GETTING THE DEAL THROUGH

Real Estate

in 30 jurisdictions worldwide

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Subscriptions@GettingTheDealThrough.com

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Chief subeditor
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Production editor
John Harris

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Subeditor
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Editor-in-chief
Callum Campbell

Publisher
Richard Davey

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London, W11 1QQ, UK
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Fax: +44 20 7229 6910

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Kenji Utsumi and Hiroto Inoue
Nagashima Ohno & Tsunematsu

TRANSFER OF REAL ESTATE

1 Legal system

How would you explain your jurisdiction's legal system to an investor?

Japan is a civil law country with a unified court system. While the courts can exercise some discretion to achieve an equitable outcome, Japan does not have a separate equity court. Specific performance may be ordered by the court in a multitude of circumstances and pre-emptive injunctions are available. Oral contracts are valid in the same way as written contracts, generally the only difference being the relative difficulty in proving the existence of an oral contract in court. Parol evidence is generally admissible.

2 Conveyance documentation

What are the legal requirements for documents recording conveyance?

Japan has a nationwide registration system for matters such as the conveyance of ownership or other rights over real property, with registration being required for such conveyance to be perfected. For most of the matters that can be registered, the parties involved (for example, seller and purchaser) should jointly apply for registration.

Registration tax is payable at the time of registration of conveyance of ownership and is generally 2 per cent (currently temporarily reduced to 1.5 per cent for land conveyances) of the value of the conveyed real property. In addition, real property acquisition tax is payable, generally at a rate of 4 per cent (currently 3 per cent for land and residential buildings). As a matter of custom, registration tax and real property acquisition tax are typically borne by the purchaser. Reduced tax rates are available for certain types of real estate transactions. For example, a special purpose company established under the Law Concerning Asset Liquidation (TMK) is entitled to reduced tax rates provided certain criteria are met. Further, in order to reduce transaction tax costs, it is common in commercial real estate transactions to entrust the subject real property and to thereafter transfer the rights to the same in the form of a trust beneficiary interest. The registration tax for transferring the subject real property to the trustee is 0.4 per cent of the value of the conveyed real property (currently temporarily reduced to 0.3 per cent for transferring land to the trustee) and once the subject real property is so entrusted, the registration tax payable upon a change of beneficiary is only ¥1,000. Subsequent beneficiary changes will be similarly recorded in the real estate registry and the registration tax payable each time per property is ¥1,000. In general, real property acquisition taxes are not assessed on transfers through the trust arrangement.

3 Foreign investors

What other factors should a foreign investor take into account in considering an investment in your jurisdiction?

Generally there are no restrictions on foreign investors investing in real property in Japan. There is a post facto reporting requirement to be filed with the Ministry of Finance through the Bank of Japan for certain types of acquisitions by a non-resident of an ownership right or other rights in real property under the Foreign Exchange and Foreign Trade Law (the Foreign Exchange Law).

4 Exchange control

If a non-resident invests in a property in your jurisdiction, are there exchange control issues? What about repatriation of capital?

Other than the post facto reporting requirement under the Foreign Exchange Law (and possible fund-transfer restrictions aimed at money-laundering prevention), generally there are no material exchange control issues in connection with a direct investment in Japanese real property by a non-resident.

5 Legal liability

What types of liability does an owner of real estate face? Is there a standard of strict liability and can there be liability to subsequent owners? What about tort liability?

Generally the owner of real property may face tort liability if it wilfully or negligently acts or fails to act in breach of its duty of care in connection with the property and as a result thereof damage is sustained by a third party.

A person in possession of a building, tree or other structure on the land will be liable for any harmful property condition of such structures existing as a result of his or her negligence. If, however, such person in possession establishes that he or she has taken due care in preventing such property condition from causing harm to others, then the owner of the subject structures will be strictly liable instead. In Japan, the existence of asbestos in older buildings has become a major environmental problem. The concept of strict liability may apply in the case of damage caused due to the existence of asbestos inadequately maintained.

Environmental contamination of land is another major environmental concern. A landowner may be liable for damage resulting from environmental contamination caused by it or the former owners of the land.

It is standard for a seller to provide a warranty against defects to a purchaser, in a contract of sale. In the case of a sale of real property from a professional seller (a licensed real estate broker) to a non-professional purchaser, the seller is statutorily required to provide a minimum of two years' defect warranty.

