IN-DEPTH

Lending And Secured Finance

JAPAN

LEXOLOGY

Lending and Secured Finance

EDITION 10

Contributing Editor

Azadeh Nassiri

Slaughter and May

In-Depth: Lending and Secured Finance (formerly The Lending and Secured Finance Review) is a global survey of the most consequential developments in the corporate lending and secured finance markets in each jurisdiction, including key challenges and opportunities facing market participants. Among other things, it addresses prevailing market conditions and regulatory changes; tax considerations; credit support and subordination; loan trading; and an outlook for future developments.

Generated: June 13, 2024

Japan

Hiroki Aoyama, Yuki Matsuda and Shuhei Takaishi
Mori Hamada & Matsumoto

Summary

Introduction

The Bank of Japan decided to end its negative interest rate policy at the end of March 2024.[1]That said, it will still promote low interest rates, targeting uncollateralised overnight call rates of around zero to 0.1 per cent. An accommodative monetary policy will be maintained for the time being to strengthen the lending appetite of Japanese financial institutions. As at the end of 2023, the value of outstanding loans held by Japanese banks exceeded ¥580 trillion, compared with ¥561 trillion and ¥537 trillion as at the end of 2022 and 2021,[2] respectively. Competitive market dynamics have enabled borrowers to take out loans with relatively low interest rates and lending fees. Banks play a central role in the Japanese loan market. The most sizeable among them are three mega banks (Mizuho, MUFG and SMBC), which, together with Resona and ResonaSaitama, accounted for 38.9 per cent of the outstanding loan balance as at the end of 2023.[3] Other players include non-bank money lenders, private investment funds and government-related financial institutions.

Syndicated lending has been a main source of finance for companies in need of large amounts of money, and the model syndicated loan agreement published by the Japan Syndication and Loan-Trading Association is generally used as the basis of the documentation for syndicated loans. Standardised forms of the Loan Market Association, the Loan Syndications and Trading Association and the Asia Pacific Loan Market Association and other international standardised forms are used mainly in cross-border transactions.

Given the wide availability of senior facilities, the role of high-yield and mezzanine facilities is somewhat limited. However, high-yield and mezzanine debt remains popular for borrowers seeking to stretch debt capacity in structured transactions, such as leveraged buyouts and real estate acquisitions. Mezzanine debt is typically provided in the form of subordinated loans or preferred shares.

Year in review

Based on the discussion of the working group established by the Financial Services Agency, a bill on a new legal framework for blanket collateral (kigyokachi tampo ken) was submitted to the Diet on 15 March 2024. The bill aims to promote cash flow-focused lending practices that do not rely on real estate collateral or guarantees from individual members of management by enabling lenders to take security over whole businesses (including intangible assets).

The bill introduces a legal framework for blanket collateral through which companies (especially start-ups) with few tangible assets, such as real estate properties, will be able to procure funds by taking advantage of their whole business value (including goodwill and future cash flows to be generated from business activities).

Guarantees provided by individual members of management are prohibited when new blanket collateral is utilised, except in the case of window-dressing by the business owner.

Holders of blanket collateral will be limited to trust companies that are subject to a newly introduced licensing examination so that blanket collateral will be properly handled.

At the time of writing, the bill is to be deliberated by the Diet in 2024. If the bill is passed by the Diet, it would become effective by as early as 2026.

Tax considerations

With respect to corporate tax, interest paid by a Japanese borrower is generally deductible from the taxable income of the borrower. As an exception to the general rule, some part of the interest paid to a non-Japanese lender with a close relationship to the borrower may not be deductible under limited circumstances; that is, when the interest paid is excessive compared with the arm's-length rate (transfer pricing); or the debt is considered to have been provided instead of a capital contribution (thin capitalisation rule). In addition, a part of interest payments made by a Japanese borrower to an overseas lender is not deductible if the net interest payment amount exceeds 20 per cent of the adjusted taxable income of the borrower even if the interest is paid to a third-party lender.

Lenders are subject to corporate tax, depending on their status. International lenders should note that, in Japan, the tax treatment of their income from loans depends on whether the profit relating to the loan arises from a permanent establishment in Japan.

Cross-border interest payments of Japanese borrowers are subject to Japanese withholding tax, subject to certain exemptions. Unless otherwise provided in an applicable tax treaty, the tax rate is 20.42 per cent.

