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Securitisation in Japan

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In Japan, the assets to be securitised are most commonly receivables and real estate; therefore, this chapter focuses principally on the securitisation of real estate and receivables. The securitisation of other asset classes (eg, whole businesses, IP and inventory assets) has some precedent, but securitisation transactions for these classes of asset are not yet common in Japan. However, the principles introduced in this chapter are also applicable to the securitisation of those asset classes.

A number of issues that must frequently be considered in securitisation transactions in Japan are also applicable to asset securitisation transactions. An originator that needs financing transfers its assets to a special purpose entity (SPE), which in Japan will be a trust or a special purpose company. The SPE raises funds either from the capital markets by issuing debt securities or preferred shares, or through loans from banks. The SPE pays the sales price to the originator from the proceeds from the debt securities issuance or the loans. The originator obtains its financing in the form of sales proceeds instead of issuing debt or equity securities or borrowing from banks.

True sale

Since investors in securities and banks extending credit to an SPE rely principally on the cash flow generated from the assets to be transferred, the risks associated with the originator's business (particularly the bankruptcy risk) must be isolated or removed from the transferred assets. For this reason, the transfer of the assets from the originator to the SPE must be a 'true sale', meaning that the asset transfer would not be regarded as a secured transaction in the event that the originator went bankrupt. If, despite the securitisation transaction, the ownership title to the transferred assets is considered to belong to the originator, such assets (including the cash flow

generated therefrom) would be subject to the originator's insolvency proceedings, meaning that the assets ostensibly transferred to the SPE would be used to pay the debts of the originator. In such an event, even if the SPE were to be treated as a secured creditor, the timely and sufficient payment of the SPE's securities and loans would be adversely affected.

In Japan, there are four principal insolvency laws:

- the Bankruptcy Law;
- the Civil Rehabilitation Law;
- the Corporate Reorganisation Law; and
- the provisions of the Company Law relating to special liquidation procedures (effective May 1 2006).

A secured creditor may collect and receive payments on obligations that are owed to it by the debtor outside the insolvency proceedings under such laws, except for proceedings under the Corporate Reorganisation Law. Although the power to negate security interests is granted to a bankruptcy trustee in proceedings under either the Bankruptcy Law or the Civil Rehabilitation Law, there are certain restrictions on the exercise of such power. For example, a bankruptcy trustee may exercise its right to negate a security interest only if the bankruptcy trustee (with the court's approval) considers that a private sale of the assets subject to the security interest without any encumbrance would be in the best interest of the creditors under the Bankruptcy Law. The Corporate Reorganisation Law is applicable only to *kabushiki kaisha* (a Japanese joint stock corporation), one of the four types of company allowed under the Company Law. Provided that the originator is not a *kabushiki kaisha*, the true sale issue is not a serious problem in asset securitisation transactions.

Avoidance power

If an originator transfers its assets to an SPE while it is insolvent, the bankruptcy trustee may declare void such transfer in the event that the originator goes bankrupt.

In 2004 a revised Bankruptcy Law was enacted and the Civil Rehabilitation Law and Corporate Reorganisation Law were amended accordingly. Under these amended laws a sale of real estate by the debtor at a fair market price is not subject to the avoidance power of the bankruptcy trustee unless the debtor concealed the proceeds of the sale or provided them as a gift to another person. This new provision gives practitioners more comfort regarding the possibility of protecting the transfer of real estate to the SPE from the trustee's avoidance power.

If an originator transfers its assets to an SPE after the originator becomes insolvent, the transfer of assets from the originator to the SPE would be regarded as a fraudulent conveyance under the Civil Code, provided that the originator had the intent to jeopardise the position of its creditors and the SPE knew this at the time of transfer. In the event of a fraudulent conveyance, the transfer of assets from the originator to the SPE will be voided by creditors of the originator as well as by the avoidance power of the bankruptcy trustee.

Executory contract

An executory contract is a contract, the obligations under which are not fully performed or paid at an applicable time (eg, the time of filing of a bankruptcy petition). An executory contract may be terminated by a bankruptcy trustee under the Bankruptcy Law, the Civil Rehabilitation Law or the Corporate Reorganisation Law.

The status of an executory contract frequently becomes an issue when lease receivables are securitised. Although the right to receive rent may be transferred to an SPE, the lease contract itself stays in place between the originator and the lessee. The usual lease contract is regarded as an executory contract because at the applicable time the lessee has not fully paid all the rent for the entire lease term and the lessor may not lease the property to a third party until the term of the lease expires. Therefore, if a lessor that is the originator of lease receivables goes bankrupt, the bankruptcy trustee of the lessor may terminate the lease contract that generates rents. The bankruptcy

trustee may consider it advantageous to the bankrupt estate to terminate the lease agreement and lease the property to a third party or execute a new lease agreement with the same lessee. In such event, the lessee will stop payment of the lease rents.

