Loans & Secured Financing

Contributing editor
George E Zobitz

2018

GETTING THE DEAL THROUGH

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Law Business Research

THE QUEEN'S AWARDS FOR ENTERPRISE: 2012

Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 3708 4199
Fax: +44 20 7229 6910

First published 2015
Third edition
ISSN 2059-5476

Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

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Loans and secured financings

1 What are the primary advantages and disadvantages in your jurisdiction of incurring indebtedness in the form of bank loans versus debt securities?

The relationship between lender and borrower of traditional bank loans is bilateral and relatively stable (the secondary market of bank loan receivables is still limited and the collection of loan receivables by disposition thereof is practically less feasible in Japan) and therefore negotiation of or amendment to the terms of the loan will be made only between lender and borrower and be relatively flexible. Meanwhile, the relationship between the debt security issuer and its holders is multilateral and relatively unstable since debt securities are usually freely transferable. Therefore, post-issue material amendment to the terms and conditions of bonds or debt securities may require the costly and time-consuming process of holding a security holders' meeting to obtain approval from the majority of security holders therein. In addition, issue of bonds or debt securities will be subject to filing registration with financial authorities, disclosure requirement (with private placement or some other exemptions) and other rather stringent securities regulations. From another point of view, the issue of bonds or other debt securities will enable long-term (most commonly, around three to 10 years) and stable funding of working capital or equipment investment, which may hedge the risk of a rising interest rate after the issue and may also demonstrate the borrower's good financial status to the public. Debt securities are often issued as unsecured, since secured debt securities will be subject to rather strict regulations under the Secured Bond Trust Law. Meanwhile, the term of the bank loan is relatively short (most commonly, around one month to five years) and the loan may be secured or unsecured depending upon the borrower's credit and other various factors since the loan will not be regulated under the Secured Bond Trust Law.

2 What are the most common forms of bank loan facilities? Discuss any other types of facilities commonly made available to the debtor in addition to, or as part of, the bank loan facilities.

Both revolving credit facilities and term loan facilities are commonly used in Japan. Revolving credit facilities are flexible and suitable for funding working capital. Meanwhile, term loan facilities are good for funding fixed amounts such as an asset's purchase price. Letters of credit and banker's acceptances are commonly used in import and export financing. As for facilities available at very short notice, swingline or bridge facilities are sometimes used but competitive bid revolving credit facilities are not yet common in the Japanese domestic loan market.

3 Describe the types of investors that participate in bank loan financings and the overlap with the investors that participate in debt securities financings.

Most investors that participate in bank loan financings are traditional banks (including nationwide mega-banks, trust banks and regional banks) and sometimes trading companies and non-banking corporations will participate as sub-members of syndicated loans. Life or fire insurance companies, pension funds and other institutional investors or hedge funds are rarely included as such members, although they will often invest in corporate bonds and other debt securities.

4 How are the terms of a bank loan facility affected by the type of investors participating in such facility?

As stated in question 3, most loan facility members are traditional banks and therefore the terms of bank loan facilities are not so much affected by the types of investors. But, national mega-banks will provide both short-term and long-term lending, while regional banks and trust banks traditionally prefer long-term lending.

5 Are bank loan facilities used as 'bridges' to permanent debt security financings? How do the structure and terms of bridge facilities deviate from those of a typical bank loan facility?

Bridge loan facilities are sometimes used for short-term lending which is intended to be replaced by permanent debt securities to be issued for financing junior debt portions of acquisition financings. While the terms of the bridge loan (eg, secured or unsecured) will be different transaction by transaction depending on the borrower's credit risk or schedule of refinancing or other factors, generally the finance term will be relatively short and the interest rate will be higher than for a permanent loan (the higher interest rate may become the borrower's incentive to make early repayment of bridge loan) and additional collateral, guarantee or covenants may be required to ensure the repayment of the bridge loan. Recently 'subscription finance' (ie, bridge finance facility secured by fund investors' capital commitments) was introduced to enable further efficient and timely fundraising by private equity funds or real estate investment funds.