Written loan agreements are subject to stamp duty. The amount of duty depends on the amount loaned and the nature of the loan transaction (such as whether the loan is a term loan or a commitment line). The maximum amount of duty is ¥600,000 per document.

Other taxes and charges that may be relevant to a loan transaction include registration fees and notary fees for the perfection of security interests.

All Japanese financial institutions are required to register with the Internal Revenue Service as foreign financial institutions and observe the Foreign Account Tax Compliance Act (FATCA). On the assumption that Japanese financial institutions observe FATCA, they are exempted from the withholding tax obligation thereunder. Thus, domestic loan documentation typically does not refer to FATCA.

Credit support and subordination

Security

Taking security generally

The concept of a 'universal' security interest for loans (whereby a security interest over all of the debtor's properties, whether present or after-acquired, is granted to the lender) does

not exist under Japanese law. Thus, the assets provided as security must be specified in the security documents, and different procedures and requirements for the creation and perfection of security interests apply to different categories of assets (such as real estate, movables and receivables).

In addition, there are peculiar issues with respect to creating a security interest for a group of secured parties (such as syndicated lenders).

These are explained further below.

Real estate

Among the forms of security available under Japanese law (i.e., mortgage, pledge and security assignment), a mortgage is typically used for real estate. The secured obligations can be specified (fixed mortgage) or designated as a certain group of unspecified obligations (blanket mortgage).

A mortgage is perfected by registration at the legal affairs bureau with jurisdiction over the location of the property. The registration fee is 0.4 per cent of the amount of the secured obligation. To reduce the upfront cost, some lenders permit the security provider to make a provisional registration only, on day one, which costs ¥1,000 per property. Once the mortgage is provisionally registered, the priority is reserved for the mortgage over subsequent competing parties, such as other mortgagees. However, provisional registration is of little use unless formal registration is completed. To upgrade from a provisional to a formal registration, documents (some of which must be provided by the security provider) must be submitted and registration fees (which are typically borne by the security provider or the borrower) must be paid. Therefore, a lender needs to consider how to secure the necessary documents and costs until the mortgage is formally registered. Typically, a security provider is obliged to submit and update the necessary documents in the lenders' custody and to upgrade to a formal registration before or upon the occurrence of certain trigger events (e.g., breach of any financial covenants or the occurrence of an event of default).

Movable properties

Pledge and security assignment (also known as security by way of assignment or assignment for the purpose of security) can be used to constitute a security over movable properties. Actual delivery of the property is required to effectuate a pledge over movable property. For this reason, security assignment is more often utilised because it does not require actual delivery. The secured obligations can be specified obligations or designated as a certain group of unspecified obligations. Subject properties can be individual properties or a pool of properties. The pool needs to be sufficiently identified by specifying the type of asset, the location and other necessary criteria. This method enables lenders to capture after-acquired movable properties as security.

To perfect a security assignment of movable property, actual or constructive delivery of the subject property (such as an occupant's manifestation of its intent to occupy the subject assets on behalf of the secured parties) is required. Alternatively, registration of the transfer will also perfect the security assignment. The registration fee is ¥7,500 per filing, in addition to the professional fees of the judicial scrivener.

Aside from the above, special requirements apply to certain categories of movable property, such as aircraft and automobiles.

Receivables

Pledge and security assignment are the most typical forms of securities for receivables. The secured obligations can be specified obligations or designated as a certain group of unspecified obligations. Future (after-acquired) receivables can be subject to a pledge or security assignment, provided that the target receivables are sufficiently identified.

Lenders can perfect the pledge or security assignment by giving notice to, or obtaining consent from, the obligor in written form with a notarised date certificate. Alternatively, registration of the pledge or transfer will also perfect the pledge or security assignment. In most cases, the registration fee is ¥7,500 per filing, in addition to the professional fees of the judicial scrivener. The cost of a notarised date certificate is even lower.

Receivables may be collateralised without having to obtain the obligor's consent even if the underlying contract has a transfer restriction clause. However, if receivables are collateralised in breach of a contractual restriction, the obligor may refuse to pay the secured party upon the enforcement of the security if the secured party was aware, or due to gross negligence unaware, of the restriction at the time of collateralisation. Although the usefulness of this type of security is somehow limited in this regard, some practitioners see new possibilities for secured transactions that utilise receivables with restrictions as collateral. One exception to the foregoing general rule relates to bank deposits, which cannot be collateralised without the bank's consent. Banks are generally reluctant to give consent unless they are a secured party.

