

International **Comparative** Legal Guides



Aviation Finance & Leasing **2020**

A practical cross-border insight into aviation finance law

First Edition

Featuring contributions from:

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1 General and Contractual

1.1 What are the typical structures available for financing the purchase of an aircraft?

The most typical structure is an SPC owning the aircraft. Such SPC is typically owned by a leasing company or other business entity, and procures funding for the purchase of the aircraft through a combination of debt financing on a limited recourse basis and equity-like cash contributions from investors in the form of a *tokumei kumiai*. (A *nini-kumiai* scheme, where the SPC and other inventors enter into a partnership agreement, and the unincorporated partnership purchases the aircraft, which will then be jointly owned by partners, is also used but less frequently.) The SPC then leases the aircraft to lessee airlines.

In some cases, investors borrow or use their own funds, directly purchase the aircraft, and lease it to lessee airlines (direct ownership structure).

1.2 What are the key advantages/disadvantages and main issues arising in relation to these financing structures?

Since SPCs are usually owned by corporate entities that are actively engaged in other businesses, SPCs are not perfectly bankruptcy-remote structures. However, financial institutions usually regard loans to SPCs as a kind of asset-based finance; thus, the credit of the investors is virtually irrelevant (i.e., financial institutions mainly look at the credit of lessee airlines and value of the aircraft. Having said that, financial institutions do usually require SPC investors that are actively engaged in business to issue a keep-well letter).

Investors can enjoy tax benefits since they can recognise depreciation costs and reduce taxable income to a certain extent. However, for SPC investors, recognition is significantly restricted by tax laws, compared to investors who directly own the aircraft. The *nini-kumiai* structure is used particularly for leases to, for example, US airlines because of the US-Japan tax treaty.

1.3 What types of leasing are possible under the laws of your jurisdiction? What are their essential characteristics?

The Act on General Rules for Application of Laws (Japanese conflicts of law) permits parties to choose the governing law of the agreement as a matter of general principle. Cross-border

lease agreements are usually governed by foreign laws, typically English or N.Y. laws. Under the Civil Code of Japan, an aircraft lease is usually classified as a “lease”. Article 601 of the Civil Code of Japan sets forth that “a lease shall become effective when one of the parties promises to make a certain thing available for use for a fee in the form of rent, and the other party promises to pay rent for the same”. Primarily for tax and accounting purposes, there is a distinction between a finance lease and an operating lease. While there is a difference between tax laws and accounting rules, generally speaking, the following criteria is used to distinguish a lease: (a) whether the agreement cannot be terminated during the lease term; and (b) full paid-out standard. Furthermore, under insolvency proceedings, a lease agreement might be re-characterised as a secured financing transaction, and as such the rent would be subject to reduction.

1.4 Are there any proposals for reform in the area of aviation finance?

There are no particular proposals in relation to aviation finance, but major amendments will be made to the provisions of the Civil Code of Japan governing, among others, contracts, statute of limitation, and others. The amendment will take effect on April 1, 2020.

1.5 Is it possible according to the laws in your jurisdiction to enter into non-binding or partially binding pre-contractual agreements (e.g. ‘letters of intent’) which will NOT take effect as fully enforceable agreements?

Yes, it is possible to enter into non-binding or partially binding pre-contractual agreements which will not take effect as fully enforceable agreements.

1.6 Is there a doctrine of ‘good faith’ in your jurisdiction which applies to all pre-contractual agreement, financing and leasing transaction documents, and the conduct of parties connected to them?

Yes. Article 1, Paragraph 2 of the Civil Code sets forth that the exercise of rights and performance of duties must be done in good faith, and Paragraph 3 sets forth that no abuse of rights is permitted. This applies to all agreements, and in some cases where this doctrine was invoked, the court recognised that certain obligations have arisen prior to the execution of the contract by the parties.

2 Taxation and Related Matters

2.1 Which government authority in your jurisdiction has primary responsibility for the accounting for and regulation of revenue control and taxes?