6 Protection against liability

How can owners protect themselves from liability and what types of insurance can they obtain?

A real property owner may obtain general liability insurance to insure against general liability claims brought against it. Insurance covering environmental liabilities, however, is extremely rare and

cost-prohibitive. The only possible realistic protection available to an owner would be legal recourse against the previous owner of the subject real property. Such legal recourse would, for example, be available to the extent covered by environmental warranties in the relevant contract of sale and, unless expressly waived, would also be covered by a statutory warranty against defect. Recourse under tort law may also be available against any person responsible for the environmental problem.

7 Choice of law

How is the governing law of a transaction involving properties in two jurisdictions chosen? What are the conflict of laws rules in your jurisdiction?

Choice of law in Japanese courts is governed by the General Law Regarding the Application of Laws, which provides that the governing law of a contract can be chosen by the contracting parties and generally such choice will be upheld by the Japanese courts. The law applicable to matters in relation to real property (such as the method of change of ownership and the perfection thereof) will be the law of the jurisdiction where the real property is located, which in the case of real property located in Japan will be Japanese law.

8 Jurisdiction

Which courts have subject-matter jurisdiction over real estate disputes? Which parties must be joined to a claim before it can proceed? What is required for out-of-jurisdiction service? Must a party be qualified to do business in your jurisdiction to enforce remedies in your jurisdiction?

The ordinary Japanese courts, which have subject-matter jurisdiction over most civil matters, have authority to hear cases and render decisions regarding disputes with respect to real property located in Japan. The parties necessary to an action will depend on the subject matter of the particular dispute. Generally the court will effect service within Japan by post. The appropriate method of out-of-jurisdiction service will depend on the terms of the relevant treaty entered into between Japan and the country of the other party. There is basically no requirement that a party be qualified to do business in Japan to enforce its rights and remedies in a Japanese court.

9 Investment entities

What legal forms can investment entities take in your jurisdiction? Which entities are not required to pay tax for transactions that pass through them (pass-through entities) and what entities best shield ultimate owners from liability?

Various legal entities are used in real property transactions in Japan. Incorporated entities, such as *kabushiki kaisha*, *godo kaisha* and TMKs, which provide limited liability to their shareholders, are the most common. Foreign corporations are also recognised and can be used as investment entities by first registering their branch offices in Japan.

To achieve pass-through tax treatment, a silent partnership (TK) is commonly used. A TK is a two-party contractual arrangement between an operator (TK operator) and an investor (TK investor), pursuant to which the profits and losses of the silent partnership business (TK business) receive pass-through tax treatment in accordance with the TK agreement. In addition, a TMK can also constitute a tax pass-through entity (although only with respect to profits), if it satisfies certain criteria. The TMK arrangement is preferred by foreign investors because it is believed less likely that the Japanese tax authorities will challenge the legitimacy of the TMK's pass-through tax treatment. In the case of the TK arrangement, there exists a possibility that the Japanese tax authorities may challenge the pass-through tax treatment by recharacterising the TK as an ordinary partnership arrangement, which would result in the foreign investor being deemed to have a permanent establishment in Japan, thereby resulting in more taxes being imposed on the foreign investor. A tax specialist should be consulted for details on the application of Japanese tax on these investment structures.

Shareholders of *kabushiki kaisha*, *godo kaisha* and TMKs have limited liability. Further, a TK investor will have limited liability with respect to the TK business conducted by the TK operator. Among these alternatives, the TK arrangement may have a slight disadvantage in light of the possibility of being recharacterised as an ordinary partnership arrangement, which would result in the loss of limited liability.

10 Foreign investors

What form of entities do foreign investors customarily use in your jurisdiction?

TK and TMK investment structures are commonly used by foreign investors.

11 Organisational formalities

What are the organisational formalities for creating the above entities? What requirements does your jurisdiction impose on a foreign entity? What are the tax consequences for a foreign investor in the use of any particular type of entity, and which type is most advantageous?

