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# THE LENDING AND SECURED FINANCE REVIEW

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EDITOR  
AZADEH NASSIRI

LAW BUSINESS RESEARCH

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# EDITOR'S PREFACE

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This first edition of *The Lending and Secured Finance Review* comes on the heels of a strong few years for the loan markets. During this period, despite some volatility and bumps in the road, lending conditions have generally continued to improve against a backdrop of greater economic stability and the return of M&A activity in Europe and globally.

It is difficult to ignore, however, that there has been a significant change in the way corporates access funding since the financial crisis and that diversification of financing sources (both in terms of products and markets) has been a key global trend for corporate treasurers. Unable to rely to the same extent as previously on their relationship lenders, and with liquidity in the European loan markets constrained, many corporate treasurers turned to the debt capital markets in the aftermath of the financial crisis and, in particular, the US high-yield and private placement markets. This trend has continued, driven in part by new regulatory reforms increasing capital requirements for banks, as well as new industry regulations and guidance impacting the leverage multiples that some banks are able to offer.

Nonetheless, loans (secured and unsecured) remain the predominant source of funding for corporates globally. While traditional banks still play an important and active role in the loan markets and remain dominant in the investment grade market, in other sectors (particularly in the leveraged, real estate and infrastructure finance markets) institutional investors, many of whom also participate in the debt capital markets, are more prominent. The last few years have also seen the rise of alternative finance providers such as direct lending funds, particularly in the mid-market.

The combination of the competition from these alternative finance providers and the high-yield market, the willingness of US investors to invest in European assets and the convergence of the European and US markets more generally, especially in the leveraged space, has resulted in a crossover of US terms and structures (particularly from the high-yield and term loan B markets). It is now not uncommon, for example, to see call protection included for term loans in a leveraged facility agreement and since

2013, covenant-lite and covenant-loose loans have re-emerged to become a reasonably significant feature of the European loan market.

It is difficult to predict how the markets will fare, in particular given underlying concerns about the depth of the global economic recovery, but growth of direct lending funds, private placements and other alternatives to traditional loan finance seems set to continue. It will be interesting to see whether competition from these alternative sources and the high-yield and term loan B markets will result in further crossover of US terms into the European leveraged loan market, including the mid-market. It will also be interesting to see how banks and other investors continue to react to the changing regulatory landscape and the political and economic risks and uncertainties in certain parts of the eurozone and the emerging markets.

*The Lending and Secured Finance Review* contains contributions from leading practitioners in 14 different countries and I would like to thank each of the contributors for taking the time to share their expertise on the developments in the corporate lending and secured finance markets in their respective jurisdictions and on the challenges and opportunities facing market participants. I would also like to thank our publishers, and in particular Nick Barette, Shani Bans and Adam Myers, without whom this publication would not have been possible.

I hope that the commentary that follows will serve as a useful source for practitioners and other readers.

**Azadeh Nassiri**

Slaughter and May

London

August 2015

## Chapter 8

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# JAPAN

*Kenichi Yamamoto, Taro Awataguchi, Kei Sasaki and Wataru Higuchi<sup>1</sup>*

### I OVERVIEW

Japan has seen a significant spike in the volume of transactions involving loan lending, such as asset acquisition finance. This is due in part to the aggressive economic stimulus policy instituted by Japanese Prime Minister Shinzo Abe, coupled with the weakening of the yen. The Japanese economy was also boosted by the recent announcement of Tokyo's successful bid for the 2020 Olympic and Paralympic Games, which are projected to generate economic activity of around ¥3 trillion. As a result, there has been a positive mood of inflation in Japan, which has in turn led to an increase in the prices of stocks and real estate.

In addition, project finance continues to grow, and is recognised as an expanding field of finance in Japan. The enactment of the Renewable Energy Act in 2012 introduced a feed-in-tariff scheme in renewable energy projects, which created a large project finance market in renewable energy projects in Japan. Indeed, to date, more than 100 projects of mega-solar power plants have been financed through such project finance schemes.