In 1995 the Supreme Court of Japan held that a full payout financial lease, in which the residual value of the leased property will be zero at the maturity of the lease term, should be treated as a financial transaction rather than as a normal lease contract. In accordance with this decision, a full payout financial lease would not be an executory contract.

Bankruptcy remoteness

In a securitisation transaction the SPE needs to be bankruptcy remote, which means that the structure of the SPE prevents it from going bankrupt. The rationale for this is that, if the SPE goes bankrupt, the investors and banks, as creditors of the SPE, will be adversely affected. For this reason, the SPE needs to be a trust or a special purpose company, the shares of which are held in a charitable trust.

Under the amended Bankruptcy Law passed by the Diet on December 8 2006, in order to achieve coordination with the amended Trust Law that was also passed on that day, trust assets will be subject to the bankruptcy procedure if they become insufficient to pay the debts of the trust or if liabilities incurred in the trust accounts exceed the assets therein. For securitisation purposes, this amendment should not have an adverse effect because the bankruptcy procedure would apply only if the assets in the trust became insufficient to pay the debts of the trust, while financing extended to the SPE is based on the value of the assets in the trust so that such assets should be sufficient.

There are several ways to support the bankruptcy remoteness of a trust, including the use of a limited liability trust, which is newly recognised under the amended Trust Law and in which the creditor to the trust account has recourse only to the assets in the trust. In addition, contractual provisions (eg, non-petition clauses and undertakings from specified

persons not to file a petition of bankruptcy against the trust) may be used in various applicable agreements and documents.

In the case of a special purpose company, such a company incorporated in the Cayman Islands, where charitable trusts are available, is typically used as the SPE. If a Japanese special purpose company is used, the ordinary shares in it are commonly held by a Cayman special purpose company, and the shares in that company are held in a Cayman charitable trust. As an alternative to a Cayman special purpose company, a trust without beneficiary (allowed under the amended Trust Law) may be used to hold the ordinary shares of the Japanese special purpose company. As the ordinary shares of the Japanese special purpose company are held by such a trust without beneficiary, effectively no party could have control over the Japanese special purpose company.

In 2002 the *chukan hojin*, a non-profit company that does not serve the public interest, became available under Japanese law. In the case of such a non-profit company, the person who contributes capital to the company may be different from the person who controls the company. If an originator needing financing contributes to the capital of such company, an independent person (eg, a certified public accountant, tax attorney or lawyer) has control over the *chukan hojin* and the ordinary shares of the Japanese special purpose company are held by this *chukan hojin*, the bankruptcy remoteness of the special purpose company will be effectively achieved. At present, rating agencies in Japan allow structures using the *chukan hojin*. On May 26 2006, however, new legislation to abolish the *chukan hojin* passed the Diet and the newly created *ippann shadan hojin* (general aggregate corporation) is expected to replace the *chukan hojin*.

To support the bankruptcy remoteness of a special purpose company, contractual provisions such as non-petition clauses, undertakings from specified persons not to file a petition of bankruptcy against the special purpose company and limited recourse clauses are used in various applicable agreements and documents.

Perfection

The transfer of the assets to an SPE needs to be perfected in order to be effective against third parties, including the bankruptcy trustee. In the case of receivables, perfection can be achieved in two different ways:

- notice to or consent from the obligor with date certification under the Civil Code; and
- filing by the transferor and transferee of certain information about the receivables with the government under the Perfection Law.

For an originator that does not want the obligors to learn about the securitisation transaction, filing is useful, and this technique is more commonly used. Under the filing system, if the SPE as assignee wishes to transfer the monetary obligations in a manner effective against the obligors in the future (eg, at the time the originator goes bankrupt), it is necessary to send to the obligors the certificate of filing, which can be issued at the request of the assignee under the Perfection Law.

In the case of real estate, registration is the only way to perfect the transfer of title.

Servicer or asset manager

Since an SPE does not typically have any employees who can manage its business, it needs to outsource the collection of monetary obligations or real estate leases.

Under the Attorney Law, a person who collects monetary obligations on behalf of another must be a licensed attorney. It is considered that the originator itself may collect monetary obligations, because in some respects it can be said that in the ordinary course of business the originator collects the obligations owed to it. This is particularly true in the event that the filing is used for perfection, since the obligation still belongs to the originator from the obligor's perspective. For this reason, until the originator goes bankrupt it is usually appointed as the servicer.

