property and the sales proceeds (including losses) are distributed to the business participants.

### 5. *Investor Protection*

The RESJBL protects investors by establishing regulations on information disclosure to them and other restrictions of business. The primary regulations are as follows:

Information disclosure regulates the provision of documents prior to contracting, contracts based on specific criteria, the provision of property management reports, the establishment of management reports on operational performance and property conditions, preparation and maintenance of investor lists, etc.

The prohibition of loaning the names, regulations on advertising, restrictions when the joint business can be started, prohibition of illegal soliciting, prohibition of money lending or acting as an agent, requirement that contracts be terminated in writing, requirement of segregation of management of property and imposition of certain confidentiality obligations among other requirements.

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<sup>27</sup> ARES, *ibid.*

<sup>28</sup> ARES, *ibid.*, 42.



There are also minimum requirements for the articles of association for any joint business specialized in real estate transactions.

There are exemptions from certain provisions of the RESJBL for qualified investors with respect to their own investment. Qualified investors include banks, trust companies, insurance companies and joint-stock corporations (KK) with paid-in capital of at least ¥ 500,000,000 and specialized knowledge and experience concerning real estate investment.

#### 6. *Supervision*

Depending on the place of the office of the business operator and any additional provisions, the RESJBL stipulates which authority will supervise the business. The primary supervisory regulations require the submission of business reports to the responsible authority each business year. The regulations provide powers to the supervisory authority to take measures to correct a business when necessary and include instructions, orders to suspend operations, orders to terminate employment of an operations manager, cancellation of permits, guidance, and on-site inspections.

#### D. *Investment Trusts and Investment Corporations*

##### 1. *The Law Concerning Investment Trusts and Investment Corporations (ITICL)*

The ITICL regulates collective investment structures, or fund management group structures. In these structures, funds are raised from a large number of small investors and then are grouped together. Professional investment managers invest these funds over a range of different assets. The proceeds of such investments are subsequently distributed to the investors in proportion to each investor's particular stake in the fund.

The ITICL distinguishes between two different structures: the investment trust and the investment corporation. The investment trust is sometimes called a contract investment trust, and the investment corporation may also be referred to as a corporate investment trust.

##### 2. *The Investment Trust Structures*

Investment trusts are further divided into investment trusts directed by settlors (trustors) and investment trusts not directed by settlors.

###### a) *Investment Trusts Directed by Settlors*

In these trusts, the settlor decides how the property is managed, and the property in question primarily<sup>29</sup> consists of managed investments in negotiable securities and real

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29 "Primarily" means more than 50 percent of the fund assets. ARES (*supra* note 23) 49.

estate. “Qualified assets” (*tokutei shisan*)<sup>30</sup> are directed in accordance with the orders of the settlor. The objective is to divide the beneficiary interest into several portions which are then acquired by many different parties.

b) Investment Trusts Not Directed by Settlers

In these trusts, the settlor cannot effect investment decisions on behalf of the trust. Such trusts are further differentiated by their ability to raise money from multiple settlors under a single trust deed that includes fiduciary responsibility for the funds passing to a manager. The manager, in turn, is granted full discretion to invest the trust’s monies in qualified assets, specifically not in accordance with the instructions of the settlor (unless the manager deems it appropriate).

3. *Open-End and Closed-End Funds*

Investment trust structures and investment corporation structures for the J-REITs (Japanese Real Investment Trusts) can be created as either open-end funds or closed-end funds. In an open-end fund, the fund redeems investors on request from assets in the funds and may create new units for new investors when requested. In a closed-end fund, an investor may not request redemption from the fund, and the fund is restricted from creating new investment units. Investment units may only be transferred through sale and purchase of units. Listed J-REITs are a good example of a closed-end fund; whereby an investor may purchase or sell units through market transactions on an exchange rather than by redemption from the funds assets.<sup>31</sup>

Historically, most securities investment trust products have tended to use an open-ended investment trust structure; this was principally driven by product design. However, if real estate funds employ the open-end structure, it would be difficult, if not impossible, for investors to redeem funds on request, because real estate is illiquid and thus the fund cannot rapidly raise cash for an investor’s redemption request. This, combined with the sophisticated governance available through the investment corporation structure, has led to listed J-REITs using the closed-end investment corporation structure.<sup>32</sup> Consequently this section will focus on the investment corporation structure.

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30 “Qualified Assets” are (1) negotiable securities, (2) real estate, (3) leasehold rights in real estate, (4) surface rights, (5) monetary debts, (6) promissory notes, (7) trust beneficiary rights (money, negotiable securities, monetary debt, real estate, surface rights for land and leasehold rights), (8) interest in TK, and (9) trust beneficiary right of monies, in which the object is the management of the investment in the TK interest primarily consisting of the trust property (Cabinet Order, Enforcement Ordinance, Art. 3).

31 ARES (*supra* note 23) 50.

32 ARES, *ibid.*

#### 4. *The Investment Corporation Structure*

##### a) Mechanism

This is a mechanism for managing investments in qualified assets using monies investors have placed in an investment corporation. The management of the investment corporation is delegated to an investment trust manager or other suitable qualified entity.

##### b) Investment Trust Manager

The investment trust manager (*tôshishintaku itaku gyôsha*) is the person who manages the trust property or the assets of the investment corporation. The investment trust manager can engage in either investment trust management or management of investment corporation assets. It is particularly regulated in Artt. 6–49 ITICL.<sup>33</sup>

##### c) Investment Corporation

The investment corporation is a legal entity (Art. 61 ITICL). It is established with the objective of managing assets, and it is not authorized to engage in any business other than asset management. The promoters are called “Establishment Planners” (*setsuritsu kikaku-jin*), and they have to prepare by-laws (*kiyaku*), among others, to establish an investment corporation (Art. 66 ITICL). It shall not open any place of business other than its home office and shall not hire employees (Art. 63 ITICL). Investment corporations are required to hire appropriately qualified, independent professionals to manage their assets, act as custodians of their assets, and conduct other practical duties. It shall use the words “Investment Corporation” (*tôshi hôjin*) in its trade name (Art. 64 ITICL). The total amount of contributions at the time of establishment shall be ¥ 100 million or more (Art. 68 ITICL). The investment corporation and its officers need to be registered with the Prime Minister prior to starting operations (Art. 74 ITICL).