The National Tax Agency has primary responsibility.

2.2 What are typically the taxes in your jurisdiction which may arise in relation to a sale, a lease or a financing of an aircraft or an engine?

Corporate tax, consumption tax and registration tax may be incurred in relation to a sale of an aircraft. Also, withholding tax may be imposed on the rent if a Japanese lessee pays rent to a foreign lessor.

2.3 Is the provision of a current tax-residency certificate by a payee sufficient for a lessee or a borrower potentially subject to withholding taxes in your jurisdiction on rental or interest payments to avail itself of treaty access and the mitigation of tax liability?

It will depend on the applicable tax treaty. Some treaties entered into by the Japanese government include a limitation of benefit clause. In that case, the payee would need to submit via the payor an application for income tax treaty relief, together with certain attachments.

2.4 Has the advent of BEPS (the Base Erosion and Profit Shifting initiative of the OECD) had any effect as regards structures in aviation finance and leasing or their interpretation?

Japan is a party to the Multilateral Convention to Implement Tax Treaty Related Matters to Prevent BEPS, which has been in effect from January 1, 2019. Therefore, depending on the country of residence of the payee, if the principal purpose of an arrangement is to obtain the treaty benefit, it would have an effect as regards structures in aviation finance and leasing.

2.5 What are the typical thresholds in your jurisdiction for which a permanent establishment may be triggered under the terms of any relevant double-tax treaty or similar?

A permanent establishment may be triggered if there is a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2.6 Is the authority at question 2.1 likely to establish a 'look-through' right or similar as regards a lender or a lessor which is a special-purpose vehicle involved for the purpose of tax treaty access?

There is no specific authority granted to the National Tax Agency to look through a lender or lessor, although some tax treaties have a limitation of benefit clause.

2.7 Will the import of an aircraft into your jurisdiction and/or the sale or leasing of the aircraft give rise to any VAT, sales or use taxes or any customs import or excise duties?

Japan is a party to the Agreement on Trade in Civil Aircraft. Therefore, importation of aircraft into Japan from another party-country is not subject to customs duty. Sale and lease of aircraft in Japan is subject to consumption tax if the aircraft is registered in Japan.

2.8 Are there any documentary taxes (for example, stamp duty payable on the execution of documents)?

Stamp duty is payable on the execution of aircraft purchase and sale agreements.

3 Registration and Deregistration

3.1 Which government authority in your jurisdiction has primary responsibility for the regulation of aviation and the registration of aircraft? Is it an owner registry or an operator registry? If the aircraft register is an operator register, is it possible to record the details of an owner or lessor and any financier with an aircraft mortgage?

The Ministry of Land, Infrastructure, Transport and Tourism has primary responsibility for the regulation of aviation and registration of aircraft. It is an owner registry but there is also a system for registering mortgages.

3.2 What is the effect of registration of the aircraft? Does registration on your national aircraft register confer proof of ownership of the aircraft and/or engine?

Registration can be made only for aircraft; there is no registration system for engines. As a general principle, in order to operate an aircraft, it must be registered in Japan (with exceptions for foreign-registered aircraft). The registration also functions as a means to perfect ownership and mortgage interests.

3.3 Can foreign-owned aircraft be registered on your national aircraft register and are there limits or restrictions on the age of aircraft that may be registered or operated?

Foreign-owned aircraft cannot be registered. The Civil Aeronautics Act stipulates that registration cannot be made with respect to any aircraft owned by (i) a person who does not have Japanese nationality, (ii) any foreign state or public entity or its equivalent in any foreign state, (iii) any juridical person or body established in accordance with the laws and ordinances of any foreign state, or (iv) any juridical person whose representative is any one of those listed in the preceding three items or one-third or more of whose officers are, or one-third or more of whose voting rights are held, by such persons. There are no limits on the age of aircraft.

3.4 Can aircraft leases be registered? If so, in what circumstances? Must the lease be in a particular form if it is to be valid and enforceable (for example, must it be in a particular language or be notarised, legalised or apostilled)?