6 What role do agents or trustees play in administering bank loan facilities with multiple investors?

Agents handle various administrative matters and work as liaison between the borrower and syndicate members such as wire transfer of loan proceeds, collection of principal repayment or interest payment and their distribution to syndicate members, transmission to syndicate members of the borrower's financial, business or other material information (periodically and on an 'if any' basis), monitoring the borrower's compliance with covenant clauses, arrangement of the decision-making process by syndicate members, etc. However, agents act for the syndicate members, not the borrower, and therefore the agent will owe a duty of care as a good manager towards syndicate members unless otherwise specifically provided in loan documents. For example, therefore, if the borrower provides information regarding its financial status to the agent, such notice will be effective immediately upon the agent's receipt of such notice. Therefore, the agent shall notify such information to syndicate members immediately after receipt thereof and if the agent fails to do so with negligence, the agent might be liable for damages against the syndicate members in breach of its duty. There are some variations to the carveout language in indemnification clauses such as: the agent will be indemnified 'so long as he or she relied upon certain objective material or an expert's opinion'; 'except for wilful misconduct or gross negligence'; 'so long as the agent conducts or misconducts in compliance with majority lenders' instruction', etc.

7 Describe the primary roles and typical fees of the financial institutions that arrange and syndicate bank loan facilities.

At the initial stages, an arranger will be appointed upon the grant of a mandate by the borrower candidate and will solicit lender or syndicate member candidates according to such mandate. At this stage, therefore, the agent owes a duty of care as a good manager against such borrower candidate. After the syndicate members are decided upon, in turn, the arranger will act as an intermediary between the borrower and the syndicate members to fix the terms and conditions of the subject loan. The amount of the arranger's fee will be determined taking into consideration various factors such as the size of syndication, the number of syndicate members, the balancing of lending terms and borrower's credit risk and other difficulties of the subject syndication, if any. Under the Law on Regulation of Receipt of Equity Investment, Deposit and Others (Law No. 195 of 1954 as amended, LRREID), a fee for brokerage of money lending shall be up to 5 per cent of the loan amount and breach of such regulation might lead to a criminal sanction. In practice, therefore, the arrangement fee will be determined within the range of up to 5 per cent of the loan amount so as not to breach such provision of LRREID. Similarly, under LRREID, if lender agrees to receive or receives interest amount exceeding 20 per cent per annum then such lender might be exposed to criminal sanctions (ie, imprisonment of up to five years, a fine of up to ¥10 million, or both).

8 In cross-border transactions or secured transactions involving guarantees or collateral from entities organised in multiple jurisdictions, which jurisdiction's laws govern the bank loan documentation?

In general, Japanese lenders prefer Japanese laws since they are familiar with them. Meanwhile, multinational borrowers tend to prefer the laws of their own jurisdiction. As a result, the choice of the governing law is usually a negotiation matter between the lender and the borrower. Where the parties do not agree on which law should be the governing law, laws of third-party jurisdictions relatively fair and friendly to financial transactions such as English law or New York law might be chosen as a compromise. One exception to the above is where a share pledge or real estate mortgage is created, the governing law of the issuer of the shares or the laws of the real estate's location shall be applicable. Similarly, the ability or capability of a judicial person shall be governed by the laws of incorporation of such judicial person. Court procedures shall be governed by the laws of the court's location.

Regulation

9 Describe how capital and liquidity requirements impact the structure of bank loan facilities, including the availability of related facilities.

Tighter regulations on capital and liquidity under Basel III will make Japanese banks (especially regional banks lending to various and numerous regional SMEs) more sensitive to the credit risk of loan lending and it may lead to credit clench, since most Japanese banks' capital amounts are relatively lower than US and European banks.

10 For public company debtors, are there disclosure requirements applicable to bank loan facilities?

Setting up bank loan facilities or borrowings thereunder will not trigger disclosure obligations of public company debtors.

11 How is the use of bank loan proceeds by the debtor regulated? What liability could investors be exposed to if the debtor uses the proceeds contrary to regulations? Can investors mitigate their liability?