### II LEGAL AND REGULATORY DEVELOPMENTS

#### i Reform of regulation on money lending business

Under Japanese law, a lender who provides a loan to a Japanese borrower must register as a Money Lending Business Operator (MLB Operator) with the Financial Services Agency of Japan (FSA) or a local government in Japan as applicable under the Money Lending Business Act of Japan (Act No. 32 of 1983, as amended; the MLB Act), unless:

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<sup>1</sup> Kenichi Yamamoto, Taro Awataguchi and Kei Sasaki are partners and Wataru Higuchi is an associate at Anderson Mōri & Tomotsune.

- a* the lender holds a bank business licence under the Bank Act of Japan (Act No. 59 of 1981, as amended; the Bank Act) or any other licence or permissions under the special laws which allow the lender to provide a loan; or
- b* the lender has been established under certain special laws.

In order to register as the MLB Operator, the lender must first fulfil certain requirements including the maintenance of certain net assets and hiring a money lending business manager who has passed certain examinations under the MLB Act.

On 1 April 2014, certain exceptions were established by the reform of the Order for Enforcement of the Money Lending Business Act (Ordinance No. 181 of 1983, as amended) with regard to this regulation on money lending business. Under the amended order, the lender may provide a loan without the registration as the MLB Operator in the case where:

- a* the borrower is a company which has certain capital relationships with the lender; or
- b* the lender is a shareholder of a borrower which is a joint venture company (JV Co), where 20 per cent or more equity of which is held by the lender, and the lender's loan has been consented by other holders of the equity in the JV Co.

After the reform, it has been clarified that a foreign lender who is a JV investor in a Japanese company and holds 20 per cent or more equity in the JV Co may also give financial support in the form of a loan without the registration as the MLB Operator in Japan.

## **ii Basel III**

Japanese banks and other financial institutions which have one or more business addresses abroad (including foreign branches or foreign companies) are subject to Basel III under the Bank Act or other applicable acts for these financial institutions. As agreed internationally, Basel III is gradually applicable to those financial institutions.

On the other hand, other Japanese local banks without any foreign business addresses are not subject to Basel III under Japanese law. However, the FSA, the Japanese financial regulatory authority, issued a notification which applies to local banks as of 8 May 2013. The notification is a kind of localised Basel III, and requires that core assets must be 4 per cent or more of its risk assets. This is a concept similar to, but different from, Tier 1 capital under Basel III. In this regard, it should be noted that it is not often the case that loan documents contain Basel III related terms and conditions.

## **iii Other regulatory updates**

Except for items mentioned above, there are no significant regulatory updates that have significant impact on loan markets or loan providers. Further, no specific and material amendments or updates to anti-corruption regimes have been found in recent years.

### III TAX CONSIDERATIONS

#### i Assumption

The explanation provided in this section is limited to the scope of loan transactions between corporations (i.e., non-individuals). Further, our explanation is based on Japanese laws and tax conventions effective as of 30 June 2015.

#### ii Income tax on the lender

##### *Corporate income tax on the lender who is a Japanese corporation or who is a foreign corporation with a permanent establishment in Japan (the Japanese lender)*

Certain interest paid by a borrower of Japanese corporation or foreign corporation that has a permanent establishment in Japan (the Japanese borrower) constitutes a taxable income for the Japanese borrower under the Corporation Tax Act of Japan (Act No. 34 of 1965, as amended). The effective tax rate applicable to a corporation in Tokyo earning a taxable income of ¥8 million or over is currently 33.10 per cent for the tax year commencing 1 April 2015 through 31 March 2016.

Interest paid by the Japanese borrower to the Japanese lender is not subject to withholding tax.

##### *Income tax on the lender who is a foreign corporation without any permanent establishment in Japan (the non-Japanese lender)*

Interest paid by the Japanese borrower to the non-Japanese lender falls within domestic source income that is subject to income tax in Japan. The interest is subject to 20 per cent withholding tax under the Income Tax Act of Japan (Act No. 33, 1965, as amended). However, in the case where the non-Japanese lender may enjoy benefit under certain tax treaty to which Japan is a party, the withholding tax is exempted or certain reduced withholding tax rate is applicable.

#### iii Tax on the Japanese borrower

Loan principal received by the Japanese borrower is not taxable in Japan.

In principle, interest paid by the Japanese borrower may be deducted from the taxable profit of the Japanese borrower for the purposes of Japanese corporation income tax. However, deduction of certain interest paid to the non-Japanese lender which has close relationship with the Japanese borrower is limited under special rules such as the transfer pricing tax regime, thin capitalisation and the earnings stripping rule under Japanese tax law. The outline of the special rules is provided in the following subsections.