No, they cannot.

3.5 How is deregistration affected and what steps can a lessor take to de-register the aircraft on termination of the lease?

Deregistration may be made by the person who registered the aircraft or his attorney-in-fact. The application for deregistration shall be submitted together with the certificates of ownership and aircraft registration.

4 Security

4.1 Is it possible to create a mortgage over an aircraft or engine in your jurisdiction? If so, what are the types of aircraft mortgage and engine mortgage available and what formalities are required in order to perfect it?

The Aircraft Mortgage Act allows mortgages to be created over aircraft. There is no equivalent legislation for engines. Regarding choice of law, while there is no express provision in the Act on General Rules for Application of Laws, the law of registration is usually considered as the governing law of the mortgage interest over the aircraft.

4.2 Can spare parts, including future parts, be subject to the aircraft mortgage or engine mortgage (as the case may be)? If not, are there any other forms of security that can be taken over spare parts?

No. Potentially, security assignments can be used for this purpose.

4.3 Is there a register of mortgages or rights over aircraft and/or engine?

There is a registration system for aircraft mortgages (but none for engines) under the Aircraft Mortgage Act.

4.4 What other forms of security can be taken over an aircraft and/or engine and can these other forms be registered?

A pledge can be created but is usually regarded as impractical because the pledgor must deliver possession of the thing pledged to the pledgee; thus, the pledgor cannot continue to use the aircraft. Security assignment is also possible but very rarely used, while security assignment is widely used for the interests over the lease.

4.5 What claims and rights would take priority in your jurisdiction over a registered mortgage?

Article 11 of the Aircraft Mortgage Acts states that an aircraft mortgagee has the same priority as a first-rank lien. However, Article 330 of the Civil Code stipulates that, for liens arising for the preservation of the aircraft, a first-rank lien holder cannot exercise priority over junior lien holders if the first-rank lien holder is aware of such junior liens at the time the first-rank lien holder acquired secured interests.

4.6 What other forms of security can be granted over an aircraft and/or engine lease?

See our answer to question 4.2.

5 Enforcement and Repossession

5.1 What are the circumstances in which a mortgagee or owner can take possession of the aircraft and/or sell the aircraft? What requirements must the mortgagee or owner comply with?

For mortgages created pursuant to the Aircraft Mortgage Act, the mortgagee should be able to exercise the security interest if an event of default has occurred.

5.2 What is the procedure for repossession of the aircraft?

Repossession based on ownership or lease interest is conducted in accordance with the Civil Execution Act. Under Article 169 of the Act, compulsory execution for movables, such as aircraft, shall be carried out by confiscation of the movables from the obligor, and delivery of such movables to the obligee, by a court execution officer. Compulsory execution shall be carried out based on “*certificate of obligation (saimu meigi)*” (this is the technical term used in the act), which includes, among others, a final and binding judgment, or a judgment of a foreign court or arbitral award for which an order for execution has become final and binding.

To obtain an order for execution, the foreign judgment must satisfy the requirements in Article 118 of the Code of Civil Procedure. Under Article 118, a final and binding judgment rendered by a foreign court is valid only if it meets all of the following requirements:

- (i) the jurisdiction of the foreign court is recognised pursuant to laws and regulations, conventions, or treaties;
- (ii) the defendant has been served (excluding service by publication or any other service similar thereto) with the requisite summons or order for the commencement of litigation, or has appeared without being so served;
- (iii) the contents of the judgment and litigation proceedings are not contrary to public policy in Japan; and
- (iv) there is guarantee of reciprocity in the country of the foreign court.

The requirements to obtain an order for execution are set forth in the Arbitration Act.

Regarding the enforcement of mortgage interests over aircraft, if the mortgage interest is registered in Japan, the procedure is similar to enforcement for real estate. For enforcement of mortgage interests registered in Japan, the aircraft registration certificate should be delivered to a court execution officer.