There are no specific laws or regulations on the use of loan proceeds and therefore the borrower may use the proceeds for redemption of debt securities, refinancing as well as working capital and capital investment. In loan documents, it is usually provided that the agent and other lenders will not be obliged to confirm the borrower's use of the loan proceeds. The use of loan proceeds is sometimes contractually limited, but usually not. However, if the loan proceeds are used for terrorism or other antisocial activities or if they are used for a hostile tender offer, contrary to initial expectations of syndicate members, this may cause compliance issues, conflict of interest issues or other legal issues, as well as reputational risks for syndicate members. To prevent such issues or risks, the use of loan proceeds shall be restricted and syndicate members' decision-making for approval of changes to the of use of loan proceeds shall be made by unanimous vote so that any syndicate member having concerns about the potential conflict of interest or other issues will have a veto against making such loans or approval of changes to the use of loan proceeds.

12 Are there regulations that limit an investor's ability to extend credit to debtors organised or operating in particular jurisdictions? What liability are investors exposed to if they lend to such debtors? Can the investors mitigate their liability?

Lending to persons related to the production of missiles or weapons of mass destruction in North Korea, Taliban-related persons, nuclear activists in Iran, terrorists or certain other designated persons needs prior approval from the Minister of Finance under the Laws of Foreign Exchange and Foreign Trade. Violation of such regulation may trigger administrative or criminal sanctions or both.

13 Are there limitations on an investor's ability to extend credit to a debtor based on the debtor's leverage profile?

In determining whether to extend credit to a debtor, a bank or other loan lender shall take into consideration various factors such as balancing of the borrower's credit risk and the borrowing amount, use of loan proceeds, reasonableness of the repayment plan under the 'lender's liability' theory. In particular, under the Money Lending Business Law, when money lending business companies lend money to individuals, as a general rule, the loan shall not be made if the aggregated loan amount (including borrowings from other money lenders) exceeds one-third of the individual's annual income.

14 Do regulations limit the rate of interest that can be charged on bank loans?

There are three major interest rate regulatory laws: the Provisional Law on Adjustment of Interest Rate (Law No. 181 of 1947 as amended, PLAIR), the Law on Restriction of Interest Rate (Law No. 100 of 1954 as amended, LRIR) and LRREID (see question 7). Under PLAIR and LRIR, interest rate shall be (i) 20 per cent per annum or less for less than ¥100,000; (ii) 18 per cent per annum or less for less than ¥1 million; and (iii) 15 per cent per annum or less for less than ¥1 million, and the default interest rate shall be less than 1.46 times of each cap rate of the above. Under LRREID, if the lender agrees to receive or receives interest exceeding 20 per cent per annum, the lender might be exposed to criminal sanctions (ie, imprisonment of up to five years or a fine of up to ¥10 million, or both).

15 What limitations are there on investors funding bank loans in a currency other than the local currency?

Lending in a foreign currency ('impact loan') has generally been liberalised after the major amendment to the Law on Foreign Exchange and Foreign Trade of 1998. To hedge the currency risk, lender will have to execute currency forward, swap or other hedging transaction in advance to or concurrently with making foreign currency loans. The borrower may repay the loan in yen unless the lender and the borrower have expressly agreed (in the loan agreement or otherwise) that the repayment of loan shall be made in certain currency other than yen.

16 Describe any other regulatory requirements that have an impact on the structuring or the availability of bank loan facilities.

Please see question 15.

Security interests and guarantees

17 Which entities in the organisational structure typically provide collateral and guarantee support for bank loan financings? Are there limitations on which entities in the organisational structure are permitted to provide such support?

Typically, if collateral or guarantee is required, collateral such as the borrower's assets or its parent company's assets (including the borrower's shares) or a guarantee from the parent company will be provided.

There are no specific restrictions on which group companies may or may not provide collateral or guarantees to other group companies.

18 What types of obligations typically share with the bank loan obligations in the collateral and guarantee support? If so, are all such obligations equally and ratably covered by the collateral and guarantee support?