Shares

Pledge is the most typical form of security for shares. The secured obligations can be specified obligations or designated as a certain group of unspecified obligations.

The method for perfection depends on the types of shares. If the shares are dematerialised, the pledge is perfected by means of electronic book entry. If not, the share pledge is perfected by the delivery of the share certificate representing the pledged shares. If the shares are not dematerialised and share certificates are not issued pursuant to the articles of association of the issuing company, the share pledge is perfected by recording the pledge in the shareholder ledger.

Even if the articles of association of the issuer contain transfer restrictions, a share pledge can be constituted by an agreement between the pledgor and the pledgee. However, lenders sometimes request that the target company amend its articles of association to remove any hindrance to the enforcement of the pledge.

Intellectual property

Pledge and security assignments are available forms of security for intellectual property, such as patents, trademarks, design rights and copyrights. A security assignment can be perfected by registration at a low cost – only ¥30,000 or less per right – whereas the cost

of registration of a pledge is 0.4 per cent of the amount of the secured obligation. One disadvantage of constituting a security assignment is exposing the secured party to a lawsuit for infringement, because the secured party becomes the legal titleholder to the intellectual property.

Others

The creation and perfection of security interests over other types of assets (such as factory foundations, debt securities and trust beneficial interests) are covered by the rules applicable to each type of asset.

Guarantees and other forms of credit support

Guarantees are commonly used for credit enhancement. There are no specific statutory limitations or restrictions on parent guarantees for its subsidiary (downstream) or subsidiary guarantees for its parent company (upstream). However, there is an issue with upstream guarantees due to the general fiduciary duty owed by the guarantor's directors. If a subsidiary provides an upstream guarantee solely for the benefit of a majority shareholder (owning less than 100 per cent of the shares in the guarantor), and there is no corporate benefit to the subsidiary in providing such guarantee, the directors of the subsidiary may be accused of breaching their fiduciary duties. To avoid this risk, in practice, subsidiaries usually refrain from providing upstream guarantees unless the consent of the minority shareholders has been obtained. The same applies to upstream security, whereby a subsidiary provides security to its parent company's lenders.

In terms of quasi-security arrangements, negative pledge undertakings are widely used in loan transactions in Japan. A typical loan agreement also allows the lenders to exercise set-off rights against the borrower's cash deposits in its bank accounts opened with the lenders. Banks' rights of set-off are strongly protected in that banks are, in principle, entitled to set-off even after a third party seizes the borrower's bank deposit or the borrower goes bankrupt.

Priorities and subordination

Several methods of subordination are used in the Japanese loan market. Aside from structural subordination (which involves borrowing entities at different levels, where the subsidiary borrows senior debt and the parent borrows subordinated debt), there are two types of contractual subordination structures: absolute subordination and relative subordination.

Under an absolute subordination arrangement, if the borrower becomes insolvent, the payment of subordinated debt is contractually made conditional upon the full payment of the senior debt. Thus, senior lenders ensure that the subordinated lender does not receive payment in priority to, or at the same ranking with, the senior lender.

The essence of a relative subordination arrangement is an intercreditor agreement between the senior and subordinated lenders. Typically, the subordinated lenders agree to turn over any payment they receive from the borrower to the senior lenders until the senior debt is paid in full, with certain exceptions of permitted payment. This type of arrangement

is not intended to bind the insolvency trustee in the case of the borrower's insolvency. If the borrower is insolvent, the insolvency trustee may disregard the intercreditor agreement and make distributions proportionate to the loan amounts held by the senior and subordinated lenders. Senior lenders then have to rely on the subordinated lenders to turn over the distributions to the senior lenders to uphold the priority of the senior debt.

Despite this disadvantage, senior lenders, as well as subordinated lenders, sometimes prefer relative subordination rather than absolute subordination. This is because a relative subordination arrangement could lead to greater distribution to senior lenders if the distributions are turned over by the subordinated lenders. Under absolute subordination, by reason of the condition attached to the subordinated debt, subordinated lenders may not participate in any distribution from the insolvency estate until the unsecured portion of the senior debt, if any, is paid in full. This means that the subordinated lenders are subordinated not only to the senior lenders but also to the general unsecured creditors, such as trade creditors, whose claims rank pari passu with the unsecured portion of the senior debt.

The ranking and priority of competing security interests are determined by reference to the timing at which each security interest is perfected, or the first perfected security is given first priority. Therefore, as a matter of ranking of the security interests, subordination can be created by perfecting the subordinated lender's security after the perfection of the senior lender's security.