##### d) Organs of the Investment Corporation

The investment corporation is required to have the following organs

- the General Meeting of Investors (*tôshi nushi sôkai*),
- one or more executive officers (*shikkô yaku-in*),
- supervising officers (*kantoku yaku-in*) whose number is one more than the number of executive officers,
- one general meeting of officers (*yaku-in kai*), and
- one accounting director (*kaikai kansayaku-nin*).

Investment corporations raise funds by the public offering of investment units. If the investment corporation is incorporated as a closed-end fund, then it may also place investment corporation bonds and conduct ordinary borrowing if permitted by its by-laws.

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33 The rules were revised recently and a part on the principal shareholder (*shuyô kabunushi*) was inserted (Artt. 10-4 – 10-7 ITICL).

e) Business of the Investment Corporation

Investment corporations may perform the following transactions regarding the qualified assets:

(1) Acquisition or assignment of securities; (2) loans of securities; (3) acquisition or assignment of real estate; (4) leases of real estate; (5) delegation of the management of real estate; and (6) other transactions provided for by cabinet order.

In addition, they may conduct acquisitions or assignment of assets other than the qualified assets, or other transactions, in conformity with the targets and approach of the asset management set forth in the by-laws. There are additional restrictions on asset management:

f) Asset Custodian Company

Investment corporations shall delegate the functions pertaining to the custody of its assets to the asset custodian company (*shisan hokan kaisha*) (Art. 2 No. 26, Art. 208 para. 1 ITICL). The custodian shall be a corporation which falls within any of the following categories: (1) trust companies, etc.; (2) securities firms (limited to the custody of securities, etc.); (3) certain entities provided for by prime ministerial ordinance (Art. 208 para. 2 ITICL). The asset custodian company shall store the assets of the investment corporation separately from its own property in a safe and orderly manner for the storage of assets (Art. 209-2 ITICL).

g) Master Servicer

An investment corporation may<sup>34</sup> delegate to third parties certain matters other than the functions pertaining to the management and custody of assets (general clerical matters), and cause them to perform such tasks. These matters include (1) offering of investment units and investment corporation bonds; (2) change of holder for investment units and investment bonds; (3) issuing investment securities and investment corporation bond certificates; (4) tasks concerning the management of its organs; (4) calculations; (5) payment of dividends and refunds to investors; (6) payment of interest and redemption money to holders of investment corporation bonds; (7) preparation of accounting books; (8) payment of taxes.

Such a third party is called a Master Servicer (*ippan jimū jutaku-sha*) (Art. 2 No. 27 ITICL).

The so-called commingling risk – *i.e.*, the risk that the funds recovered by the servicer for third-party debts and the servicer's own operating funds become mixed together and the servicer becomes insolvent – shall be mitigated by the use of separate dedicated accounts for the management of collected funds for third parties, reduction of the period of time the servicer actually holds the funds in its accounts to a minimum, and credit enhancement of the servicer through posting of cash collateral, use of bank guarantees, etc.

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34 “May” shall be understood as “must,” ARES (*supra* note 23) 55.

## h) Investment Corporation Bond Manager

When offering investment corporation bonds, the investment corporation shall designate an investment corporation bond manager (*tôshi hôjin-sai kanri-sha*) and shall delegate to it the power to receive the discharge, protect claims, and perform other management of the investment corporation bonds on behalf of creditors pertaining to the investment corporation bonds. However, this shall not apply when the face amount of each investment corporation bond issued in such offering is ¥ 100 million or more (Art. 139-7 ITICL).

The investment corporation bond manager must possess a banking license, a trust company license, or a license under the Collateralized Corporate Bond Trust Law.<sup>35</sup>

## IV. TRUST LAW AND TRUST BUSINESS LAW

In all structures, trusts are used regularly. Accordingly we will briefly introduce the Trust Law<sup>36</sup> and the Trust Business Law.<sup>37</sup>

## A. Trust Law

The purpose of the Trust Law (TL) is to define various trusts and proclaiming rules regarding trusts.

A “trust” under this law means a transfer of the legal title to any property to another person or any other disposition thereof, allowing the other person to manage or dispose of said property pursuant to a specific purpose (Art. 1 TL). The legal nature of the trust is that of a transfer of ownership right in the trust property to the trustee with a beneficiary claim of the trustor against the trustee.<sup>38</sup> Thus, the Japanese trust is similar to the German concept of “*Treuhand*” and different from the common law concept of “trust,” which can only be explained with the historically grown separation of law and equity which separates the legal title into legal ownership and equitable ownership.<sup>39</sup>

A new trust law<sup>40</sup> was promulgated on December 15, 2006, and will come into effect sometime before June 2008.

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35 ARES (*supra* note 23) 55.

36 *Shintaku-hô*, Law No. 62/1922, last amended by Law No. 88/2004.

37 *Shintaku-gyô-hô*, Law No. 154/2004, last amended by Law No. 87/2005.

38 Dominant opinion in: T. AOKI, *Shintaku-hô ron* [Discussion of Trust Law] 299-301; S. IRIE, *Zentei shintaku-hô genron* [Principle of Trust Law] 150-154. The minor opinion holds that the trust property shall have a legal entity and the trustor holds ownership in it as well as a beneficiary right against the trustee, K. SHINOMIYA, *Shintaku-hô* [Trust Law] 79 *et seq.* Various opinions on the legal nature of the trust are described in detail in M. ARAI, *Shintaku-hô* [Trust Law] 29 *et seq.*

39 WEST's Law and Commercial Dictionary, Keyword “Trust”.

40 *Shintaku-hô* [Trust Law] Law No. 108/2006 of December 8, 2006; *Shintaku-hô no shikô ni tomonau kankei hôritsu no seibi-tô ni kansuru hôritsu* [Accompanying Law for the Implementation, etc. of Regulations to the Trust Law] Law No. 109/2006.