##### *Transfer pricing*

The transfer pricing tax regime is a policy that prohibits control of prices for cross-border transactions between related companies, which results in reducing taxable income in Japan. If interest paid to a 'foreign related party', which is a party: (1) who has directly or indirectly 50 per cent or more of capital contribution in the Japanese borrower; or (2) who can make substantial decisions in relation to all or part of the Japanese borrower's business is beyond arm's-length interest rate (or paid under preferred terms), the loan transaction is deemed as being made at arm's-length terms and excess interest paid to

the foreign related party cannot be deducted from the taxable profit of the Japanese borrower.

### *Thin capitalisation rule*

The thin capitalisation rule limits cross-border loan transactions in order to provide financial support for Japanese subsidiaries instead of capital contribution, since interest on the loan principal can be deducted from the taxable income as opposed to cash distribution which cannot be deducted in principle. This leads to reduction of the tax base in Japan. The basic rule states that in circumstances where interest is paid on liabilities due to a foreign controlling shareholder and its related entities (Foreign Controlling Shareholder) or a lender who provided the capital or guarantee by the foreign controlling shareholder for the loan to the Japanese subsidiaries (Capital Supplier), where the average balance of liabilities due to either a Foreign Controlling Shareholder or Capital Supplier exceeds three times of the capital in the paying entity held by the Foreign Controlling Shareholder then the amount of interest payable on the excess amount of such liabilities would not be tax-deductible.

Simply put, this exception provides that where a company is not thinly capitalised overall (because it is maintaining a debt to equity ratio of less than three to one) it would not be treated as thinly capitalised with respect to a particular foreign controlling shareholder, even if lending from them exceeded three times their equity interest.

### *Earnings stripping rule*

The earnings stripping rule, which has been effective since 1 January 2014, prevents the reduction of taxable income in Japan by paying excessive interest against non-Japanese borrowers. If the net interest payment of the Japanese borrower to the related parties (which is interest paid to the related parties after deduction of interest paid to the Japanese borrower by related parties and which is multiplied by certain rate of interest payment to the related parties against whole interest payment) is beyond 50 per cent of certain adjusted taxable income for a certain tax year, the excess amount of the net interest payment of the Japanese borrower to the related parties cannot be deducted from the taxable income of the Japanese borrower for the tax year.

#### **iv Stamp duty**

If an original copy of the loan agreement is signed or sealed in Japan, the parties are subject to stamp duty obligations. The price of the stamp required under the Stamp Duty Act of Japan (Act No. 23 of 1967, as amended) would depend on the loan principal. If the loan principal is ¥100 million, the necessary stamp duty is ¥60,000 and if the loan principal is ¥500 million, a stamp duty of ¥100,000 is required. In order to save stamp duty cost, practically, parties to loan transactions often prepare only one original copy and the lender retains the original copy and the borrower only receives a duplicate copy of the loan agreement.

#### **v FATCA**

The Japanese government continuously encourages Japanese financial institutions to comply with the Foreign Account Tax Compliance Act (FATCA). The Japanese

government, together with the US government, issued the Statement of Mutual Cooperation and Understanding between the US Department of the Treasury and the Authorities of Japan to Improve International Tax Compliance and to Facilitate Implementation of FATCA on 11 June 2013, and issued an additional statement on 18 December 2013 modifying the original statement. Based on these statements, the FSA and some other Japanese administrative departments have requested Japanese financial institutions (including banks and securities firms) to register with the Internal Revenue Service in the USA as a Foreign Financial Institution and comply with FATCA. Based on this framework, Japanese financial institutions, in principle, are exempted from withholding obligations under FATCA.

## IV CREDIT SUPPORT AND SUBORDINATION

### i Security

Different types of security interests may be created by one security agreement. However, the security interest in each type of asset must be perfected separately. We set out a brief summary of the common methods of taking security over different types of assets in Japan, including how such security interests are typically created, any perfection requirements and the extent of any registration, tax or other costs involved below.

#### *Real property (land)*

Under Japanese law, a typical security interest upon real property is a mortgage. For a revolving facility with a maximum claim amount, a revolving mortgage is applicable.