5.3 Will local courts recognise a choice of foreign law in an aircraft mortgage? Are there any mandatory local rules that apply, despite a choice of foreign law?

See our answer to question 4.1.

5.4 Will local courts recognise and enforce a foreign court judgment in favour of a mortgagee or lessor? Are any interim relief measures available?

See our answer to question 5.2. Interim relief measures are provided under the Civil Provisional Remedies Act.

5.5 Are powers of attorney from a local airline in favour of a lessor or mortgagee likely to be effective to allow the lessor or mortgagee to deregister the aircraft? Can such powers be irrevocable, be governed by a foreign law and/or do they need to be in any particular form for local recognition?

There is no clear answer for this issue. The Ministry of Land, Infrastructure, Transport and Tourism has prepared a power of attorney form to be used for the purpose of deregistration of the aircraft. The Ministry requires the power of attorney to be sealed with the registered seal, and submitted to the Ministry with a certificate of corporate seal issued within the last three months. Obtaining an updated certificate of corporate seal would be a practical issue.

5.6 If recovery of the aircraft is contested by the lessee and a court judgment is obtained in favour of the lessor, how long is it likely to take to gain possession of the aircraft?

To our knowledge there is no such precedent; thus, it is difficult to estimate how long it is likely to take to gain possession of the aircraft.

5.7 Are there any restrictions on the ability of the lessor to export the aircraft from your jurisdiction on termination of the leasing?

The Foreign Exchange and Foreign Trade Act regulates the export of goods, including the engines and navigation systems. With respect to ordinary civil aircraft, an export licence is usually required only where (i) the exporter is aware that the aircraft will be used for military purposes, (ii) the importer is included in the concerned user list of the Ministry of Economy, Trade and Industry (METI), or (iii) the METI notifies the exporter of the concern over the importer (a catch-all rule). With respect to the engines, assuming that the exported civil aviation engine is (i) certified by a civil aviation authority of Japan or another Wassenaar Arrangement participating country, (ii) intended to power non-military manned aircraft for which any civil aviation authority of Japan or another Wassenaar Arrangement participating country issues certification as a civil aircraft, and (iii) not designed to cruise at Mach 1 or higher for more than 30 minutes, an export licence is required only where (i) the exporter is aware that the engine is used for a military purpose, (ii) the importer is included in the concerned user list of Ministry of Economy, Trade and Industry (METI), or (iii) the METI notifies the exporter of the concern over the importer (an catch-all rule).

5.8 Are exchange controls prevailing in your jurisdiction as regards payments in foreign currency? Will any consents be required for the remittance of the sale proceeds abroad?

Exchange controls can be imposed on payments/remittances under certain exceptional cases (e.g., payment to a person residing in an area subject to international sanctions) but, as a general rule, these are only subject to a *post facto* reporting requirement.

5.9 If the lease is governed by English law and a judgment is obtained by the lessor in the English courts, can that judgment be automatically enforced in your jurisdiction or will the case have to be re-examined on its merits?

See our answer to question 5.2. Foreign judgments are not automatically enforced; rather, an order for execution is required, but the case will not be re-examined on its merits.

5.10 What is the applicable procedure for repossession of an aircraft under other forms of security interests?

See our answer to question 5.2.

6 Conventions

6.1 Has your jurisdiction ratified any of the following: (a) The Chicago Convention of 1944 on International Civil Aviation (the Chicago Convention); (b) The 1948 Convention on the International Recognition of Rights in Aircraft (the Geneva Convention); (c) The 1993 Convention for the Unification of Certain Rules Relating to the Precautionary Arrest of Aircraft (the 1993 Rome Convention); and (d) The Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (the Cape Town Convention) and the Protocol on the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment?

Japan has ratified (a) the Chicago Convention of 1944 on International Civil Aviation (the Chicago Convention). Japan has not ratified (b) the 1948 Convention on the International Recognition of Rights in Aircraft (the Geneva Convention), (c) the 1933 Convention for the Unification of Certain Rules Relating to the Precautionary Arrest of Aircraft (the 1933 Rome Convention), or (d) the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (the Cape Town Convention) and the Protocol on the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment.