### B. *Trust Business Law*

The purposes of the Trust Business Law (TBL) is to protect trustors (settlers) and beneficiaries of trusts by establishing principles necessary for the regulation of entities engaging in a trust business, a trust agreement agency business, and a business of distributing trust beneficiary certificates, etc. and to ensure fair trade in regard to acceptance of trusts and other trust-related businesses, and thereby contribute to the sound development of the national economy (Art. 1 TBL).

A company that wishes to engage in the business of accepting trusts (trust business) needs to apply for a license from the Prime Minister (Art. 3 TBL). Notwithstanding the license requirement, a company may register with the Prime Minister as a management-type trust company<sup>41</sup> pursuant to Art. 7 para. 1 TBL.

## V. REAL ESTATE MONETIZATION

### A. *Characteristics of Real Estate Monetization*

Real estate monetization is used when placing real estate assets or assets derived from real estate into a structure where investors can have greater liquidity. Usually this is where someone owning cash-generating assets (originator) establishes an entity solely for the purpose of owning these assets (specific purpose vehicle) and transfers the assets to the special purpose vehicle. Investment products with greater liquidity characteristics than the underlying assets and backed by assets and cash flows that those assets generate are then issued to investors.<sup>42</sup> Basic requirements of real estate monetization structures are bankruptcy remoteness and pass- or pay-through taxation.

There are two forms of securitization vehicles: contract and corporation-based vehicles. This section will focus on the specific purpose company (*tokutei mokuteki kaisha*, TMK) under the Law Regarding Asset Monetization (AML).<sup>43</sup>

### B. *The Specific Purpose Company (tokutei mokuteki kaisha)*

#### 1. *Registration*

A TMK shall notify the Prime Minister of Japan prior to commencing business pertaining to the monetization of assets (Art. 4 para. 1 AML) and prior to commencing business pertaining to the monetization of assets under a new asset monetization plan (Art. 11 para. 1 AML).

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41 The other type is called an investment type trust company.

42 ARES (*supra* note 23) 14.

43 *Shisan ryûdô-ka ni kansuru hôritsu*, Law No. 105/1998 as last amended by Law No. 66/2006.

## 2. *General Provisions*

A TMK is a legal entity similar to a Japanese joint stock corporation. A TMK shall adopt as part of its name the words “*tokutei mokuteki kaisha*” (Art. 15 AML).

## 3. *Establishment*

To establish a TMK, the promoter(s) (*hokki-nin*) shall prepare the articles of incorporation (*teikan*) in writing or by virtue of electromagnetic record. Art. 16 para. 2 AML enumerates the matters that must be included (purpose, trade name, location of principal office, amount of specific capital, name and address of promoters, and period of existence and events of dissolution). If applicable, the articles must contain the details of persons making non-cash contributions, details of post-incorporation non-cash contributions, special profits of promoter, and organization expenses (Art. 16 para. 3 AML). In addition, it may contain those matters that only become effective if they are included in the articles of incorporation where the law so requires, and any other matters upon discretion of the promoters that do not contravene the laws or ordinances may be inserted (Art. 16 para. 4 AML).

The articles of incorporation need to be authenticated by a Japanese notary public (Art. 16 para. 6 AML, Art. 30 Company Act).

The promoters unanimously decide the number and the amount of specific contribution units to be attributed to each promoter at the time of establishment of the TMK. The promoters must subscribe all specified contribution units at the time of establishment, and each founder shall subscribe more than one specified contribution unit (Art. 17 AML). There is no statement in the law regarding minimum amount of contributions or capital.

After notarization of the articles of incorporation, the promoters need to apply at the district court for the appointment of an inspector for the purpose of verification of the articles' statements (Art. 18 AML, Artt. 868 ff. Company Act).

The promoters must immediately make payment after subscription of specific contribution units (Art. 19 AML).

The right of the promoter to become a specified member cannot be assigned (Art. 20 AML).

The promoters must immediately after having completed payment on subscribed specified contribution units appoint the initial directors (*torishimari-yaku*) and statutory auditors (*kansa-yaku*). If the TMK is a corporation maintaining accounting consultants (*kaikei san'yo*), an accounting consultant – or if it is a corporation maintaining accounting auditors (*kaikei kansa-nin*), an accounting auditor – shall be appointed (Art. 21 AML).

The TMK must be registered at the place of its principal office within two weeks after the completion of the investigation of the incorporation or the date determined by the promoters (Art. 22 AML). It is the registration that establishes the TMK as a legal entity (Art. 23 AML).

#### 4. *Rights and Duties of Members (Artt. 26-50 AML)*

The members of a TMK that does not issue preferred investment units shall be its specific members (*tokutei sha'in*), and the members of a TMK that issues preferred investment units (*yûsen shusshi*) shall be its preferred members (*yûsen sha'in*), Art. 26 AML.

The liability of a member is limited to the amount of its contribution (Art. 27 I AML).

A member has the right to receive a dividend and the proceeds of the liquidation amount as well as other rights as stipulated in the AML (Art. 27 II AML).

A specific member has a voting right. A preferred member does not have a voting right except when the AML specifically grants him a voting right. This does not apply if the articles of incorporation stipulate otherwise (Art. 27 III-IV AML).

#### 5. *Organs of a tokutei mokuteki kaisha*

One of the organs of a TMK is the general meeting of members (Art. 51-66 AML). Furthermore, there are one or more directors (*torishimari-yaku*, Artt. 78-85 AML), one or more statutory auditors (*kansa-yaku*, Artt. 87-90 AML), and an accounting auditor (*kaikai kansa-nin*, Artt. 90-93 AML). The articles may provide for an accounting consultant (*kaikai san'yo*, Art. 86 AML). The same requirements do not apply in case of a TMK that exclusively issues specific corporate bonds as asset-backed securities not surpassing a certain amount (Art. 67 AML).

Directors, etc. may be held responsible for damages caused due to neglect of their duties (Artt. 94-97 AML).