A mortgage on land or a building is created by an agreement between a mortgagor and a mortgagee. In order to perfect the mortgage against a third party, the mortgage must be registered with the Legal Affairs Bureau (LAB) having jurisdiction over the property. There are approximately 500 LABs throughout Japan.

Under Japanese law, the land and any building on the land are treated independently. Therefore, the mortgagor of the land and the mortgagor of any building on the land could be different entities. It is, therefore, important to separately create and perfect the mortgage as a first lien upon both the land and the building. In Japan, almost all land (by parcel) and buildings (by building, upon completion) are already registered with the LAB. The registration of the mortgage is made as an addition to such existing registration. Therefore, it is necessary to investigate the title and confirm whether the property is already encumbered by an existing mortgage. Typically, a mortgage registration includes:

- a* the name and address of the debtor and mortgagor;
- b* the origin and date of the mortgage;
- c* the priority; and
- d* the loan amount (in the case of a revolving mortgage, the maximum loan amount).

Though various covenants and other provisions may be included in the mortgage agreement, the full mortgage agreement is not recorded in the registration. The registration fee which has to be incurred in order to register a mortgage is 0.4 per cent of the loan amount.

### *Moveable property*

#### *Pledge*

Moveables may be collateralised by way of a pledge. While there is no transfer of ownership, critical to the creation of a pledge is the physical delivery and possession of the subject matter of the pledge. In other words, in order to create and perfect a pledge, the pledger must physically deliver the moveables and the pledgee must hold possession of the same, and thus the pledger cannot use the pledged assets until the secured claim is satisfied.

#### *Assignment as security*

Moveables may be also collateralised by way of assignment as security. This security interest can be created by a security agreement between an assignor and an assignee. In order to perfect this security interest, the target moveable must be 'delivered' from the assignor to the assignee. Delivery can be made not only by: (1) physical delivery, but also by (2) constructive delivery or (3) registration with the LAB. The security provider (assignor) can continue to possess and use the moveable assets if (2) constructive delivery or (3) registration with the LAB is selected as a means of perfection, and this is the advantage of assignment as security compared to pledge. Assignment as security is typically used to create security over inventories or machinery, which a debtor would usually prefer to retain possession of. It is not certain whether a concept of priority exists for assignment as security, although there is court precedent that would seem to admit the concept of the priority generally.

### *Receivables*

A security interest in receivables (i.e., a claim) may be taken by a pledge or assignment as security. These security interests can be created by a security agreement between the pledger or assignor and pledgee or assignee.

In creating the security interest, it is necessary to identify the target receivable enough to specify it (such as kind, date of origination and other items to the extent applicable). If the target is a claim to be generated in the future (future claim), the period (beginning and end dates) must be specified in the security agreement and in connection with perfection. If there is an agreement made between the debtor and the obligor of the target receivable which prohibits pledge or assignment of the target receivable, the pledge or assignment is basically invalid, with two exceptions:

- a* if the pledgee or assignee is unaware of the prohibition agreement without gross negligence, the pledge or assignment shall be valid; and
- b* the pledge or assignment will become valid retroactively from the time of the pledge or assignment (to the extent not harmful to a third party) if the obligor of the target receivable consents to the pledge or assignment, even if there has been a prohibition agreement.

The pledgee or assignee can assert the security interest against the obligor of the target receivable upon:

- a* notice to the obligor from the pledger or assignor; or
- b* acknowledgment of the obligor.

The pledgee or assignee can assert the security interest against a third party (such as a double pledgee or assignee or bankruptcy trustee of the pledgor or assignor) upon:

- a* notice to the obligor of the target receivable from the pledgor or assignor by a certificate with (a stamp of) a fixed date;
- b* an acknowledgment of the obligor of the target receivable by a certificate with (a stamp of) a fixed date; or
- c* a claim pledge or assignment registration with the LAB.

The registration can be made with the LAB upon creation of the security interest without notice to the obligor. In such a case, practically, the notice to the obligor of the target receivable will be sent upon the event of default of the pledgor or assignor, and the notice must be accompanied by a registration certificate (this notice can be sent by the pledgee or assignee).

### *Shares*

Shares of companies incorporated under Japanese law can be pledged or assigned as security. Since, in practice, pledges are commonly used rather than assignment as security, we explain the concept of share pledge below. In this regard, the following three types of shares may be pledged, namely:

- a* shares which are unlisted and with certification;
- b* shares which are unlisted and without certification; and
- c* shares which are listed.