6.2 Has ratification of the Cape Town Convention caused any conflicts or issues with local laws?

This is not applicable.

6.3 What is the legal position regarding non-consensual rights and interests under Article 39 of the Cape Town Convention?

This is not applicable.

6.4 Has your jurisdiction adopted the remedies on insolvency provided under Article XI of the Protocol to the Cape Town Convention?

This is not applicable.

6.5 What is the procedure to file an irrevocable deregistration and export request authorisation under the Cape Town Convention (IDERA)?

This is not applicable.

7 Liability for Damage and Environmental

7.1 Can the owner be strictly liable – liable without a requirement to prove fault or negligence – for any damage or loss caused by the aircraft assuming the owner is an innocent owner with no operational control of the aircraft?

There is no express provision to recognise such strict liability on the owner of the aircraft, although some academicians believe that such liability should be recognised.

7.2 Does the EU Emissions Trading System (EU ETS), or any similar scheme, apply to aircraft and aircraft operators in your jurisdiction? Will charges levied according to the EU ETS, or its equivalent, give rise to any *in rem* rights in relevant aircraft which are part of the fleet of the operator concerned and, if so, will such rights rank in priority ahead of any mortgage interests properly registered in the relevant aircraft and/or engine?

The Act on Promotion of Global Warming Countermeasures provides for a “quota account inventory” system in accordance with international decisions regarding the calculation of quotas pursuant to Article 7, No. 4 of the Kyoto Protocol applies to aircraft and aircraft operators in Japan.

7.3 What liabilities (actual or potential) could an owner, lessor or financier of an aircraft incur in your jurisdiction because of a failure to comply with local environmental law and/or regulations on the part of an operator of aircraft leased or financed by it?

As a general principle, owners, lessors, or financiers of aircraft are not made liable for the failure of the operators of the aircraft to comply with local environmental laws and/or regulations; however, you may need to check each law and/or regulation on this point.

8 Insolvency and Searches

8.1 Are there any public registers in your jurisdiction where a search can be carried out to determine whether an order or resolution for any bankruptcy, bankruptcy protection or similar insolvency proceedings has been registered in relation to an operator or lessee?

If the operator or lessee is a corporation, the registration of insolvency proceedings will be made in the corporate registry.

8.2 In the event that an operator or lessee were to become insolvent either on a balance sheet basis (assets less than liabilities) or is unable to pay debts as fall due, would an operator or lessee be required to file for insolvency protection?

The operator or lessee would not be required to file for insolvency protection.

8.3 Do the available forms of insolvency protection in your jurisdiction involve the appointment of either an officer of the court or a specifically court appointed official to take control of the operator or lessee (an ‘Insolvency Official’) while in insolvency protection?

It depends on the type of insolvency protection. In Japan, we have three types of insolvency regimes, i.e. the Bankruptcy Act, the Civil Rehabilitation Act, and the Corporate Reorganization Act. The Corporate Reorganization Act is applicable to Japanese stock companies (*kabushiki kaisha*) only. The Companies Act also provides for a special liquidation process.

8.4 Does the commencement of insolvency protection involving the appointment of an Insolvency Official in your jurisdiction have the effect of prohibiting the owner from taking the following actions to enforce the lease after commencement of such protection: (a) applying any security deposit held by the owner against any unpaid amounts due under the lease; (b) accepting payment of rent or other lease payments from the lessee, a guarantor or a shareholder; (c) giving notice of default under the lease; (d) obtaining a judgment or arbitral award for unpaid lease payments; (e) giving notice to terminate the leasing of the aircraft and/or engine; or (f) exercising rights to repossess the aircraft and/or engine?

(a) is generally permitted. (b) is generally not permitted. As to (c), (e) and (f), according to court precedents, the effect of the termination of the lease is unlikely to be recognised. (d) is generally not permitted apart from insolvency proceedings.