#### 6. *Accounting*

Each closing period, the directors shall prepare the balance sheet, the profit/loss statement, the operating report, the agenda concerning the disposition of profits or disposal of losses, and the annexed specifications thereof. The AML contains rules on accounting books, bills, etc. amount of capital, etc. and allotment of profit.

#### 7. *Issuance of Specific Bonds*

The TMK may issue specific bonds (*tokutei shasai*) according to the manner prescribed in the AML (Artt. 121 *et seq.* AML). It shall designate a specific bond manager (*tokutei shasai kanri-sha*) and shall entrust to him the management of the qualified bonds on behalf of the specific bond holders (Art. 126 AML). The TMK may also issue convertible specific bonds (*tenkan tokutei shasai*) and specific bonds with new preferred contribution warrants (*shin yûsen shusshi hikiuke-ken-tsuke tokutei shasai*) in conformity with the provisions of the asset liquidation plan (Artt. 131, 139 AML).

A TMK may, limited to enumerated cases (*e.g.*, where it is necessary to acquire specific assets, the maximum amount is fixed by the asset liquidation plan, and further requirements provided for by Cabinet Ordinance are met), issue specific short-term bonds (*tokutei tanki shasai*), Art. 148 AML.



## 8. *Business*

The TMK shall entrust the specific assets (other than the beneficial rights in trust) to a trust company, etc. in order to cause it to perform business pertaining to the administration and disposition thereof (Art. 200 I AML)

The TMK may in the limited enumerated cases issue promissory notes (*yakusoku tegata*<sup>44</sup>) (Art. 205 AML), borrow funds (Art. 210 AML), and certain activities are restricted, such as solicitation of asset equivalent securities, acquisition of certain assets, etc. disposition of specific assets, etc.

## 9. *Parent of tokutei mokuteki kaisha*

### a) Cayman Limited Company with Charitable Trust

Conventionally, a Cayman limited company with voting shares entrusted to a charitable trust under Cayman law is used as the parent of a Japanese TMK.

A Cayman limited company (exempted company) requires no government authorization or licenses and is free from any form of income, capital gains, or corporation tax in the Cayman Islands. No withholding taxes are imposed on any of the company's tax flows and it is able to obtain an undertaking from the Cayman government that it will remain tax-free for 20 years (this can be extended to 30 years).<sup>45</sup>

### b) Japanese Mid-sector Corporation

The mid-sector corporation (*chûkan hôjin*) under the Mid-sector Corporation Law<sup>46</sup> is a legal entity whose corporate purpose is to seek the common interest of the members without distributing dividends to its members. The *chûkan hôjin* is available in two types: limited liability *chûkan hôjin* and unlimited liability *chûkan hôjin*.

### c) Japanese Public-Interest Corporation

A reform of the system of public-interest corporations (*kôeki hôjin*) is currently under consideration. According to the "Policy for Further Administrative Reform" approved by the Cabinet as of December 24, 2004, a system is planned under which a non-profit corporation can be incorporated by simple registration (without requirement of approval) regardless of whether it has a public-interest nature. The current system of mid-sector corporations will be subsumed into the new system. It will thus be necessary to pay close attention to post-reform developments as to whether it will remain possible to employ a scheme to block a TMK from influencing parties interested in the securitization transaction.<sup>47</sup>

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44 In German "*Solawechsel*." Contrary to Germany, promissory notes are often used in Japan.

45 WALKERS, The benefits of Cayman Islands structures, IFLR special supplement Japan 2005.

46 *Chûkan hôjin-hô*, Law No. 49/2001 as last amended by Law No. 87/2006.

47 K. ITO / F. SUGIHARA, The TK+YK Scheme and Non-Recourse Loans, *Asialaw JAPAN Review*, January 2006, 8.

The General Affairs Ministry announced “the annual report regarding 2006 public-interest corporation” (the public-interest corporation white paper) 15 August 2006.<sup>48</sup>

## VI. CREDIT SECURITIES

### A. Overview

Securities are given by a debtor in order to assure the payment or performance of his debt, by furnishing the creditor with a resource to be used in case of failure in the principal obligation.

For granting a security interest in accounts receivable, a pledge (*shichi-ken*) or a security assignment (*jôto tanpo*) is usually used in Japan.<sup>49</sup>

Encumbrances are the hypothec (*teitô-ken*, Art. 369 ff. Civil Code) and the base hypothec (*ne-teitô-ken*, *Höchstbetragshypothek*). However, many real estate finance transactions work without hypothecs due to various reasons.

Provisional registration (*kari tôki*) according to the Law Regarding Provisional Registration of Security Contracts<sup>50</sup> and personal guarantees are also used.

### B. Hypothec, Maximum Hypothec, and Joint Hypothec<sup>51</sup>

A hypothec allows the obligee to auction the immovable given as security and has priority against other obligees in the distribution of the proceeds of sale. Until such sale, the person giving the security has the possession and use of the immovable (Art. 369 para. 1 Civil Code).

The hypothec has the following attributes

- (1) Preferential satisfaction
- (2) Dependence (*Akzessorietät*): The existence of the hypothec is strictly connected to the existence of the underlying claim.
- (3) Attendance (*Adhäsion*): The assignment of the claim automatically transfers the hypothec, if there is no agreement to the contrary.
- (4) Indivisibility: All of the property given as security at the time of creation remains hypothecated until all of the secured obligation rights are discharged. Further, the effect of a hypothec also extends over substitutes, *i.e.*, money or other property received from third persons when the hypothecated property is sold, leased, destroyed, or damaged.

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48 <[www.koueki.jp](http://www.koueki.jp)>.

49 M. ONO / A. TOKUYASU, Report on Japan, in: GLG International Comparative Legal Guide to: Securitisation 2006, 165.

50 *Kari tôki tanpo keiyaku ni kansuru hôritsu*, Law No. 78/1978, last amended by Law No. 152/2004.