Regarding some types of assets, however, there are technical difficulties in creating several security interests with different rankings. For example, it is theoretically unclear whether there can be multiple security assignments at different rankings over one property (unlike multiple pledges giving rise to no such issue). Moreover, the book-entry system does not accept multiple pledges over dematerialised shares. Under security trust and parallel debt structures, these issues can be avoided by creating one security assignment or pledge held by a security trustee or security agent. Otherwise, senior lenders and subordinated lenders need to agree to a special contractual arrangement to circumvent these technical difficulties, or the subordinated lenders simply give up taking security over these types of assets.

Taking security for a group of lenders

Traditionally, as a generally accepted principle of Japanese law, security interests must be held by the holders of secured obligations. Therefore, all lenders (rather than a single security agent or security trustee) are secured parties in most syndicated loan transactions. This sometimes leads to burdensome procedures when there is a transfer of loans or collective enforcement of security interests.

The security trust structure is an alternative to the traditional approach. After the amended Trust Act of Japan introduced the concept of a security trust in 2007, it became clear that a security trust can be utilised under Japanese law. In practice, however, security trusts have not been very frequently used, partly because of the increase in transaction costs because of fees payable to the licensed security trustee and complex documentation.

Another alternative is the use of a parallel debt structure, where a security agent holds security interests to secure parallel debts owed to it by the borrower, rather than to secure loan obligations owed to each lender. Although the concept of parallel debt is novel to the Japanese legal community and there are no widely reported domestic transactions using

a parallel debt structure governed by Japanese law, it is theoretically feasible to create a parallel debt structure under Japanese law.

Legal reservations and opinions practice

Insolvency avoidance is a notable risk for secured lenders. The creation of a security interest by a financially distressed borrower may be invalidated (by the insolvency trustee or the debtor-in-possession) if the security interest was created to secure existing debt:

1. after the filing of an insolvency petition against the borrower (and the creditor knew that the petition had been filed);
2. during the period when the borrower is unable to pay (i.e., unable to pay its debts generally when they fall due) and the creditor knew that the borrower was unable to pay, or that the borrower did not pay, its debts generally when they fell due; or
3. 30 days or fewer before the borrower became unable to pay, and the borrower voluntarily created the security interest in favour of a specific creditor (and the creditor knew that the creation of the security would prejudice other creditors).

The perfection of a security interest may also be avoided even where the creation of the security interest itself may not be avoided. This is to prevent an invisible secured creditor from obtaining priority over general creditors after the borrower becomes financially distressed. The requirements of such avoidance include the perfection being made after the suspension of payments or the filing of an insolvency petition, and not being made within 15 days of the creation of the security interest.

Obtaining a guarantee or receiving payment may be avoided under certain circumstances.

In connection with a subsidiary providing an upstream guarantee or security interest for its shareholder, there is an issue regarding the fiduciary duty of the guarantor's directors. However, a wholly owned subsidiary often provides a guarantee and security interest in favour of the lender of the parent. This is also the case in the context of leveraged buyouts. Although it may not be entirely free from academic discussion, it is common practice in Japan for a target company to provide a guarantee and security interest to secure loan facilities taken out by the acquisition vehicle to finance its acquisition of the shares in the target, as long as the acquisition vehicle wholly owns the target at the time of provision of the guarantee and security interest.

As to opinions practice in Japan, domestic lenders do not usually require a legal opinion in connection with simple corporate loan transactions. However, when the loan transaction involves some complexity (e.g., in the case of project finance, acquisition finance, asset-backed finance or international transactions) lenders usually require a legal opinion. The borrower's counsel, rather than the lender's, normally issues a legal opinion addressed to the agents and lenders. Disclosure of the opinion to a third party is made subject to the consent of counsel, with occasional exceptions of the disclosure being permitted to a participating lender or a supervisory authority on a non-reliance basis.

In line with international practice, a Japanese law opinion is rendered with several assumptions, qualifications and limitations. As one of the common qualifications peculiar

to Japan, the opinion on the validity and perfection of security interests over ordinary (not fixed-term) bank deposits is usually limited or not given at all. This is because of an old court decision that denied the validity of such security interests, although today's leading law professors are unanimously supportive of its validity and most practitioners agree with their view. Likewise, opinions on security interests over shares in a limited liability company, a summary type of corporation, is usually limited or not given at all. This is because of the lack of clear statutory provisions or court rulings.