Roughly speaking, most forms of incorporated entities can be incorporated with nominal capital and relatively simple documentation (such as articles of incorporation), accompanied by registration in the corporate registry. As a practical matter, the corporate registry office requires that at least one Japanese resident be appointed by the company as a representative director or, depending on the type of company, in another equivalent capacity. A foreign entity operating its business continuously in Japan is required to register at least one individual to act as its representative in Japan, at least one of whom must reside in Japan. Corporate taxation of Japanese corporate entities and of branch offices of foreign companies are basically the same, except for the special tax pass-through arrangements mentioned above (those for TKs and TMKs).

12 Documentation

Is it customary in your jurisdiction to execute a form of non-binding agreement before the execution of a binding contract of sale? Will the courts in your jurisdiction enforce a non-binding agreement or will the courts confirm that a non-binding agreement is not a binding contract? Is it customary in your jurisdiction to negotiate and agree on a term sheet rather than a letter of intent? Is it customary to take the property off the market while the negotiation of a contract is ongoing?

With regard to the sale of real property of substantial value (eg, ¥100 million or more), it is common for the potential purchaser to submit a letter of intent to the seller before undertaking a comprehensive due diligence investigation and it is not common for the seller and potential purchaser to engage in negotiations over the terms to include in the term sheet for the contract of sale. Whether such letter of intent is binding will depend on its provisions. A letter of intent that is intended to be non-binding should expressly state that it is non-binding to ensure that a court will interpret it as such.

Customarily, sellers are reluctant to explicitly agree to take the subject property off the market while negotiating a definitive contract of sale. However, by exchanging a non-binding offer and acceptance for the sale and purchase of the real property, a court may find that the seller has implicitly indicated its intention to take the property off the market before the execution of a binding agreement.

13 Contract of sale

What are typical provisions in a contract of sale?

A contract of sale typically includes a description of the real property to be sold, the sales price, date of closing and a warranty against defects. A typical contract of sale for commercial real property additionally includes seller's representations and warranties, closing conditions and seller's covenants.

In real property sale and purchase transactions, it is not unusual to require a 10 per cent deposit at the time the contract is entered into. Generally no escrow arrangement is used. The deposit will be forfeited if the transaction is wrongfully cancelled by the purchaser, and an amount equal to double the amount of the deposit must be paid by the seller to the purchaser if the transaction is wrongfully cancelled by the seller. Under Japanese law, it is difficult to obtain irrefutable evidence of good title to the property. Rights over real property must be registered in the real estate registry to be perfected; however, while the registry can serve as strong evidence of the existence of such registered rights, it does not serve as conclusive evidence. Accordingly a purchaser will have to rely on the representations and warranties of the seller as to the quality of title to the conveyed property. The cost of the search of the real estate registry is borne by the purchaser, unless otherwise agreed.

14 Environmental clean-up

Who takes responsibility for a future environmental clean-up? Are clauses regarding long-term environmental liability and indemnity that survive the term of a contract common? What are typical general covenants? What remedies do the seller and buyer have for breach?

The owner of contaminated land may be ordered by the relevant government authority to take appropriate measures to avoid any harm being caused to the neighbourhood by such contamination. When purchasing commercial real property, it is common for the purchaser to commission an environmental survey of the land, and generally the cost for such survey will be borne by the purchaser. If any contamination is found as a result of the survey, generally the seller will be responsible for the clean-up of such contamination.

Although it is common for commercial real property contracts of sale to contain representations regarding environmental matters, it is not common for future purchasers of the subject land to rely on representations made in past contracts of sale. In some cases, the purchaser is willing to rely on the results of the environmental survey and purchases the land on an as-is basis. In such cases, the seller will not be responsible for any contamination clean-up.

Clauses regarding long-term environmental liability and indemnity that survive the term of a contract are not common in Japan. The only exception is in the case of real estate securitisation contracts, where comprehensive and detailed environmental representation and warranty provisions and defect warranty provisions that survive for a certain time after the closing may be commonly found. Japanese law does, however, provide for a post-closing statutory defect warranty, which although not mandatory and waivable by agreement under certain circumstances, is generally understood to cover environmental problems discovered after the closing.

A typical covenant in real property contracts of sale is that the seller will keep the real property in good condition until closing. Generally, liabilities for taxes and utilities are prorated as of closing, with the seller being responsible for pre-closing amounts and the buyer being responsible for amounts accruing from and after the date of closing. Generally risk of loss prior to closing is borne by the seller. In the case of breach of a contractual covenant by a party, the non-breaching party may assert a claim for damages, and also request specific performance, such as delivery of possession of the subject property (or alternatively request termination of the contract of sale).