51 H. MORII, Hypothec, in: KITAGAWA (ed.), Doing Business in Japan, Chapter 4.

In ordinary business practice, the subject matter of a hypothec is usually land, buildings, or a business establishment, including the equipment in factories. The hypothec extends to the immovable and all its fixtures (Art. 370 Civil Code). Accessories may be recognized as fixtures, if it is regarded as ordinary accessories.<sup>52</sup> The scope of secured claims include the principal, interest, default interest, the amount payable under a contractual penalty, if any, and the expenses necessary to exercise the rights of the hypothec. However, preferential satisfaction is limited to the interest and default interest accrued in the last two years (Art. 374 Civil Code).

A hypothec right may also be exercised against money which the hypothecator is entitled to receive from a third party by reason of sale or lease of the hypothecated immovable, and against insurance money which the hypothecator is entitled to receive as a result of damage to and destruction of the property by fire (Subrogation, Artt. 372, 304 Civil Code).

The hypothec contract is purely consensual and no special form is required, but in practice a written contract is used in order to clarify the agreement and to facilitate registration. The contract will specify the secured claim and the property which is the subject matter of the hypothec. Neither the registration of a hypothec (*Buchhypothek*) nor the issuance of a hypothec certificate (*Briefhypothek*) is legally required for a valid hypothec. The issuance of a hypothec certificate according to the Hypothec Security Law<sup>53</sup> may facilitate the trading of hypothecs. However, the registration is required to secure priority. If the hypothecator executes a similar contract with another obligee, the obligee who registers first will have priority over the other. Also, a preliminary registration to secure priority is available.

A hypothecary obligee may re-hypothecate his hypothec to secure another claim or may assign or waive his hypothec or its rank of priority for the benefit of another obligee of the same obligor (re-hypothec – *ten-teitô*) Art. 375 Civil Code). Re-hypothecation is used to facilitate financing among obligees of the same debtor.

A hypothec is enforced under the Civil Execution Act,<sup>54</sup> which covers both compulsory execution and auction for realization of security rights.

Since the procedure for a public auction is time-consuming – sometimes it takes two years – and often does not yield the real value of the property, agreements often provide that the hypothec obligee may dispose of the property at a reasonable price, at a reasonable time, and in a reasonable manner. An agreement may also provide that the ownership over the property will be transferred as a substitute for nonperformance. Such

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52 Supreme Court, 28 March 1969, 23 Minshû 699.

53 *Teitô shôken-hô*, Law No. 15/1931, as last amended by Law No. 29/2005.

54 *Minji shikkô-hô*, Law No. 4, 1979 as last amended by Law No. 154/2004.

agreements are called a contract for substitute performance with a suspensive condition (foreclosure agreements).<sup>55</sup>

An ordinary hypothec is inappropriate where financing transactions between the same parties are often repeated over a long period of time. The secured claims may alter, become extinct, or be replaced. The base hypothec<sup>56</sup> was developed to secure unspecified obligation rights up to a specified limit arising out of successive transactions. A base hypothec's most distinctive difference from an ordinary hypothec is that until the amount of the secured principal is determined, the scope of the obligation rights secured may be altered or the base hypothec disposed of without the disposal of the secured obligation rights.<sup>57</sup>

The contract for creation of a base hypothec must specify the hypothecated immovables, the maximum amount (*kyokudo-gaku*), and the scope of secured claims.

The base hypothec, which secures unspecified claims, becomes an ordinary hypothec securing the specific claim existing between them from the time of determination (*kakutei*). The principal secured by a base hypothec is determined when the agreed-upon date for determination arrives (Art. 398-19 para. 1 Civil Code) or earlier if one of the five conditions enumerated in Art. 399-20 Civil Code occurs. Where no date has been agreed, the base hypothecator may demand determination after three years.

Two or more hypothecs held over two or more immovables to secure a single claim are called joint hypothecs (*kyôdo teitô*, Art. 392 Civil Code).

### C. Pledge of Rights

A property right may be the object of a pledge (Artt. 342, 362 Civil Code).

A pledgee may directly collect the claim under the pledge (Art. 367 I Civil Code). In some cases Artt. 147 ff. Company Act regarding the pledge of share may be applied *mutatis mutandis*. The object of a pledge could be

- Trust beneficiary rights<sup>58</sup>
- Specific interest in a TMK (Art. 32 AML)
- Investment unit in an investment corporation (Art. 79 para. 4 ITICL, Art. 147 Company Act)
- Right to claim insurance payments
- Right to claim any penalty or damages
- Bank deposits<sup>59</sup>

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55 Different opinion T. HIGUCHI, Legal aspects of project finance in Japan, Japan Business Law Review, April 2006, 55: "Although legally possible it is not common practice."

56 Artt. 398-2 – 398-22 Civil Code. It went into effect on April 1, 1972.

57 It is similar to a "*Höchstbetragshypothek*" under German law but different from a "*Grundschuld*", since the dependency of the hypothec to the underlying claim cannot be eliminated.

58 FINANCIAL LAW BOARD, Effect of Pledge Established on Beneficial Interest in Trust, September 15, 2004, 2.

The requirements for the validity of a pledge of a claim is only an agreement between the parties without requiring the delivery of any instrument. However, if the claim is evidenced by a certificate, the delivery of the certificate shall be required in order to establish a pledge (Art. 363 Civil Code). In addition, in order to set up (perfect) the pledge of the claim versus the original debtor or third party, the original debtor or third party should either be notified or his consent shall be obtained (Art. 364 Civil Code). Where a non-bearer debenture is the object of a pledge, perfection is achieved by entering the creation of the pledge in the books of the company in accordance with the provisions relating to the transfer of the debenture (Art. 365 Civil Code). A pledge on a certificate in bearer form is perfected in many cases by delivery and continuous possession of the certificate due to the *mutatis mutandis* application of Art. 147 Company Act.<sup>60</sup>

#### D. Assignment of Rent Receivables

Assignment of rent receivables under the lease agreement of the real property is frequently used.