Where a bank loan lender is also the counterparty of a swap or other relevant hedging transaction, the borrower's obligations under such swap or other hedging transaction are often also secured or guaranteed by the same collateral or guarantee on an equal and pro rata basis. Where the counterparty is not the bank loan lender, it might be made on an unsecured basis, but might be required to have the same or additional collateral or guarantee depending upon the borrower's credit or other relevant factors.

19 Which categories of assets are commonly pledged to secure bank loan financings? Describe any limitations on the pledge of assets.

Personal properties such as machinery, equipment and commodities and sales or other receivables are often pledged. In theory, real estate may be pledged but practically speaking real estate is rarely pledged since transfer of possession is essential to create a valid pledge but the pledger often prefers to continue to use the collateral real estate, while the pledgee is reluctant to physically control or manage such real estate until in the event of a default. Instead, a mortgage (which does not require the transfer of possession) is often used when real estate is collateralised.

20 Describe the method of creating or attaching a security interest on the main categories of assets.

A mortgage on real estate will be created by registering with the public registry where the real estate is located. Security assignment of real estate is not so common since required registrations of transfer and re-transfer (upon expiry) will accompany the payment of registration and certain other taxes and the obligations and liabilities (eg, soil pollution) will be transferred to the security assignee. Pledge or security assignment of personal property will be created by the relevant parties' agreement and (to create a pledge on personal property, in addition thereto) by transfer of the possession of the subject property from pledger to pledgee. To create a security assignment of collective personal properties, the type, location and quantity limit of the subject properties shall be specifically agreed. To create a security interest over shares, a pledge or security assignment is commonly used. Security interests over shares are created by delivery of a share certificate or registration in the list of shareholders of the issuer company as well as execution of a share pledge or security assignment agreement. To create a security interest over transfer-restricted shares, approval by the board meeting (or shareholders' meeting) will be required for creating and enforcing such security interests. A pledge or security assignment of sales receivables shall be created by contractual agreement between the security provider or borrower and the secured loan lender. However, a pledge or security assignment of 'assignment-prohibited receivables' is void under the current Civil Code of Japan but will be valid and perfected against a third party if certain requirements are satisfied under the recently amended Civil Code of Japan. Cash collateral or current or savings account collateral becomes more common in international finance transactions but the validity of such security interests is not yet publicly recognised under statutes or court precedents.

21 What steps are necessary to perfect a security interest on the main categories of assets? What are the consequences of failing to perfect a security interest?

In case of real estate mortgage, no proceeding other than registration filing will be necessary. To perfect a pledge over personal properties, transfer and successive possession of personal property will be necessary (perfection by registration of a pledge of personal property is not allowed). As for security assignment of personal property, transfer of possession (including constructive transfer of possession) of such properties to the assignee will be necessary. To perfect a share pledge or security assignment of shares, transfer of possession and subsequent continuous possession of share certificates (in case of shares of a 'share certificate issuing company') or registration in the list of shareholders of the issuer company (in case of shares of a 'no share certificate issuing company') is necessary, respectively. In case of a 'no share certificate issuing company', the pledgee should be careful of unauthorised amendment to the list of shareholders if the issuer is a pledger or borrower itself or its group company. To perfect a security interest over shares of listed companies, creating or amendment to the registration record in the Share Deposit and Transfer Institute will be necessary. A pledge or security assignment of sales receivables shall be perfected by notice to or consent by the debtor or registration of such pledge or transfer. In the case of a security interest not being perfected, the security holder may not claim its priority against the third party or bankruptcy trustee of security provider in collecting claims from the subject collateral assets.

22 Can security interests extend to future-acquired assets? Can security interests secure future-incurred obligations?

Security assignment of collective personal properties will cover inventory or other future-acquired assets. Pledges or security assignment of future receivables are possible if such receivables are sufficiently specified (identification of debtors is not necessarily required), although the validity of security interests over future receivables after commencement of a bankruptcy procedure of the security interest provider is still unclear and a much-discussed issue. Under the recently amended Civil Code of Japan, it is expressly confirmed that assignment of receivables may be valid even if such receivables are not yet incurred upon such assignment. Future-incurred obligations may be secured by security interests if so agreed between the parties and (in case of real estate mortgages) so registered.