15 Lease covenants and representation

What are typical representations made by sellers of property regarding existing leases? What are typical covenants made by sellers of property concerning leases between contract date and closing date? Do they cover brokerage agreements and do they survive after property sale is completed? Are estoppel certificates from tenants customarily required as a condition to the obligation of the buyer to close under a contract of sale?

Typical representations made by sellers of real property regarding existing leases relate to, among other things, the major terms of such leases (such as the term of each lease and the rent, facility charges, and security deposits payable thereunder), the existence or non-existence of any default under such leases, the existence or non-existence of tenants experiencing financial difficulties, the existence or non-existence of tenants of an antisocial nature, the existence or non-existence of any disposal of rights under such leases (eg, the creation of pledge over the right to demand the return of the security deposit), the existence or non-existence of any requests by a tenant to reduce its rent or any other disputes with the tenants. For major leases, it is typical for the seller to covenant to not take any action in relation to such lease between the contract date and the closing date without the prior consent of the purchaser. However, for minor leases, such as lease agreements for residential condominiums, such a covenant from the seller is not usually provided as it is typical to leave matters concerning the operation of the property to the seller until the closing date as long as the property is operated in the ordinary course of business. Generally, representations and covenants do not cover brokerage agreements. Lease representations and covenants generally do not survive after the completion of the sale. Estoppel certificates from tenants are not customarily required as a condition to the obligation of the buyer to close under a contract of sale.

16 Leases and mortgages

Is a lease generally subordinate to a mortgage pursuant to the provisions of the lease? What are the legal consequences of a lease being superior in priority to a mortgage upon foreclosure? Do lenders typically require subordination and non-disturbance agreements?

Generally, a lease agreement will not provide for its subordination with regard to mortgages. Priority between a lease and a mortgage is determined according to the chronological order of perfection of such right over the subject real property. Generally the perfection of a right over real property is done by registration in the real estate registry. In addition to registration, a lease for land can be perfected where the lessee owns the building that is located on the leased land and the ownership of such building is registered in the real estate registry. Further, the lease of all or a part of a building can be perfected by delivering possession of the leased premises to the lessee. Most leases are not registered and are instead perfected using the latter alternative methods of perfection. If a lease has priority over a mortgage, the lease will survive, and be unaffected by, the foreclosure of the mortgage. It is not typical for a lender to require subordination and non-disturbance agreements from a lessee.

17 Delivery of security deposits

What steps are taken to ensure delivery of security deposits to a buyer? How common are security deposits under a lease? Do leases customarily have periodic rent resets?

Pursuant to Japanese case law, when ownership of real property is transferred to a buyer, all obligations under a perfected lease with respect to such real property (including the obligation to repay security deposits to existing tenants) are automatically transferred to the buyer. In order for a buyer to ensure delivery of all security deposits, it is common for the buyer to offset the amount of such tenants' security deposits against the purchase price. Generally,

security deposits are paid in cash, not by letter of credit. Under most leases, security deposits are required to secure the tenant's performance of its obligations, such as its obligation to pay rent. It is common for residential leases to have a short term (one or two years) and to have rent reviews at the end of such term. Various rent review methods are used in the case of commercial leases.

18 Due diligence

What is the typical method of title searches and are they customary? How and to what extent may acquirers protect themselves against bad title? Does your jurisdiction provide statutory priority for recorded instruments?

As mentioned above, for a purchaser to perfect its ownership as against third parties, the transfer of ownership must be registered in the real estate registry. Although registration is not conclusive evidence of ownership, it is generally understood that the real estate registry serves as strong evidence of ownership. To perform a title search in Japan, one will typically order and examine a certified copy of the real estate registry. It is common to use the services of a judicial scrivener – a licensed professional with expertise in real estate registry matters – or a lawyer to assist in examining the certified copy of the real estate registry. There is no practice of title insurance or legal title opinion. Japan provides 'statutory priority' for recorded documents only in the sense that the real estate registry is based upon a 'race' registration system which results in constructive notice to the world of all registered matters.