For shares which are unlisted and with certification (physical certificates are issued), a pledge can be created by a security agreement between a pledgor and a pledgee followed by physical delivery of the certificates to the pledgee, and perfected against the issuing company and any third party by continuous possession of the certificates by the pledgee. As this type of pledge is unregistered and thus unknown to the issuer, any dividend will be paid to the pledgor, and upon an event of default, the pledgee has to seize the dividend before it is paid to the pledgor. In contrast, if the name and address of the pledgee and target shares are registered on the shareholders' list at the request of the pledgor, the dividend can be paid directly to the registered pledgee.

For shares which are unlisted and without certification, a pledge may be created by an agreement between the pledgor and pledgee, and must be perfected against the issuer and any third party by registration of the pledge on the issuer's shareholders' list.

For shares which are listed, such shares are subject to the book-entry system controlled by Japan Securities Depository Center, Inc. (JASDEC) and no certificate is issued. A pledge over listed shares is created and perfected by registering the pledge with the pledgor's account established at the applicable institution under the book-entry system following a security agreement between a pledgor and a pledgee.

### *Intellectual property*

Patents, trademarks, utility model rights and design rights can be pledged or assigned as security. A pledge or security over the intellectual property can be created and perfected

by registering with the Japan Patent Office following a security agreement between a pledger or assignor and a pledgee or assignee. The registration fee for pledge is 0.4 per cent of the loan amount, while that for assignment as security is ¥15,000 (patent), ¥30,000 (trademark) or ¥9,000 (utility model right and design right) per patent, trademark, utility model right or design right, respectively.

Copyrights may also be pledged or assigned as security. A pledge or security is created by a security agreement between a pledger or assignor and a pledge or assignee and perfected by registering with the Agency for Cultural Affairs. The registration fee for pledge is 0.4 per cent of the loan amount, while that for assignment as a security is ¥18,000 per copyright.

In practice, pledges are more commonly used compared with assignments as security, but the secured loan amount to be registered is often reduced to lower the registration fee.

### *Contractual position*

Contractual positions may be subject to an option agreement, under which such positions may be transferred to a lender or a person who is designated by the lender upon the occurrence of an event of default. This arrangement is relatively common in project finance transactions and is used to secure the lender's option to transfer all contractual relationships which an existing borrower SPC has to a new SPC at the lender's option, in the event of default. In order to secure the lender's option, an acknowledgement with a stamp of a fixed date should be obtained by a third party obligor, or notice with a stamp of a fixed date should be delivered to him or her.

### *Security interests for syndicated loans*

Under the Japanese practice of syndicated loans, it is common that lenders appoint a security agent for administrative purposes only. A security agent does administrative work such as sending out notices on behalf of lenders, but cannot enforce the security interests on behalf of lenders. For syndicated loan transactions, instead of a scheme using a security agent, a security trust scheme, under which a security trustee can enforce security interests on behalf of lenders, can be adopted. The security trust scheme is, however, not commonly used in practice partially because this is a relative new scheme introduced in 2007 and there are some practical issues, in addition to issues of cost.

### *Security interests to secure bonds*

Under Japanese law, a trustee is required to be appointed to create security interests to secure bonds. Because of this requirement, it is not common for bond holders to take security.

Some specific laws, however, provide that all assets belonging to a certain type of bond issuers (such as utility companies, a certain special purpose company) shall be subject to security interests without any actions.

## ii Guarantees and other forms of credit support

Guarantees are commonly used as in the case of a parent company's guarantee for debts owed by its subsidiary. Unless a guarantee agreement stipulates that a guarantor is severely and jointly liable against a lender, a guarantor may claim that a lender should make a first demand against the debtor and take first recourse over the debtor's asset, before making a demand against the guarantor.

Set-off works as quasi-security. For example, a bank may provide loans to its depositor on the condition that the bank offsets outstanding loan amount with deposits and thereby secures the loans. In addition, authorisation by a debtor to a lender to receive payments in combination with set-off is used as quasi-security. Under this authorisation structure, a debtor authorises a lender to receive payment from a third party obligor against whom the debtor has a monetary claims and the lender offsets its outstanding loans to the debtor with its obligation to repay money that the lender receives from the third party.