23 Describe any maintenance requirements to avoid the automatic termination or expiration of security interests.

Under normal circumstances, security interests will not be automatically terminated or expire unless they expire as a result of being subject to statutes of limitation.

24 Are security interests on an asset automatically released following its sale by the debtor? If so, are the releases mandated by law or contract?

In general, security interests will not automatically be released upon the asset's sale by the debtor. However, in case of personal property, if the possession of the property is transferred to a third party, the pledge will be expired or unperfected and the pledgee may not exercise such pledge. Similarly, the holder of a statutory lien on personal property may not exercise such lien if the possession of such property is transferred to a third party. In case of security assignment of collective personal property, if the inventory is sold and delivered out of the subject location, such inventory will be automatically released from such security interest.

25 What defences does a guarantor have against claims for non-fulfilment of guarantee obligations? Can such defences be waived?

Non-jointly liable guarantors will have a 'defence of notice to the borrower' under which the creditor shall first request the borrower to perform the obligation, and will also have a 'defence of collecting from the borrower' under which the creditor shall try to collect first from the borrower if the guarantor proves that the borrower is capable of repayment and enforcement upon the borrower is straightforward. Therefore, such guarantee is less common in business transactions. Meanwhile, in the case of a jointly liable guarantee, the guarantor does not have such defences and shall perform the guaranteed obligations upon the guarantee's request unless the borrower has already performed the obligations or the guarantor may claim any other defence. The guarantor may claim the same defences that the borrower may claim against the lender unless the guarantor waives such defences.

26 Describe any parallel debt or similar requirements applicable in a secured bank loan financing where an agent acts for multiple investors.

While parallel debt arrangements are sometimes found in cross-border acquisition financing transactions, their validity is unclear under

the current Civil Code of Japan, but such arrangements will fall under the category of 'multi-debtor joint receivables' (*rentai saiken*), which is a newly statutorily recognised form of receivables under the recently amended Civil Code of Japan but it is not yet often used for domestic bank loan transactions.

27 What are the most common methods of enforcing security interests? What are the limitations on enforcement?

In the case of real estate mortgages, statutory foreclosure is an option to enforce it. However, the foreclosure price will usually be considerably lower than the sales price in a voluntary sale. Therefore, so long as the relevant parties agree, mortgaged real estate will be often sold by voluntary sale rather than statutory foreclosure. Where a bankruptcy procedure or civil rehabilitation procedure is commenced, security interests will be treated as an 'out-of-procedure right' and in general may be enforced outside the procedure. However, in case of commencement of a civil rehabilitation procedure, the court may prohibit or suspend the foreclosure if certain requirements are satisfied. Furthermore, in either procedure, security interests might be forced to expire with certain compensation with the court's approval. Meanwhile, in case of the corporate reorganisation procedure, all security interests are treated as security interests subject to the reorganisation procedure and may not be separately exercised outside the procedure (ie, they will just be entitled to receive dividends under the approved reorganisation plan).

28 Describe the impact of fraudulent conveyance, financial assistance, thin capitalisation, corporate benefit and similar doctrines on the structure of bank loan financings.

Preferential activities by a debtor or a debtor attempting to reduce its assets might be void by exercise of the avoidance right by the bankruptcy trustee. There is no specific regulation on 'financial assistance' but directors of group companies providing a guarantee or collateral to the purchaser of a target company should not breach their duty of care or duty of loyalty where the target company still has minority shareholders. Where the debt amount owed to a foreign parent company exceeds three times the capital amount held by such parent company, the corresponding interest payment may not be deductible from taxable income under thin capitalisation taxation. There are no court precedents that have specifically adopted the 'corporate benefit' doctrine.