19 Structural and environmental reviews

Is it customary to arrange an engineering or an environmental review? What are the typical requirements of such reviews? Is it customary to get representations or an indemnity? Is environmental insurance available? Is it customary to obtain a zoning report or legal opinion?

Although historically not customary, it has become common to arrange for an engineering review when acquiring high-value real property (eg, ¥1 billion or more in price), especially in the context of a securitisation transaction. An engineering review will typically cover such matters as legal compliance with national and local codes and regulations related to building, construction and fire prevention, structural integrity, soil contamination and other environmental matters, as well as other physical conditions of the building. In a commercial real property contract of sale, it is customary to obtain representations, warranties and indemnities in relation to legal compliance with applicable laws and regulations, engineering and environmental matters. It is extremely rare to purchase environmental insurance. It is not customary to obtain a zoning report or legal opinion in relation to due diligence of real property.

20 Review of leases

Do lawyers usually review leases or are they reviewed on the business side? What are the lease issues you point out to your clients?

Historically, leases were reviewed from the business side; however, these days it is common practice to have lawyers review leases in securitisation transactions or in important commercial lease transactions. In advising our foreign clients, we explain that the Land Lease and Building Lease Law of Japan is very favourable to lessees. For example, under this law, subject to certain exceptions, the lessor is not permitted to refuse a lessee's request for lease term renewal unless the lessor can demonstrate a justifiable reason for its refusal (under Japanese case law, the concept of justifiable reason has been construed very narrowly); and notwithstanding the express terms of its lease agreement, a lessee may, in principle, seek a court order reducing its lease rent (if it is unreasonably high), even in the middle of a current lease term. The number of disputes relating to commercial leases has been increasing recently. A lender typically will not have a problem with a lease having priority over its mortgage; however, it is extremely unusual for a lender to permit a property management agreement or other management agreements to have priority over its mortgage.

21 Other agreements

What other agreements does a lawyer customarily review?

In commercial property transactions, in addition to the real property contract of sale itself, it is customary for lawyers to review a variety of other transaction-related documents, including a certified copy of the real estate registry, brokerage agreements, trust agreements (where the transaction will be accomplished by way of a transfer of a real estate trust beneficiary interest), asset management agreements (where the purchaser is a special purpose company requiring asset management services), TK agreements (where equity investments to purchaser are to be implemented through TK investments), property management agreements and other service contracts, and if applicable, debt financing-related agreements. Documents necessary for registering the transfer of title upon closing of sale are usually drafted by a judicial scrivener.

22 Closing of transaction

How does a lawyer customarily prepare for a closing?

Lawyers are sometimes, but not always, involved in closing a commercial real property transaction. Many smaller real property transactions in Japan are closed through the involvement of only the realtors and perhaps judicial scriveners. In the case of a hard asset conveyance, the principal documents at closing will be those required for registering the transfer of real property ownership, such as the *kenrisho* (that is, documented proof of the seller's ownership of the subject property, possibly in the form of an officially stamped application for registration when the seller obtained ownership to the subject property) and powers of attorney from both seller and buyer. In the case of a transfer in the form of a real estate trust beneficiary interest, written consent from the trustee with a certified date stamp from a public notary will be the principal document. A typical real estate securitisation transaction could involve over 100 closing documents (including equity investor sponsor letters and borrower counsel's legal opinions), depending on the requirements of the particular lender involved. The lawyer may be responsible for the preparation of the transaction document closing checklist. Japanese parties usually use corporate seals to execute documents, with confirmation of due corporate authorisation being accomplished through confirmation that the proper corporate seal has been used. Prorations are customary at closing.

FINANCING

23 Form of lien

What is the method of creating and perfecting liens?

Mortgages and revolving mortgages are the typical methods for creating collateral security interests over real property. They are perfected by registration in the relevant real estate registry. Where the transaction is accomplished by way of an acquisition of real estate trust beneficiary interests, instead of the underlying real property itself, a pledge is created over the real estate trust beneficiary interests, and such pledge is perfected by way of written consent (with certified date stamp by a public notary) of the trustee. Collateral security interests over personalty are generally perfected by transfer of possession of the same to the secured party. In order to create a pledge over a borrower's right to a bank account, the written consent (with certified date stamp from a public notary) of the bank with whom the bank account is maintained is required. Collateral security interests are possible for certain forms of intangible property (such as patents) and are perfected through registration.

