

Does Interest Rate Restriction Act apply to corporate bonds?

10 December 2019 | Contributed by [Nagashima Ohno & Tsunematsu](#)

Introduction

Interest Rate Restriction Act

Facts

Decision

Comment

Introduction

Interest rates applicable to loans made in Japan are subject to the Interest Rate Restriction Act, which is Japan's usury law. For decades, legal experts and others questioned whether this regulation also applied to corporate bonds, thereby affording bond issuers the same protections against high interest rates as those enjoyed by borrowers.

This longstanding question appears to have been resolved by a recent Tokyo District Court judgment. This article briefly explains the relevant background and opposing views on this issue, summarises the facts of and judgment in the relevant Tokyo District Court case before providing analysis and concluding remarks.

Interest Rate Restriction Act

The Interest Rate Restriction Act (100/1954) establishes the highest rates of interest that can be charged on loans. These caps range from 20% to 15% per annum depending on the principal amount of the borrowing. Any agreement on an interest rate exceeding the cap set out in the act for a loan will be deemed void. Obviously, the main purpose of the act is to protect borrowers, which are generally in weaker negotiating positions compared with their lender counterparties, from being charged interest at excessively high rates. The act states that these limits apply to interest on "loans".

Whether the Interest Rate Restriction Act applies to interest rates applicable to corporate bonds has been a debated issue for decades. Although an old government notice dated 24 December 1954 expressly states that the Interest Rate Restriction Act does not apply to corporate bonds, views on this issue, including those of leading scholars, have been split. One group believes that the act should apply to not only loans, but also corporate bonds. Supporters of this view point to the similarity between the two funding arrangements, although corporate bonds are primarily governed by the Companies Act while the Civil Code of Japan governs loans. Other commentators hold the view that the Interest Rate Restriction Act should not apply to corporate bonds based on the strict construction of the wording of the act. In addition, they stress that the main aim of the Interest Rate Restriction Act is to protect general consumers as borrowers from being exploited by financial institutions, while general investors as bondholders should be protected as opposed to issuers in the case of corporate bond offering transactions. According to the latter group, the Interest Rate Restriction Act was not enacted to protect corporate bond issuers to the disadvantage of bondholders.

In addition to these legal philosophical differences, practical problems exist. For example, if the reference index of an index-linked note surges, its interest rate may be raised to a level that exceeds the applicable cap under the Interest Rate Restriction Act. Alternatively, a case may arise where a lender can choose to subscribe to corporate bonds with a prohibitively high interest rate in lieu of disbursing a loan just to circumvent the restriction under the Interest Rate Restriction Act.

In its judgment of 13 June 2019, the Tokyo District Court ruled on the issue of whether the act applied to corporate bonds.

Facts

AUTHOR

[Takashi Tsukioka](#)



An issuer, a Japanese joint stock company, issued two series of corporate bonds in accordance with the Companies Act. The defendant subscribed all of the issued corporate bonds as the sole subscriber for each of the two series. The interest rates applicable to those series of bonds exceeded the interest rate cap under the Interest Rate Restriction Act. Subsequently, the issuer redeemed the corporate bonds subscribed by the defendant (ie, the bondholder) and paid interest thereon to the defendant, the amount of which was calculated based on the agreed interest rates. However, the issuer filed for bankruptcy thereafter and a bankruptcy trustee was appointed to administer the bankruptcy case, including collecting assets of the debtor-issuer. The bankruptcy trustee, as plaintiff, brought this lawsuit against the defendant seeking reimbursement of alleged overpayments of interest based on the plaintiff's assertions that:

- in essence, the Interest Rate Restriction Act applied to corporate bonds because they are equivalent, or similar, to loans;
- the relevant interest rates applicable to the corporate bonds at issue exceeded the highest interest rate that could legally be charged under the Interest Rate Restriction Act;
- such interest rates should be deemed null and void to the extent they exceeded the statutory maximum rate; and
- consequently, the excess amount of interest paid by the debtor-issuer to the defendant should be returned to the debtor-issuer's bankruptcy estate.

Decision

The Tokyo District Court ruled against the plaintiff on its claim based on the court's reasoning that the Interest Rate Restriction Act does not apply to interest on corporate bonds issued pursuant to the Companies Act because corporate bonds are not loans to which the limits on interest under the Interest Rate Restriction Act apply. According to the judgment, this determination similarly applies where corporate bonds are offered through a private placement transaction as opposed to a public offering made to the general public.

With regard to the plaintiff's argument regarding the similarity between loans and corporate bonds, the court noted the various differences between loans and corporate bonds, including differences in the rules and procedures governing those instruments and the authority and rights of lenders and bondholders under applicable laws. Further, the court mentioned that it did not find any basis for applying the Interest Rate Restriction Act to corporate bonds irrespective of the text of the act (ie, indicating that it applies to loans), whose aim is to protect borrowers which are generally in a weaker negotiating position than lenders. Issuers of corporate bonds are not always in a weaker negotiating position compared with bondholders and the issuer is in a position to determine the applicable terms and conditions of its corporate bonds. The court believed that the application of the Interest Rate Restriction Act to corporate bonds could stifle financial activities by corporations and lead to the protection of corporate issuers' interests at the cost of the interests of general public investors.

Comment

It has been reported that the Tokyo District Court's judgment is the first court decision addressing whether the Interest Rate Restriction Act applies to corporate bonds. As this issue has been debated for decades, the impact of this decision will be significant from both a legal philosophical and practical perspective. However, there were several unique points that are worth highlighting. First, the issuer had issued 203 series of corporate bonds (and for each such issuance, there was only one subscribing investor) before it went bankrupt and all of the proceeds were used for investments in high-frequency trading.

Further, the interest rates applicable to most series of the issued corporate bonds exceeded the legally permissible interest rate cap under the Interest Rate Restriction Act. In this regard, the issuer's position was clearly far from the typical 'weak borrower' intended to be protected under the Interest Rate Restriction Act. Thus, this decision may not necessarily be followed in a case with different facts. A court faced with this same issue with a different set of facts might decide the case differently depending on the particular circumstances of the issuer or the use of proceeds, especially where it is evident that the parties elected to proceed with corporate bonds as the preferred financing arrangement to circumvent the Interest Rate Restriction Act restriction. As the Tokyo District Court's judgment has been appealed by the plaintiff, developments in relation to this case should be monitored.

For further information on this topic please contact [Takashi Tsukioka](mailto:t_tsukioka@noandt.com) at Nagashima Ohno & Tsunematsu by telephone (+81 3 6889 7000) or email (t_tsukioka@noandt.com). The Nagashima Ohno & Tsunematsu website can be accessed at www.noandt.com.