Japanese courts generally recognise the validity of a choice of a foreign law as the governing law of a contract, but the governing law of security interests cannot be chosen by the parties. For example, security interests over real estate and movable properties are governed by the law of the location of the subject properties.

Japanese law adopts the principle of reciprocity regarding the recognition of foreign judgments. As such, Japanese courts will recognise final and conclusive civil judgments rendered by a foreign court if:

1. the foreign court has jurisdiction over the matter based on relevant laws or treaties;
2. the unsuccessful party received due service of process or appeared in court;
3. the content of the judgment and the related court proceedings are not contrary to the public order and good morals of Japan; and
4. there exists reciprocal recognition between the relevant foreign jurisdiction and Japan.

Japan is a party to the New York Convention (1958) and the Geneva Conventions (1927). Therefore, to the extent these conventions are applicable, the recognition of a foreign arbitral award is determined in accordance with these conventions. Otherwise, recognition of a foreign arbitral award is determined based on the same requirements applicable to a domestic arbitral award under the Arbitration Act. Those requirements are as follows:

1. the award must be final and conclusive;
2. the parties must have received due service of process and been afforded the opportunity to defend themselves;
3. the award must have been given in accordance with the law of the location of the arbitration; and
4. the contents of the arbitral award must not be contrary to the public order and good morals of Japan.

Loan trading

The most common transfer mechanism in the secondary loan market is the outright transfer of loan receivables. A loan receivable can be transferred without the borrower's consent unless the relevant loan document provides otherwise. The benefit of the associated security package can be transferred with or without the consent of the security provider

and other lenders, depending on the nature of the security interests, such as whether the security interest is a fixed security or a blanket security. Many loan documents oblige the security providers, subject to certain conditions, to cooperate with the secondary transaction by giving consent to the transfer of the security interest.

Another secondary mechanism is participation. Under a participation arrangement, the loan receivable and security package does not legally transfer to the participant. As such, the participant benefits indirectly from the security package via the lender's enforcement. Under Japanese law, unlike New York law participation, the participant is exposed to the credit risks of the existing lender as well as the borrower. In the event of an insolvency of the existing lender, the participant has a contractual claim against the existing lender for the amounts owed by it under the participation agreement.

Special considerations

There are usury laws in Japan. Although multiple acts address this issue in a complex manner, the most notable regulation is that the maximum interest rate for loan transactions is 15 per cent where the amount loaned is ¥1 million or greater.

Usury laws provide that fees or other monies paid to a lender in respect of a loan are deemed to be interest for the purpose of the usury laws. In this context, the scope of deemed interest often becomes a practical issue. First, under the Commitment Line Act, commitment fees are statutorily exempted from the scope of deemed interest provided that the borrower falls within the prescribed categories, such as a stock corporation with a share capital that exceeds ¥300 million. Second, whether other fees such as arrangement and agent fees fall within the scope of deemed interest has, at times, been a critical issue. The practitioners' approach to this issue is, put simply, that provided that the independent and substantial services (such as arrangement services) are provided and the amount of fees is within a reasonable range for such services, the fees should not fall within the scope of deemed interest.

Outlook and conclusions

At the time of writing, Japan is finally emerging from the negative impact of the covid-19 pandemic. To recover from the financial damage suffered during the pandemic period, some companies are using out-of-court workouts to implement financial restructuring. The number of companies that are attempting to restructure their borrowings or need other financial support may further increase in 2024. Banks are striving to provide liquidity to support borrowers to ensure the survival and rehabilitation of their business. Some banks are extending commitment lines, while others are responding flexibly to requests for amendments of existing loan terms (including extensions of loan repayments).

In terms of the loan market generally, the interest rate in Japan has been low for a long time. This has made it difficult for banks and other financial institutions to accomplish high profitability in the conventional lending business. However, short-term interest rates in the Japanese market may trend upwards after the end of negative interest rates, which may

attract interest from financial institutions and market participants who are seeking new investment opportunities, combining new lending practices with conventional structured finance.

Endnotes

1 https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2024/k240319a.pdf. Back to section

2 http://www.zenginkyo.or.jp/stats. Back to section

3 ibid. Back to section

MORI HAMADA & MATSUMOTO

Hiroki Aoyama hiroki.aoyama@mhm-global.com
Yuki Matsuda yuki.matsuda@mhm-global.com
Shuhei Takaishi shuhei.takaishi@mhm-global.com

Mori Hamada & Matsumoto