24 Legal requirements

What would be the ramifications of a lender from another jurisdiction making a loan secured by collateral in your jurisdiction? What is the form of lien documents in your jurisdiction? What other issues would you note for your clients?

The mere making of a loan secured by collateral situated in Japan will not trigger any licensing requirements. However, a lender who repeatedly makes loans to residents of Japan may be found to be engaging in the business of moneylending and thus, be required to register as a professional moneylender.

A mortgage or the revolving mortgage is usually granted by execution of an agreement between the lender and the borrower (who is the owner of the real property to be mortgaged). Initial registration of a mortgage or a revolving mortgage is subject to a substantial registration tax (basically 0.4 per cent of the amount of a secured loan in the case of a mortgage, or of the maximum amount of loan secured in the case of a revolving mortgage). A mortgage is typically assignable without the consent of the mortgagor or any other mortgagees, and a revolving mortgage is typically assignable with the consent of the mortgagor, but without the need for consent from any other mortgagees. The registration tax rate for the transfer of a registered mortgage or revolving mortgage will usually be 0.2 per cent (as compared with the 0.4 per cent rate in the case of an initial mortgage registration).

25 Loan interest rates

How are interest rates on commercial and high-value property loans commonly set (with reference to LIBOR, central bank rates, etc)? What rate of interest is unreasonably high in your jurisdiction and what are the consequences if a loan exceeds the reasonable rate?

Reference to TIBOR (Tokyo Interbank Offered Rate) or LIBOR to determine a floating rate loan's interest rate is common. Interest rates established as a spread amount over LIBOR, Euribor, TIBOR or central bank interest rate indexes are basically enforceable in Japan. However, interest rates over 15 per cent per year (where the principal amount of the loan is ¥1 million or more) are not enforceable. If a loan's interest rate exceeds 109.5 per cent (20 per cent in the case of a professional moneylender) per year, the lender will be subject to criminal sanction. Fees are generally considered a part of the interest, except for costs incurred in connection with the execution of a loan agreement and a loan repayment.

26 Default and enforcement

How are remedies against a debtor in default enforced in your jurisdiction? Is one action sufficient to realise all types of collateral? What is the time frame for foreclosure and in what circumstances can a lender bring a foreclosure proceeding? Are there restrictions on the types of legal actions that may be brought by lenders?

Enforcement of a debtor's obligations under a loan agreement can be made through judicial proceedings. In the case of a mortgage or revolving mortgage, the loan collateral can be foreclosed upon through judicial proceedings. The loan agreement will typically specify what constitutes a 'foreclosure event', with default of a material loan agreement obligation typically serving as an event of default, and then grounds for loan acceleration and foreclosure. Although there will be some amount of variation from case to case, typically it will take from several months to more than a year to complete a mortgage or revolving mortgage foreclosure. A separate foreclosure action will have to be brought to realise on each type of collateral. Japan does not have a concept similar to the 'one-action' rule nor does it have a 'one at a time' rule (ie, a rule which prohibits a lender from bringing an action on a note or guaranty if the lender has commenced a foreclosure action against collateral securing the borrower's payment obligations under said note or guaranty, or which prohibits a lender from bringing an action on a note or guaranty simultaneously with the lender's filing of said foreclosure action), provided, however, that, once a lender's claim has been fully satisfied through the foreclosure of its lien on collateral securing debtor's obligations under the note, such lender is required to suspend all other actions to collect on said note, to enforce obligations under a guaranty or otherwise.

27 Protection of collateral

What actions can a lender take to protect its collateral until it has possession of the property?

By obtaining a judicial order for attachment of rents, the mortgagee may require that the tenants of the mortgaged property pay their rents over to the mortgagee. Such an attachment order can be sought even before commencement of the foreclosure proceedings. Once a written order for commencement of auction (the initial step in a typical foreclosure proceeding in Japan) has been issued by the court and served on the mortgagor, the mortgagor will be prohibited from transferring ownership to the mortgaged property. In certain cases, the court may order a court enforcement official to take possession of the mortgaged property; however, it is quite unusual for a court to do so.