The Law Concerning Special Exceptions to the Requirements for the Perfection of Assignment of Receivables under the Civil Code<sup>61</sup> allows the substitution of the requirement of notification of the assignment to the debtor by registration of the assignment in the assignment register. Under an amendment of October 3, 2005, it is possible to perfect vis-à-vis third parties, through registration, the assignment of future claims against unspecified obligors, and it is possible to similarly perfect the collective security assignment of personal property other than real estate.<sup>62</sup>

Assignment of a security interest over a future right to receive money is not perfectly clear under Japanese law. Recent judicial decisions have established that a security interest can be granted over nearly seven years of future rights at the time the security interest is granted.<sup>63</sup> The contract regarding the assignment of future claims (*saiken jôto no yoyaku*) must specify the claims so as to make them distinguishable from all other claims of the creditor.<sup>64</sup>

For the perfection, it is sufficient to notify the debtor that the assignor shall be entitled to collect the assigned receivables in his own name and receive payment.<sup>65</sup>

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59 Not perfectly clear, T. HIGUCHI (*supra* note 55) 55.

60 FINANCIAL LAW BOARD (*supra* note 58) 4.

61 *Saiken jôto no taikô yôken ni kansuru minpô no tokurei-tô ni kansuru hôritsu*, Law No. 104/1998 as last amended by Law No. 87/2006.

62 K. KITAMURA, Perfection Law clears way for financing opportunities, Supplement – The IFLR guide to Japan 2006.

63 T. HIGUCHI (*supra* note 55) 55.

64 Supreme Court, 21 April 2000, Minshû 54 (4) 1562 reported in D. SCHÜSSLER-LANGEHEINE, ZJapanR / J.Japan.L 13 (2002) 283.

65 Supreme Court, 22 November 2001, Minshû 55 (6) 1056 reported in D. SCHÜSSLER-LANGEHEINE, ZJapanR / J.Japan.L 15 (2003) 280.

### E. Personal Guarantees

#### 1. Types of Guarantees

The most important are the guarantee (*hoshô*, Art. 446), the joint guarantee (*rentai hoshô*, Art. 456 Civil Code), and the joint and several obligation (*rentai saimu*, Art. 432 Civil Code). Sponsor letter and the guarantee on first demand are also used in business practice.

#### 2. Sponsor Letter

The obtainment of a sponsor letter of a principal investors (for example principal TK-investor) is a widely used practice.<sup>66</sup>

## VII. POSITION OF SECURED CREDITORS IN INSOLVENCY PROCEDURES

Japanese insolvency law includes two re-organization laws and two liquidation laws. Beside them, private arrangement procedures are often used. This section provides an overview of the existing insolvency laws and briefly explains the rights of secured creditors in each insolvency procedure.

### A. Laws with the Aim to Reorganize (Rehabilitate) a Business

#### 1. Corporate Reorganization under the Corporate Reorganization Law

The Corporate Reorganization Law<sup>67</sup> is aimed to reorganize large joint stock corporations (e.g., listed corporations). If a corporation is unable to make payments or is threatened with bankruptcy, it may file a petition for corporate reorganization. The court appoints a reorganization trustee who can administer the business as well as manage and dispose of the assets of the corporation. The reorganization trustee must prepare a reorganization plan, but debtor, creditors, or shareholders can also produce a plan. If a reorganization plan is accepted by special majority of several classes of creditors and approved by the court, the reorganization plan will be effective.

One of the characteristics of the corporate reorganization procedure is that the collateral covered by secured creditors is incorporated into the estate and the payment of secured debts is made under the reorganization plan. Accordingly, the secured creditor is prohibited from exercising and enforcing his or her rights outside such a procedure. Moreover, an insolvency officer can extinguish all security rights on secured properties by paying money equivalent to the value of the properties to the court in accordance with a judgment of the court (Art. 104 Corporate Reorganization Law).

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<sup>66</sup> K. ITO / F. SUGAHARA (*supra* note 47) 9.

<sup>67</sup> *Kaisha kôsei-hô*, Law No. 154/2002 as last amended by Law No. 10/2006. See H. HORIKOSHI, Japan's New Corporate Reorganization Law, *The International Lawyer* 38 (2004) 855-865.

## 2. *Civil Rehabilitation under the Civil Rehabilitation Law*

The civil rehabilitation procedure under the Civil Rehabilitation Law<sup>68</sup> is aimed to rehabilitate small and medium-sized companies under a simplified and often speedy process. The law allows a debtor to keep its operation as a “debtor in possession” (similar to the Chapter 11 of the U.S. Bankruptcy Code or the German “*Eigenverwaltung*”) unless a trustee is appointed by the court. Under the law, if a bankruptcy occurs, the debtor may file a petition to start the civil rehabilitation procedure. The debtor shall prepare a civil rehabilitation plan under control of a court-appointed supervisor. Civil rehabilitation plans may be approved by the majority of rehabilitation creditors attending a creditors’ meeting where the creditors holding the majority of the rehabilitation claims are present.

A secured creditor may enforce its security interest in collateral separately (Art. 53 para. 2 Civil Rehabilitation Law). However, the rehabilitation debtor or the trustee can extinguish all security rights on secured properties by paying money equivalent to the value of the properties to the court in accordance with a judgment of the court (Art. 148 Civil Rehabilitation Law)<sup>69</sup>.

### B. *Laws with the Aim to Liquidate the Insolvent Business*

#### 1. *Bankruptcy under the Bankruptcy Law*

Upon occurrence of a bankruptcy<sup>70</sup> (e.g., suspension of payment but not over-indebtedness as in German law), either the creditor or the debtor may file a petition of bankruptcy with a court. A bankruptcy trustee is appointed by the court upon adjudication of bankruptcy. The bankruptcy trustee can dispose of all the debtor’s estate and distribute the proceeds to creditors equally. Collateral covered by security interests is not included in the estate for bankruptcy purposes. Upon completion of the bankruptcy procedure, the bankrupt company is dissolved and liquidated.

Secured creditors may enforce their security interests in collateral outside the bankruptcy procedure (Art. 65 Bankruptcy Law), with the exceptions that (1) the bankruptcy trustee can commence the procedure of compulsory execution of the secured properties (Art. 184 Bankruptcy Law); and (2) where the secured creditor has the right to dispose of secured properties outside the regulated compulsory execution, the period of exercising of such right is restricted by the order of the court (Art. 185 Bankruptcy Law).