Intercreditor matters

29 What types of payment or lien subordination arrangements, or both, are common where the debtor has obligations owing to more than one class of creditors?

There are two types of subordination arrangements: 'structural subordination' and 'contractual subordination'. Structural subordination may be achieved if a senior creditor lends money to a subsidiary (target company in case of acquisition finance), while a junior creditor lends money to its parent company (acquisition vehicle in case of acquisition finance), under which situation a senior creditor may collect its claims directly from the subsidiary's assets, while the junior creditor may collect its loan from the assets of the subsidiary remaining after senior creditors' collections and distributed as dividend or residual assets to the parent company. Contractual subordination is sub-categorised into: 'relative subordination' and 'absolute subordination'. In the 'relative subordination' method, senior lenders, mezzanine or subordinate lenders and borrowers will agree on the subordination of mezzanine or subordinate loans against senior loans. Since this is just a contractual arrangement among the relevant parties, it will not have any binding effect over other creditors or bankruptcy trustees. As a result, within the bankruptcy procedure, senior lenders and mezzanine or subordinate lenders will be distributed on a pro rata basis and thereafter adjustment of distribution will be made only among senior lenders and mezzanine or subordinate lenders based on their contractual arrangement. Meanwhile, the 'absolute subordination' method is an agreement between mezzanine or subordinate lenders and borrowers to the effect that where a bankruptcy, civil rehabilitation or corporate reorganisation procedure is commenced, the order of payment of mezzanine or subordinate loans will be subordinate to payment of subordinated bankruptcy claims (article 99(1) of the Bankruptcy Law of Japan, including, for example, claim of payment of interest accrued after the commencement of bankruptcy procedure). In such an arrangement, the mezzanine or subordinate loan is subordinate to subordinated bankruptcy claims within the bankruptcy procedure. Similarly, an agreement to the effect that 'in the event of occurrence of bankruptcy, the right to receive distribution under the mezzanine or subordinate loan will become conditional upon the completion of repayment of the senior loan' will have the same effect as above. In addition, interest payments on the mezzanine or subordinate loan will be made at a later date or later timing during the same day under normal circumstances, and, in the event of a default or certain interest payment suspension event, interest payments on a mezzanine or subordinate loan will be suspended until completion of payment to senior lenders.

30 What creditor groups are typically included as parties to the intercreditor agreement? Are all creditor groups treated the same under the intercreditor agreement?

Senior creditors, mezzanine creditors, subordinate creditors and any other relevant creditor groups agreeable upon such intercreditor agreement will be the parties thereto. Subordination arrangement as referred to in question 29 will be incorporated into such intercreditor agreement and each creditor group will be differently treated according to such arrangement.

31 Are junior creditors typically stayed from enforcing remedies until senior creditors have been repaid? What enforcement rights do junior creditors have prior to the repayment of senior debt?

See question 29.

32 What rights do junior creditors have during a bankruptcy or insolvency proceeding involving the debtor?

See question 29.

33 How do the terms of the intercreditor arrangement change if creditor groups will be secured on a pari passu basis?

Where loans are secured on a pari passu basis, the methodology of exercising security interests, the restriction on assignment or otherwise transfer of security interests and any other matters necessary or relevant to the exercise of security interests shall be specifically provided in intercreditor agreements and the decision of whether or not to exercise security interests or the timing or method of exercising security interests will usually be entrusted in advance to majority secured lenders who will decide such matters and exercise such security interests for and behalf of all creditor groups including themselves.

Loan document terms

34 What forms or standardised terms are commonly used to prepare the bank loan documentation?

The forms prepared by the Japan Syndication and Loan-trading Association (www.jsla.org) are recognised as the market 'norm' and are commonly used. Traditionally, as a prerequisite to commencing a banking transaction, a comprehensive banking transaction basic agreement shall be executed between the bank loan lender and the borrower but recently ad hoc loan transactions without executing such basic agreement have become rather common, especially in cross-border transactions with a foreign or international business company.

35 What are the customary pricing or interest rate structures for bank loans? Do the pricing or interest rate structures change if the bank loan is denominated in a currency other than the domestic currency?