Under the Servicer Law, which was enacted in 1998, a servicer approved by the government may also engage

in the business of collecting certain monetary obligations (eg, bank and non-bank loans and lease receivables).

The most substantial risk associated with the servicer is the commingling risk. Under Japanese law, cash is considered to be the property of the person who possesses it. If the servicer goes bankrupt while possessing collected money, this money will be subject to the insolvency proceedings of the servicer and may be used to satisfy the obligations of the servicer. In many cases the originator acts as the servicer. To mitigate the commingling risk of such events, it is typical to require that the collected money be frequently transferred to the SPE (eg, once every three months). In addition, the transaction structures frequently require the cash equivalent of three months' cash flow to be held by the SPE.

Before September 2007 only certain types of beneficial interest were regarded as securities under the Securities and Exchange Law of Japan. However, after September 2007, when the Financial Instruments and Exchange Law replaced the Securities and Exchange Law, any beneficial interests came to be regarded as securities. Accordingly, any person who provides advice on the values of the beneficial interests (eg, the asset manager to the SPE which holds the beneficial interest) must be registered as an investment adviser under the Financial Instruments and Exchange Law. If the asset manager not only provides advice to the SPE but also makes investment decisions (ie, a decision to purchase or sell a beneficial interest at a certain price and time and using a certain method) on behalf of the SPE, then the asset manager needs to be registered as an investment manager.

Once the asset manager is registered as an investment adviser or investment manager, such asset manager may not act for the SPE to borrow money from a bank in respect of any transaction in respect of which the asset manager gives advice or makes the investment decision unless the SPE is regarded as a professional investor.

Any person who commercially sells, purchases, exchanges or becomes the broker or agent of another

person for the sale, purchase, exchange or lease of land for residence or building must be licensed by the Japanese government as a residential land and building dealer under the Residential Land and Building Dealing Business Law. An asset manager acting as a broker or agent for the SPE in carrying out such an act must be licensed as such a dealer. Although the effectiveness of a securitisation transaction would not be affected by a failure by the asset manager to obtain a licence as a residential land and building dealer, the asset manager could be subject to criminal penalties.

Structures of asset securitisations in Japan

Trust structures

There are several reasons why the trust structure is often used to achieve bankruptcy remoteness in asset securitisation transactions in Japan.

Beneficial interest structure

This structure is widely used for receivables securitisation transactions in Japan. Under this structure the originator entrusts the assets (receivables or real estate) to a trustee. In return, the trustee issues the beneficial interest to the originator. This beneficial interest is evidenced by one or more beneficial interest certificates. In many transactions the beneficial interest is divided into several classes and the originator holds the most subordinated portion. The originator sells the preferred portion of the beneficial interests to the investors. If the subordinated portion is fairly large, the transfer of the receivables and beneficial interest may impair the qualification of the transaction as a true sale of the assets. There is no authority with respect to the percentage of the subordinated portion that would jeopardise the true sale treatment. If, however, this percentage is more than 40 per cent, some additional measure or step to protect a true sale treatment is advisable.

In this type of structure the originator, arranger or asset manager needs to take precautions no matter whether a licence to conduct financial instruments business is required, because under the Financial Instruments and Exchange Law beneficial interests are

regarded as securities so that any person who purchases or sells for its own account, or represents a customer or acts on behalf of a customer in purchasing or selling beneficial interests, is regarded as engaging in financial instruments business, and any person who conducts financial instruments business needs to be registered. Although the effectiveness of a securitisation transaction is not affected by failure to obtain such registration, the person failing to obtain such registration could be subject to criminal penalties.

Loan and redemption structure

This structure is sometimes used for receivables securitisation transactions in Japan. In this structure the originator entrusts the assets (receivables or real estate) to a trustee. In return, the trustee issues beneficial interests to the originator. The trustee then borrows money from the investors or banks and holds them in the trust account. A substantial portion of the beneficial interests held by the originator is redeemed out of the loan proceeds on or shortly after drawdown, thereby providing the originator with the desired funds.

Since the Trust Law allows a beneficiary who is the sole and insolvent beneficiary of a trust to request the court to terminate a trust, it is typical in this structure to provide for the issuance of two beneficial interests, one having a large and the other having a small denomination. The large denomination is held by the originator and the other is held by the bankruptcy-remote SPE.

Special purpose company structure

In a special purpose company structure, the originator transfers the assets to the special purpose company. The special purpose company then issues debt securities or preferred shares or borrows from banks to get financing to pay the sales price to the originator. For special purpose companies in Japan, the *tokutei mokuteki kaisha* and a Cayman company are often used.