In addition, the bankruptcy trustee can extinguish a secured right on properties and enter some part of the money received by the disposal of such properties into the bankruptcy estate in accordance with a court’s judgment, and the secured creditor will be

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68 *Minji saisei-hô*, Law No. 225/1999, last amended by Law No. 84/2006.

69 For details, see S. STEELE, Too Hot to Handle: Extinguishing Secured Creditors’ Interest in Insolvency under Japan’s Civil Rehabilitation Law, *ZJapanR / J.Japan.L.* 16 (2003) 223, 230.

70 *Hasan-hô*, Law No. 75/2004 as last amended by Law No. 84/2006.

subject to such procedure unless it enforces the secured right by itself or offers to purchase the secured properties at a price which is more than 5% higher than the price set in such a procedure (Artt. 186-191 Bankruptcy Law).

## 2. *Special Liquidation under the Company Act*

A joint stock corporation that went into liquidation pursuant to Art. 475 Company Act<sup>71</sup> (liquidating joint stock corporation) may be liquidated by using the special liquidation process if the court deems that circumstances exist which would seriously impede the carrying out of the liquidation, or that there is the suspicion of insolvency (insufficient assets to fully discharge its obligations), and upon application of a creditor, liquidator, auditor, or shareholder may order the special liquidation. Contrary to the regular liquidation process, the procedure must be supervised by the court. Compared to the bankruptcy procedure, the special liquidation follows a simplified process.

After the petition for special liquidation has been filed, the concerned parties may file a separate petition for the court to order measures of preservation of the corporation's assets. Once the procedure has started, executions, garnishment actions, and provisional injunctions, etc. are prohibited or must cease. Although secured creditors may enforce their collateral security interest outside the procedure, the court may order an end to the enforcement of security rights for a reasonable period if it is in the interest of creditors in general and is unlikely to cause any reasonable damage to any applicant for public auction (Art. 516 Company Act).

In practice, the special liquidation is often used by parent companies to liquidate insolvent affiliations, because of tax advantages, and because it is less harmful for the reputation of the parent company than a bankruptcy procedure.

## C. *Private Arrangement Procedures (Out-of-Court Workouts)*

The private arrangement procedure is used for both liquidation and rehabilitation cases.

The advantages over the statutory procedures are that the private arrangement procedure can be started earlier since there are no requirements for commencement. This might help to minimize the possible damage of an insolvency. It might be speedier since the creditors themselves agree on how best to proceed instead of following rigid provisions on due process. Private arrangement procedures allow for confidentiality since it does not need to be published in the official gazette. Private arrangements can only be made by certain kinds of creditors with the exclusion of other creditors if they agree. There are no court costs or trustee fees payable, so private arrangement procedures are cost efficient.

The disadvantages can be uncertainty that the necessary information (including the debtor's assets) will be disclosed or that the procedure will be monitored. There is no

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71 *Tokubetsu seisan*, Artt. 510 *et seq.* Company Act.



guarantee of impartiality of the chairperson(s) in the procedure. The legal effect of a private arrangement is limited to the parties only and does not extend to other right holders who might oppose the arrangement.

Guidelines on Private Arrangements were issued on September 19, 2001, by a study group whose main members are the Japanese Bankers Association and the Japanese Business Federation (*Nippon Keidanren*). In February 2003, METI published "Guidelines for the Early Revitalization of Business" that were designed to help distressed companies start the processes of revitalizing their businesses faster with earlier timing.

#### VIII. OUTLOOK: FROM SECURITY EXCHANGE LAW TO FINANCIAL INSTRUMENTS AND EXCHANGE LAW

Laws to amend the Security Exchange Law were promulgated on June 14<sup>72</sup> and December 15, 2006.<sup>73</sup> The relevant provisions regarding the legal framework for investment services will foreseeably come into effect at a date to be designated by cabinet order, not exceeding 18 months after the promulgation (by December 13, 2007). The name of the Security and Exchange Law will change to "Financial Instruments and Exchange Law (FIEL)." Major points of change for investment services are<sup>74</sup>:

- It abolishes four laws, including the Financial Futures Trading Law, the Law Concerning Foreign Securities Firms, Law Concerning the Regulation of Investment Advisory Services Relating to Securities, and the Law Concerning the Regulation of Mortgage Business, to be consolidated into the FIEL.
- Eighty-nine laws will be amended in total, some parts of which will be consolidated into the FIEL.
- The legal name for a firm subject to regulation in the FIEL, such as securities firms, financial futures trading firms, commodity funds sales firms, trust beneficiary rights sales firms, investment advisory firms, investment trust management firms, etc. will be changed to "financial instruments firm," and the name for an exchange, including stock exchanges and financial futures exchanges, will be changed to "financial instruments exchange."<sup>75</sup>

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72 *Shôken torihiki-tô no ichibu o kaisei suru hôritsu* [Law for the Reform of Securities Trade and other related Laws] Law No. 65/2006. *Shôken torihiki-tô no ichibu o kaisei suru hôritsu shikô ni tomonau kankei hôritsu no seibi-tô ni kansuru hôritsu* [Accompanying Law for the Implementation, etc. of Regulations to the Law for the Reform of Securities Trade and other related Laws] Law No. 66/2006. Partly effective.