28 Recourse

May security documents provide for recourse to all of the assets of the borrower? Is recourse typically limited to the collateral and does that have significance in a bankruptcy filing? Is personal recourse to guarantors limited to actions such as bankruptcy filing, sale of the mortgaged property or additional financing encumbering the mortgaged property or ownership interests in the borrower?

Unless otherwise provided in the loan agreement, a lender will have recourse against all of the assets of the borrower. Recourse loan agreements are typical. There is basically no difference between recourse and non-recourse security arrangements in a bankruptcy filing. Typically, a lender's recourse, as against a guarantor, will not be limited to an action forcing the guarantor into bankruptcy, an action foreclosing on the mortgaged property, or an action compelling the guarantor to obtain additional financing to protect said guarantor's interest in the mortgaged property or ownership interest in the borrower.

29 Cash management systems

Is it typical to require a cash management system and do lenders typically take reserves?

In the case of a non-recourse loan to a special purpose company, it is typical to require that a cash management system be established pursuant to which the borrower must establish and maintain reserves for various purposes (such as reserves for future interest payments, tax payments, repair and maintenance costs). It is relatively rare to require cash management systems and reserves for other types of loans.

30 Credit enhancements

What other types of credit enhancements are common? What about forms of guarantee?

With the exception of payment guarantees, it is relatively rare for a lender to obtain credit enhancements beyond mortgages and other security arrangements mentioned in the answers above. Letters of credit and holdbacks are not common in Japanese loan transactions. On occasion, the equity sponsor to a special purpose company receiving a non-recourse loan will provide a recourse carve-back guarantee letter (a 'sponsor letter') to the lender with regard to 'bad boy acts'. Such recourse carve-back guarantee letters are generally considered as enforceable. Use of completion guarantees in development transactions is relatively rare.

Update and trends

An amendment to the TMK Law was recently made effective. The underlying purpose of the amendment was to introduce more flexibility into the TMK structure and thereby induce more investment in the Japanese real estate market. The three major points are as follows:

- TMKs are required to conduct their operations in accordance with an asset liquidation plan (ALP) for each TMK submitted to the Japanese regulatory authority, and prior to the amendment the law required that proper notifications be given to the Japanese regulatory authority if any change (minor or substantial) to the ALP had been made. The amendment eliminated the notification requirement in the case of certain minor changes to the ALP. In addition, in response to criticism of the cumbersome ALP amendment procedures (eg, the requirement to obtain consents from all interested parties), a simplified procedure (eg, resolution by the TMK's directors) was adopted to address minor changes to the ALP.
- Before the amendment, special-purpose borrowings, one of the principal means of debt financing for TMKs under the TMK Law, were allowed only for the purpose of acquiring specified assets. The amendment removed the restriction (the name for this type of borrowing was also changed to special borrowings), and accordingly it enables TMKs to borrow funds for any purpose, such as to pay for costs to renovate entrusted real estate assets or operating costs of TMKs.
- Before the amendment, even in cases of real estate acquisitions (eg, purchases of hotel properties), TMKs were essentially unable to acquire minor moveables relating to such real estate (eg, the furniture, fixtures and equipment of a hotel) in such acquisition transactions because the requirement of segregated safe-keeping of assets under the TMK Law (eg, obligations to file the purchase and sale agreement and to enter into an entrustment arrangement with a trust bank) were too cumbersome and impractical to fulfil for minor assets. The amendment exempts TMKs from fulfilling various obligations regarding such minor assets, and consequently enables TMKs to acquire those minor assets together with the real estate.

Another noteworthy development resulting from the amendment is a clarification by the regulatory authority that TMKs are permitted to acquire additional assets upon approval of all interested parties, even after the initial filing of a notification of commencement of operations. Prior to such clarification, it had long been understood that acquisition of additional assets was impossible after the initial filing of the notification of commencement of operations.

31 Loan covenants

What covenants are commonly required by the lender in loan documents? What is the difference depending on asset classes?

In the case of a non-recourse loan, it is common to incorporate a set of covenants aimed at protecting the lender. Such covenants may include the borrower's obligation to maintain its bankruptcy remoteness status, to effect loan repayments through a pre-designated cashflow waterfall, and to refrain from taking on additional debt or selling or otherwise disposing of the lender's collateral. Covenants in a recourse loan arrangement (typically corporate loans) are much more limited in scope and number. Covenants in loan documents are not generally different depending on asset classes.