When the special purpose company issues bonds or notes, the withholding tax on the interest payments will be exempted if the bonds or notes are recorded or issued in a book-entry system and the bonds or notes

are held by certain qualified financial institutions. Another withholding exemption is available to the non-resident holders of the bonds or notes.

If the structure provides for the bonds or notes to be secured by the assets held by the special purpose company, it is necessary to comply with the Secured Bond Law. Under this law a licensed secured bond trustee must be appointed and the security interest used in the structure must be one of the types prescribed in the Secured Bond Law. Secured bonds or notes that are not issued in compliance with the Secured Bond Law will be invalid, meaning that they would not survive as unsecured bonds or notes.

In practice, in order to address this restriction, sometimes the subscriber of the bonds also becomes the guarantor of the bonds. The right to have recourse to the special purpose company as issuer of the bonds or notes, rather than the bonds or notes themselves, is then secured by the assets held by the special purpose company. However, the validity of this guarantee structure is uncertain.

Tokutei mokuteki kaisha

The Asset Securitisation Law recognises a special type of company called a *tokutei mokuteki kaisha*, which has characteristics designed to be useful in asset securitisation transactions. The Asset Securitisation Law allows certain protective measures for the debt and equity investors. However, in order to start an asset securitisation transaction under the Asset Securitisation Law, a report of the asset securitisation transaction and the asset securitisation plan must be filed with the Japanese government before the transaction is entered into. From May 1 2006 it has been possible to establish a *tokutei mokuteki kaisha* with a stated capital of ¥1.

Beneficial interest structure

Under this structure the originator first entrusts the assets and in return receives the beneficial interest in such trust. The originator then transfers the beneficial interest to the *tokutei mokuteki kaisha*. The *tokutei mokuteki kaisha* then issues bonds or preferred shares or

borrows from a bank in order to pay the purchase price for such beneficial interest.

This trust structure is frequently used in real estate securitisation transactions in Japan because through its use the real estate acquisition tax is exempted and a lower registration tax is imposed on the person who registers the transfer or other disposition of land and buildings. Another reason for the use of the trust structure is that, when the *tokutei mokuteki kaisha* is used, the assets held by the *tokutei mokuteki kaisha* must be managed by a trust company or other person allowed by law. If the asset transferred to the *tokutei mokuteki kaisha* is a beneficial interest, however, this requirement is inapplicable.

Recently the Japanese regulatory authority penalised a Japanese trust bank for accepting the entrustment of real estate that did not meet the legal requirements, on the grounds that the Japanese trust bank as the trustee did not satisfy its duty of care as a licensed trust bank. The trust bank ceased operating its trust business in Japan. As a result, many trust banks and trust companies are hesitant to accept the entrustment of real estate parcels that may not comply with the applicable laws of Japan, and it now takes longer for a trust bank or trust company invited to participate in a transaction to indicate whether it will accept the entrustment.

Direct acquisition structure

Under this structure the originator transfers title to the applicable assets directly to the *tokutei mokuteki kaisha*. The *tokutei mokuteki kaisha* then issues bonds or preferred shares or borrows from a bank to pay the purchase price for such title.

This structure is not widely used in Japan because, as is the case in structures where the *tokutei mokuteki kaisha* is used, the assets held by the *tokutei mokuteki kaisha* must be managed by the trust company or another person allowed by law.

Foreign company (Cayman) structure

A Cayman company is often used in securitisation structures to achieve bankruptcy remoteness. In such

structures a Japanese branch of a Cayman special purpose company is usually established in order to enable settlement of money within Japan.

Beneficial interest structure

Under this type of structure the originator first entrusts the assets and in return receives the beneficial interest. The originator transfers the beneficial interest to the Cayman special purpose company. The Cayman special purpose company then issues bonds or preferred shares or borrows from a bank in order to pay the purchase price for such beneficial interest.

Direct acquisition structure

Under this structure the originator transfers the assets directly to the Cayman company. The Cayman company then issues bonds or preferred shares or borrows money from the bank in order to pay the purchase price for such assets.

Godo kaisha/tokumei kumiai structure

This type of structure is often used in real estate securitisation transactions. In this structure the originator entrusts the real estate and in return receives the beneficial interest. The originator transfers the beneficial interest to a *godo kaisha*, a type of limited liability company used as a closed company, as the Japanese special purpose company. The *godo kaisha* raises money from the equity investors by entering into a *tokumei kumiai* (an anonymous partnership agreement) and usually borrows money from a bank in order to obtain debt financing. The *godo kaisha* pays the money raised to the originator as the purchase price for the real estate.