73 Law No. 109/2006. For the amendment of the Trust Law, see *supra* note 40.

74 See FINANCIAL SERVICES AGENCY (FSA), New Legislative Framework for Investor Protection, September 2006.

75 However, existing firms or exchanges may continue with names such as "securities firm" or "stock exchange," etc.

- The scope of “securities” will be expanded in the FIEL (Art. 2 para. 1 and 2). For example, all interests in trusts will be deemed as securities, and interests in collective investment schemes will be comprehensively positioned as securities.
- The scope of “derivatives trading” will be expanded in the FIEL (Art. 2 XX). For example, interests in trusts in general, interests in collective investment schemes and various transactions on a wide range of assets and indexes will be covered in the FIEL.
- For interests in collective investment schemes, “sales and solicitation” by the members of the scheme (so-called self-offering), will also be subject to regulation. In addition, it is clearly stated that the management of properties for investment purposes in collective investment schemes (so-called self-management) will be subject to regulation.
- More flexible rules for entry into the financial instruments businesses according to the type of business.
- New rules of conduct (rules for sales and solicitation) for financial instruments firms.
- Differentiation between professional investors and general investors.
- Amendments of various statutes, such as RESJBL, etc. regarding “sales and solicitation” provisions for transactions with strong investment characteristics.
- Reorganization of other systems for user protection, especially enhancing the Financial Products Services Law to facilitate the filing of claims for damages, etc.
- Establishing Certified Investor Protection Organizations.

Investor protection will improve the quality of the capital markets and further stimulate investment activities in Japan.

## ZUSAMMENFASSUNG

*Vor dem Hintergrund anhaltender wirtschaftlicher Erholung und niedriger Zinsen leben die japanischen Immobilienmärkte derzeit wieder auf. Grundstücke und darauf errichtete Gebäude sind rechtlich zu unterscheiden. Daher erfolgt herkömmlicherweise auch die Preisermittlung getrennt. Grundstückspreise wurden bisher durch Marktvergleich auf der Grundlage von Grundstückspreisindizes bestimmt, die von der Regierung herausgegeben werden. Neuerdings beginnt man jedoch, Grundstückspreise durch die zu erwartenden Erträge des Grundstücks und der darauf errichteten Gebäude ganzheitlich zu bewerten. Auf dieser Grundlage erfolgt die Finanzierung ohne Rückgriff auf den ursprünglichen Eigentümer der Immobilien.*

*Investitionen von Ausländern unterliegen keinen besonderen Beschränkungen. Enteignung setzt ein spezielles Bedürfnis voraus und ist zu entschädigen. Die Verfassung garantiert das Eigentum als ein Menschenrecht. Seit kurzer Zeit haben sog. private financing initiative Projekte (PFI), bei denen es um den Einsatz von privatem Kapital für öffentliche Einrichtungen nach dem PFI-Gesetz geht, an Bedeutung gewonnen.*

*Es existiert kein Gesetz, das die Regulierung von Immobilienfonds umfassend regelt. Private Immobilienfonds werden oft als Partnerschaften oder als stille Gesellschaften aufgelegt. Die Anforderungen und Beschränkungen des Immobilien-Joint-Venture-Gesetzes können umgangen werden, wenn die Immobilien einem Treuhänder übereignet werden. Immer wenn der Gegenstand des Fondsvermögens ein bebaubares Grundstück oder ein Gebäude ist, ist das vorgenannte Gesetz anwendbar, und ein spezieller Anlegerschutz und staatliche Aufsicht greifen ein.*

*Öffentlich angebotene Anlagen werden regelmäßig nach dem Gesetz über Anlagetrusts und Anlagegesellschaften (ITICL) vertrieben. Anlagetrusts werden nach Vertragstyp und Gesellschaftstyp unterschieden. Dabei hat der Anleger gegenüber dem Träger des Fonds nur teilweise ein Weisungsrecht. J-REITs können entweder als offene oder als geschlossene Fonds errichtet werden. Börsennotierte J-REITs verwenden in der Regel eine geschlossene Anlagegesellschaft; der Artikel nimmt daher die geschlossenen Anlagegesellschaft nach dem ITICL in den Blick.*

*Bei allen Strukturen werden regelmäßig Treuhandformen verwendet. Der Artikel stellt kurz die Inhalte des Treuhandgesetzes und des Gesetzes über das Treuhandgeschäft dar.*

*Die Verbriefung von Immobilienrechten erfolgt, um den Anlegern größere Liquidität zu sichern. Der ursprüngliche Eigentümer der Immobilien überträgt diese an eine Zweckgesellschaft. Dadurch können den Anlegern statt Rechten an den Immobilien Finanzprodukte mit besseren Liquiditätsmerkmalen angeboten werden. Die wichtigsten Voraussetzungen der Verbriefung von Immobilienrechten sind die Konkursfestigkeit und die steuerliche Transparenz oder Abzugsfähigkeit solcher Gestaltungen.*

*Es existieren zwei Formen von Verbriefungsvehikeln: vertrags- und gesellschaftsbasierte Vehikel. In der Praxis ist vor allem die japanische special purpose company nach dem Gesetz über Liquidierung von Vermögen von ausschlaggebender Bedeutung.*

*Als Muttergesellschaft der special purpose company wird oft eine Cayman limited company mit wohltätigem Trust oder, seit jüngster Zeit, eine Zwischengesellschaft nach japanischem Recht verwendet. Daneben wird derzeit die Nutzung von gemeinnützigen Gesellschaften diskutiert.*

*Typische Kreditsicherheiten sind Pfandrechte, Sicherheitsabtretungen, Hypotheken, Gesamtbetragshypotheken, vorläufige Registrierung und persönliche Garantien. Allerdings werden Hypotheken bei Immobilienfinanzierungen kaum verwendet.*

*Das gesetzte Recht schützt die Position des gesicherten Kreditgebers bei Insolvenzverfahren in gewissem Umfang. Daneben oder anstelle der vier Insolvenzgesetze sind außergerichtliche Umschuldungsverhandlungen üblich.*

*Schließlich gibt der Artikel einen Ausblick auf das neue Gesetz über den Handel mit Finanzinstrumenten, welches das Gesetz über den Wertpapierhandel ablöst und voraussichtlich bis zum 13. Dezember 2007 vollständig in Kraft treten wird. Die Änderungen beinhalten wichtige Punkte in Bezug auf Investitionsdienstleistungen, wie z.B. die Verbesserung des Anlegerschutzes. Der Autor kommt zu dem Schluß, daß das neue Gesetz die Qualität der Kapitalmärkte verbessern wird und daß dadurch die Anlagen in Finanzinstrumenten in Japan weiter gefördert werden.*