Both fixed and floating interest rates are customarily used. While the 'LIBOR or TIBOR (Tokyo Inter-Bank Offered Rate) plus spread' method is often used in making loans to large corporations, the 'prime rate plus/minus premium/discount' method is still customarily used in making loans to SMEs or individuals. In case of bank loans denominated in foreign currency, the 'cost interest rate (eg, LIBOR) plus margin' method is often used.

36 What other bank loan yield determinants are commonly used?

When making a new loan (especially to a new customer), for a sales promotion or otherwise, a discounted interest rate may be applicable.

Update and trends

The long-awaited law on the amendments to the Civil Code of Japan (the Amendment Law) was finally approved by the Diet on 2 June 2017 and will be effective within three years after such date. This is an epoch-making legislation since the Civil Code of Japan has barely been amended in the 120 years since it was initially enacted in 1896. While the Amendment Law includes various amendments, they may be categorised into two groups: (i) amendments aiming to respond to the social and economic changes that have taken place over the past century; and (ii) amendments made to reflect the ample court precedents and legal interpretations accumulated during the same period. The notable amendments are, inter alia, as follows:

- the short-term statute of limitation applicable only to specific receivables such as doctors' or attorneys' fees, food and drink charges owed to a restaurant or bar, etc, will be abolished and instead receivables will be expired if they have not been claimed for five years since the creditor knew that the receivables may be claimed or if they have not been claimed for 10 years since the time the creditor was able to claim such receivables;
- the statutorily applicable interest rate will be reduced from 5 per cent (fixed) to 3 per cent and such interest rate will be revised according to the market interest rates from time to time;
- an individual person's guarantee of business-related debts shall be invalid unless its intention of guarantee is confirmed by a notarised document executed within one month prior to the execution of the guarantee agreement;
- the upper limit of the duration period for leasing will be changed from 20 years to 50 years and tenants will not be liable for the cost of restoring normal wear and tear or changes over the years of the leased things;
- it is statutorily confirmed that assignment of future receivables will be valid even if such receivables have not yet been incurred upon such assignment;
- even in the event the creditor and the debtor agree that the assignment of receivables is prohibited or limited, the assignment of such receivables may be valid (invalid under the current law) but the debtor may refuse to pay the receivables, or may claim the expiry of the receivables due to payment to the assignor or other reasons, against the assignee who knew or did not know with gross negligence of the agreement prohibiting or limiting assignment of receivables; and
- standard terms and conditions of contract (*yakkan*) may be validly incorporated into the parties' agreement if certain requirements are satisfied.

These amendments may materially affect loan and secured financing transactions with consumers and individuals and some amendments regarding prohibition or limitation of assignment of receivables, statutory interest rate or leasing contract, etc may also affect corporate loan and financing transactions, and the parties shall confirm that the relevant contract duly reflects and responds to these amendments to the Civil Code of Japan.

Recently, following the trend of negative interest rates, a zero floor (ie, base rate deemed zero if TIBOR or LIBOR falls below zero) was introduced. Original issue discount is used in the case of issue of debt securities such as zero-coupon bonds or discount bonds. In the case of acquisition finance, the applicable interest rate may be reduced gradually according to the decrease in the leverage ratio after certain scheduled principal repayments have safely been made ('pricing grid').

37 Describe any yield protection provisions typically included in the bank loan documentation.

As for increased cost, usually the borrower can choose between bearing such increased cost (excluding the cost increased owing to change of tax rate applicable to lender's taxable income), or repaying the relevant loan amount and thereby releasing the relevant lender's lending obligations. If the borrower intends to make prepayments, the borrower has to pay break funding costs corresponding to the prospective interest amount to be accrued for the remaining loan period. In cross-border loan agreements, tax gross-up provisions are sometimes provided in loan agreement upon the lender's request. However, even without such clause, it is generally considered that the borrower shall pay the originally agreed interest amount (ie, grossed-up amount) if withholding tax is imposed, on the ground that the borrower has agreed to pay such amount. If the borrower is to repay the loan in advance to its original maturity date, the borrower might be required to pay break funding cost to reimburse the lender's loss of future profit (which may not be covered by reinvestment of the repaid amount) and/or the lender's payment of cancellation fee of the covering transaction.