From May 1 2006, as a result of the enactment of the new Company Law, the minimum capital requirements for all types of company were abolished; a *godo kaisha* may now be established with a stated capital of ¥1.

Choosing the right structure

One reason to use a *godo kaisha* as the Japanese special purpose company is that the Corporate Reorganisation

Law is not applicable to such structures, so if a creditor of the *godo kaisha* is secured by assets held by the *godo kaisha*, the lender to the *godo kaisha* need not be concerned about the bankruptcy risk.

However, a trust structure should be used to avoid the possible application of the Real Estate Common Business Law. This law requires any person that commercially distributes the profits from real estate transactions in accordance with the provisions of a *tokumei kumiai* or partnership agreement to be licensed as a person conducting real estate common business. It also requires that the Japanese government approve the terms and conditions of the *tokumei kumiai* or partnership agreement. If a trust structure is used, the Real Estate Common Business Law will not apply.

Equity investors in a *tokumei kumiai* have only limited liability and their share of the profit and loss arising from the *tokumei kumiai* is regarded as the investors' profit and loss. Therefore, the profits from the *tokumei kumiai* will pass directly to the investors without any corporate tax deduction.

Under the Financial Instruments and Exchange Law, certain types of partnership interest in a *tokumei kumiai* are regarded as securities, so that any person who purchases or sells for its own account, or represents a customer or acts on behalf of a customer in purchasing or selling partnership interests in a *tokumei kumiai*, is regarded as engaging in financial instruments business, and any person who conducts financial instruments business needs to be registered.

Recent development of securitisation-related laws

In addition to the changes in the laws affecting securities transactions discussed above, the following changes should be noted.

Perfection Law amendment

The Perfection Law was amended in 2005. The law allows perfection of a transfer and pledge of receivables owned by a corporation by means of a filing with the Japanese government and without the need to notify or obtain consent from the obligors.

As a result of the amendment, both the transfer or pledge of monetary claims and the transfer and pledge of personal property may be perfected by such filing. This amendment allows the securitisation of inventory or receivables secured by personal property.

For the transfer of receivables arising in the future, certain matters otherwise required to be filed may be omitted so that, for example, a transfer of the receivables arising from a sales transaction that will be entered into between the originator and the obligor at some future point can also be perfected.

New bond in book entry system

The Bond Transfer Law was enacted in 2003 but the transfer system did not come into effect until January 10 2006. The bond in recording system (which is the former bond in book entry system) was abolished in January 2008. After January 6 2008 only those bonds issued in the new transfer system are exempt from withholding tax.

Company Law amendment

The new Company Law was enacted on July 26 2005 and became effective on May 1 2006.

The *yugen kaisha*, which was often used as a Japanese special purpose company in securitisation transactions because of its less onerous capital requirement (¥3 million) at that time and the inapplicability thereto of the Corporate Reorganisation Law, has not been in use by new companies since April 30 2006, and since that date a pre-existing *yugen kaisha* has been treated as if it were incorporated as a *kabushiki kaisha*. As a result, the Corporate Reorganisation Law became applicable to any existing SPC in the form of *yugen kaisha* after May 1 2006. As a result, now, instead of a *yugen kaisha*, a *godo kaisha*, the Japanese version of a limited liability company, is used as a Japanese SPC.

Also effective as of May 1 2006, the minimum capital requirement for every type of company was abolished. Further, from that date the organisation of a *kabushiki kaisha* may be simplified. For example, a company with one director is permitted. In addition, the law requiring inspection by a person appointed by the court in the event that a *kabushiki kaisha* acquires, within two years of its inception, any assets that existed before the organisation of the *kabushiki kaisha* and uses these in company business has been repealed effective from May 1 2006.

Trust Law amendment

An amendment to the Trust Law became effective on September 30 2007. The amendment recognises a new form of limited liability trust such that the trustee has limited liability to any third party that enters into an agreement with the trustee regarding the trust account. Before this amendment, such limited liability was achieved through limited recourse provisions in the agreement.

In addition, the amendment allows for a type of trust that does not have a beneficiary (often referred to as a purpose trust). This type of trust is expected to be used as a holding vehicle for special purpose companies.

Financial Instruments and Exchange Law

The Financial Instruments and Exchange Law, which became effective on September 30 2007, amended the Securities and Exchange Law and consolidated the Foreign Security Firms Law, part of the Investment Trust Law and the Investment Advisory Law with the amended Securities and Exchange Law. All types of beneficial interest are deemed to be securities under the Financial Instruments and Exchange Law.

The author wishes to acknowledge the contribution of John C Roebuck of Jones Day, Tokyo in the preparation of this chapter.