8.5 Can the commencement of insolvency proceedings have retrospective effect in relation to any such actions taken before commencement? If so, for what period can there be a look back?

Insolvency proceedings take effect when a commencement order is issued by the court.

8.6 Is there, either under law or as a matter of practice in your jurisdiction, a period of time within which the Insolvency Official will either ‘adopt’ the lease and pay rent and other lease payments as an expense of the insolvency or ‘reject’ the lease and permit the owner to enforce such rights as it may have under the lease? (a) If the lease is ‘adopted’, will the Insolvency Official also pay any unpaid lease payments due as at commencement of the insolvency protection? (b) If not or if the lease is ‘rejected’, would the owner’s claim for any outstanding sums rank equally with other ordinary unsecured creditors of the lessee?

Yes. The Japanese insolvency legislation generally permits the Insolvency Official to adopt or terminate the lease. If the lease is adopted, lease payments after the commencement of the insolvency proceedings will not be subject to restrictions under the insolvency proceedings, while in many cases the Insolvency Official seeks voluntary reduction of the rent as a condition to adopt the lease. Irrespective of whether the Insolvency Official adopts or terminates the lease, all outstanding claims as at the commencement of the insolvency proceedings rank equally with claims or other ordinary unsecured creditors of the lessee.

8.7 Are there certain types of preferred creditors whose claims will rank above claims of the owner?

Yes, there are.

8.8 If the aircraft is in the possession of a person other than the operator or lessee at the commencement of Insolvency Protection of the operator or lessee, for example, an independent maintenance facility, will such person be entitled, under the laws of your jurisdiction, to assert a lien arising under law or contract over the aircraft in respect of amounts then due and unpaid to such person by the operator or lessee?

Generally no. Liens are permitted on the properties of the obligor (in this case the operator or lessee).

9 Detention and Confiscation

9.1 Other than insolvency laws (see section 8), are there any laws which may have the effect of defeating the owner's right in the aircraft – for example, Government requisition? Do the laws of your jurisdiction provide for any compensation in such circumstances?

Article 29, Paragraph 3 of the Japanese Constitution stipulates that private property may be taken for public use subject to payment of just compensation. There is no special legislation for aircraft.

9.2 Are there any rights in relation to third parties to detain or sell the aircraft pursuant to illegal activities, tax or any other laws if the operator or lessee fails to pay when due? If so, can the aircraft be forfeited and sold without the owner being made aware?

The aircraft and engine used to traffic illegal drugs may be confiscated by the law enforcement authority pursuant to Article 69-3, Paragraph 2 of the Narcotics and Psychotropics Control Act, Article 24-5, Paragraph 2 of the Cannabis Control Act, and Article 41-8, Paragraph 2 of the Stimulants Control Act. While these acts do not explicitly eliminate the possibility of aircraft owned by a third party being confiscated, the confiscation would be allowed only where the owner of the aircraft was aware of the relevant offence because the Supreme Court has taken the position (in a case involving another confiscation law in 1957) that such awareness is required to confiscate property owned by a third party. The ability to confiscate depends on the awareness of the owner, not of the airline, because the ground for the restriction on confiscation is based on the constitutional protection of property rights, which are held by the owner. Airports and air navigation authorities are not granted any special rights to detain or sell aircraft or engines in relation to any payment obligations, except for possible statutory liens.



Taro Omoto's practice focuses mainly in the field of capital markets and structured instruments, particularly on aircraft/ship financing and financial regulation. Taro regularly advises leasing companies, investors, banks and airlines on the formation of new JOL/JOLCO transactions, as well as its restructuring. Taro joined Mori Hamada & Matsumoto in 2000, and was promoted to a partner in 2009. He is a qualified lawyer in Japan and New York and a graduate of Harvard Law School (LL.M.) 2005 and Keio University (LL.B., *magna cum laude*) 1999. He has received awards from many groups, including *Chambers Global*, *Chambers Asia-Pacific* and *Best Lawyers*.

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