Negative pledge undertakings are commonly provided in loan agreements, although the undertaking is a contractual obligation that may trigger an event of default when the debtor breaches the undertaking.

## iii Priorities and subordination

Debt subordination is effected by intercreditor agreements. The security interests for subordinate lenders should be ranked after the interest of senior lenders. The rank or priority of security interests may be achieved by registering such ranks for security interests for which registration is made (such as mortgage and intellectual properties) or arranging the timing of the perfection for pledge (e.g., pledged assets are physically delivered to a senior lender at first and then constructively delivered to a subordinated lender). Please note that, as seen in Section IV.i, *supra*, it is not certain whether a concept of priority would exist for assignment as security.

# V LEGAL RESERVATIONS AND OPINIONS PRACTICE

## i Legal reservations

It should be noted that, in certain types of insolvency proceedings, exercisability of security interests will be limited or affected. In corporate reorganisation proceedings under the Corporate Reorganization Act (Act No. 154 of 2002, as amended), which is used for relatively large companies, secured lenders cannot exercise its security interests and they will receive repayment of the value of the collateral as of the commencement of the proceedings in accordance with the reorganisation plan. In civil rehabilitation proceedings under the Civil Rehabilitation Act (Act No. 225 of 1999, as amended), which is more commonly used for many companies, secured lenders may exercise their security interests as a general rule, although such exercise may be temporarily stayed for reasonable period if the court finds that the stay conforms to the common interest of the ordinary unsecured creditors and is not likely to cause undue damage to the secured lender. In bankruptcy proceedings under the Bankruptcy Act (Act No. 75 of 2004, as amended), secured lenders may exercise their security interests without stay.

**ii Practice with regard to legal opinions**

Project finance transactions in Japan involve the borrower's legal counsel submitting a legal opinion, which opines, among other things, the borrower's capacity and validity and enforceability of transactions documents and security interests, to lenders. Disclosure of the legal opinion is typically limited to lenders and their advisers.

**iii Governing law and jurisdiction**

The courts of Japan will observe and give effect to the choice of foreign law as the governing law to the extent that such choice of law is valid under the foreign law, except where a Japanese court could not determine what the law of the foreign law is or finds that the application of the foreign law would result in a violation of public order or good morals of Japan. In addition, Japanese courts will observe and give effect to the submission to the jurisdiction of a court of foreign countries unless:

- a* the relevant disputes are subject to the exclusive jurisdiction of Japanese courts; or
- b* such a court in a foreign country designated by parties does not accept jurisdiction in the relevant proceedings.

Final and conclusive judgment obtained in a court in a foreign country will be recognised by Japanese courts and will be enforceable, provided that:

- a* the jurisdiction of the court is admitted under the laws of Japan;
- b* the debtor has been served by a summons and not by public notice (or notice comparable thereto) or has appeared before such a court in a foreign country;
- c* the judgment is not contrary to the public order or good morals of Japan; and
- d* there exists reciprocity as to recognition of a final judgment obtained in the court of Japan by a court in a foreign country.

**VI LOAN TRADING**

The practice in Japan is that loans are commonly traded. The most common method of loan trading is an assignment. A loan purchaser may obtain security interests and guarantees automatically along with the loan receivables, although perfection process is required for the loan purchaser.

Revolving security (e.g., revolving mortgage) or revolving guarantee, which secures unspecified debts, however, shall not be transferred to the loan purchaser unless a security provider or guarantor consents to the transfer. Thus, such consents should be obtained upon the transfer of the loan.

**VII OUTLOOK AND CONCLUSIONS**

The reform bill for the Japanese Civil Code was submitted to the Diet on 31 March 2015. These reforms follow a fundamental review of the Civil Code undertaken in 2006, which has remained largely unchanged for more than 100 years. While the reforms proposed are sweeping in the area of claims (mainly, Chapter III of the Civil Code), their impact

on the field of lending practice is likely to be limited, as the amendments in this area mostly relate to codifying rules already established through court precedents.

That being said, there are a number of important changes that would impact the current lending practice; for instance, the change on the rules relating to restriction on transfer or assignment of claims. This change could promote a new type of finance transactions including assignment of a number of accounts receivables in the near future.

## Appendix 1

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