32 Financial covenants

What are typical financial covenants required by lenders?

In the case of a non-recourse loan, it is common to incorporate a set of financial covenants, including loan-to-value ratio and debt service coverage ratio covenants. To effect such financial covenants, it is common to require that the borrower submit financial reports and update collateral appraisal reports periodically. It is also common to impose such obligations upon the borrower in the event of default or acceleration. The above-mentioned financial covenants are relatively rare in a recourse loan.

33 Bankruptcy

Briefly describe the bankruptcy system in your jurisdiction.

There are several types of bankruptcy-related proceedings in Japan. Bankruptcy proceedings can be commenced either voluntarily or involuntarily. Although there is no automatic stay upon the filing of an application for bankruptcy in Japan, upon such filing, the bankruptcy court will normally issue a preliminary court order staying execution against the assets of the bankrupt borrower. Thereafter, once a bankruptcy proceeding has officially commenced, a stay against such execution will come into effect. Except in the case of a corporate reorganisation proceeding, one of the bankruptcy proceeding forms available in Japan, the secured creditor will basically have priority over the general creditors of the bankruptcy estate. In certain cases, especially those under a corporate reorganisation proceeding, valuation proceedings will be required. In general, a secured lender is not entitled to collect rents from its collateral during the bankruptcy proceedings. Knowledge of bankruptcy laws and proceedings has become increasingly important for real estate transactions in Japan.

34 Secured assets

What are the requirements for creation and perfection of a security interest in non-real property assets? Is a 'control' agreement necessary to perfect a security interest and, if so, what is required?

Typically, mortgages or revolving mortgages over real properties in the case of hard asset financing transactions, and pledges over real property trust beneficiary interests in the case of trust beneficiary interest, serve as the key security interests for lenders. In addition to this key collateral, sometimes security interests in non-real property assets, such as pledges over the rights under casualty insurance insuring the target building, the borrower's bank accounts, shares in the borrower and the borrower's rights against other transaction-related parties (such as asset managers and property managers), as well as limited recourse agreements from the equity sponsors of the borrower, are also provided to the lender. Although not legally required, these additional security interests are usually granted by way of written agreement. Perfections of such pledges are typically accomplished by consent (with certified date by a public notary) from the relevant obligee (eg, insurance companies, banks, or such other transaction-related parties). A pledge over the shares in the borrower is basically perfected via the borrower's consent (with certified date by a public notary), consents from all of the borrower's shareholders or by registration in the borrower's shareholders' registry. A sponsor's limited recourse agreement is typically provided by way of a sponsor letter submitted by the sponsor. The scope of a sponsor's limited recourse agreement is usually limited to indemnification of only the 'bad boy acts' of the borrower.

35 Single purpose entity (SPE)

Do lenders require that each borrower be an SPE? What are the requirements to create and maintain an SPE? Is there a concept of an independent director of SPEs and, if so, what is the purpose? If the independent director is in place to prevent a bankruptcy filing, has the concept been upheld?

In the case of a non-recourse loan, the lender will usually require that a borrower is an SPE. For this purpose, a limited liability company incorporated under the Companies Act, or a TMK, is typically used. Incorporation of these companies is neither difficult nor

materially different from incorporation of the more standard forms of companies. However, in the case of a TMK, an asset liquidation plan must be submitted to the relevant local office of the Financial Services Agency. To achieve remoteness from influence of a bankrupt equity sponsor and asset manager, the non-recourse lender will commonly require the appointment of an independent director as well as an independent shareholder for the SPE. It is quite common for the non-recourse lender to require the independent director to submit a non-petition letter for the purpose of trying to preclude a bankruptcy filing; however, the enforceability of such a non-petition letter is arguable and has not been judicially tested in Japan.

NAGASHIMA OHNO & TSUNEMATSU

Kenji Utsumi **kenji_utsumi@noandt.com**
Hiroto Inoue **hiroto_inoue@noandt.com**

Kioicho Building
3-12, Kioicho, Chiyoda-ku
Tokyo 102-0094
Japan

Tel: +81 3 3288 7000
Fax: +81 3 5213 7800
www.noandt.com

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