38 Do bank loan agreements typically allow additional debt that is secured on a pari passu basis with the senior secured bank loans?

Except for permitted security interests that are usually created in advance of the relevant bank loan, additional secured debt will be permitted only if lender separately agrees in advance to such borrowing. Such phased financing arrangements are sometimes used for cross-border acquisition financing, real estate development financing or project financing transactions.

39 What types of financial maintenance covenants are commonly included in bank loan documentation, and how are such covenants calculated?

Typical financial covenants are: maintaining certain ratings, leverage ratio (typically, interest-bearing debt divided by EBITDA), DSCR (debt service coverage ratio: typically, free cash flow divided by debt service amount), ICR (interest coverage ratio: typically, free cash flow divided by interest payment), minimum net asset or worth, capital and EBITDA (on a consolidated basis), fixed charge coverage ratio, or maximum capital expenditure amount. The calculation method will be different depending on the borrower's credit and other factors in each transaction. In domestic syndicate loans, additionally, negative covenants such as 'not to go in the red for two consecutive business years' or affirmative covenants such as 'maintain 75 per cent or more of net asset value of the previous business year' are often used. These covenants are usually tested annually, semi-annually or on a quarterly basis. The further details of covenants vary from transaction to transaction.

40 Describe any other covenants restricting the operation of the debtor's business commonly included in the bank loan documentation.

Affirmative covenants are, for example: compliance with the designated use of loan proceeds; maintaining the corporate status of the borrower; maintaining the licence and approval necessary for the borrower's business; timely payment of tax and public charges; maintaining major assets; and the subject debt will not be subordinated to any debts to other creditors. Meanwhile, negative covenants are, for example: not to materially change the business of borrower; not to merge or otherwise restructure the organisation; not to sell material assets; not to liquidate; not to owe debt beyond a certain amount; and not to create a security interest over its assets without the lender's consent.

41 What types of events typically trigger mandatory prepayment requirements? May the debtor reinvest asset sale or casualty event proceeds in its business in lieu of prepaying the bank loans? Describe other common exceptions to the mandatory prepayment requirements.

In typical acquisition finance, surplus cash flow, sales proceeds of assets, funds procured by separate borrowing or other debt financing, funds procured by issue of share or other equity financing, insurance proceeds received due to casualty events or indemnification received under the acquisition contract shall be mandatorily repaid to the lender. The calculation method or amount of such surplus cash flow subject to mandatory repayment, minimum threshold amount or exceptions or exemptions is often heavily negotiated between the lender and the borrower. In cross-border loan transactions, a 'change of control' clause will often be agreed as a mandatory repayment event, not an event of default, to circumvent triggering the cross-default clause of other debt financial documents. However, in domestic syndicated loan transactions, a 'change of control' unauthorised by the lender will usually

constitute a default event and with this in mind the acquirer or its financer should carefully review the domestic loan documents of the target company.

42 Describe generally the debtor's indemnification and expense reimbursement obligations, referencing any common exceptions to these obligations.

Regarding indemnification of increased cost, see question 37. Costs and expenses (including attorneys' fees) incurred in relation to the execution of or amendment to the loan agreement and other relevant documents as well as the lender's securing or exercising the rights and performing the obligations under the loan agreement will be borne by the borrower and indemnified to the lender unless such cost bearing or indemnification is prohibited under applicable laws or regulations or such cost is incurred due to the lender's fault. Tax and other public charges incurred in relation to the execution, amendment and enforcement, etc, of the loan agreement and other relevant documents will also be borne by the borrower and indemnified to the lender. In addition, the borrower shall indemnify the lender for damages, loss or expenses incurred due to the borrower's breach of covenant or other obligation or incorrect representation or warranties.

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