

Real Estate

Contributing editor
Joseph Philip Forte



2018

GETTING THE
DEAL THROUGH

GETTING THE
DEAL THROUGH 

Real Estate 2018

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CONTENTS

Global overview	5	Mexico	95
Joseph Philip Forte Sullivan & Worcester LLP		Moises Shehoah Chiver and Diana L Sologuren Perez SMPS Legal	
Austria	8	Monaco	103
Michaela Pelinka bpy Hügel Rechtsanwälte GmbH		Sophie Marquet and Didier Klatt CMS Pasquier Ciulla & Marquet	
Dominican Republic	15	Nigeria	110
Fabio J Guzmán Ariza, Christoph Sieger and Alfredo A Guzmán Guzmán Ariza		Kingsley Opia-Enwemuche and Odunayo Ayorinde Jackson, Etti & Edu	
England and Wales	23	Norway	118
Jon Pike and Siobhan Hayes Reed Smith LLP		Christoffer Nicolaisen and Knut Skarvang Deloitte Advokatfirma AS	
France	31	Romania	127
Alfred Fink Taylor Wessing		Roxana Negutu Voicu & Filipescu SCA	
Germany	42	Slovenia	134
Christian Gunßer and Melanie Döring Oppenländer Rechtsanwälte		Matej Perpar and Ajda Okršlar Kirm Perpar Law Firm	
Ghana	51	Sweden	141
Theresa Tabi Gyandoh Asmah & Co		Jan Litborn, Erik Borgblad and Alexander Camitz Advokatfirman Glimstedt	
India	60	Switzerland	150
Hardeep Sachdeva, Ravi Bhasin and Abhishek Awasthi AZB & Partners		Corrado Rampini Bär & Karrer Ltd	
Japan	70	Thailand	157
Hiroto Inoue, Junji Yamanaka and Makoto Saito Nagashima Ohno & Tsunematsu		Olaf Duensing, Jerrold Kippen and Weeraya Kippen Duensing Kippen	
Kenya	79	United Arab Emirates	167
Nyawira Kirubi and Joy Kamau Muthaura Mugambi Ayugi and Njonjo Advocates		Manish Narayan Galadari Advocates & Legal Consultants	
Malta	87	United States	175
Christian Farrugia, Damien Degiorgio, Denia Ellul and Madeleine Fenech Fenech Farrugia Fiott Legal		Joseph Philip Forte Sullivan & Worcester LLP	

Japan

Hiroto Inoue, Junji Yamanaka and Makoto Saito

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General

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 separate equity courts. A court may order specific actions 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. Real estate-related laws are generally nationally applicable.

2 Land records

Does your jurisdiction have a system for registration or recording of ownership, leasehold and security interests in real estate? Must interests be registered or recorded?

Japan has a nationwide real property registration system for matters such as the conveyance of ownership or other rights over real property, with registration being required for that conveyance to be perfected.

Registration generally only has the power to perfect interests, and interests can be created without registration and the existence (or non-existence) of the registration of interests does not guarantee the existence (or non-existence) of interests.

3 Registration and recording

What are the legal requirements for registration or recording conveyances, leases and real estate security interests?

For most matters that can be registered, the parties involved (eg, the seller and the purchaser) should jointly apply for registration.

Registration tax is payable at the time of the registration of the conveyance of ownership, and is generally 2 per cent of the value of the conveyed real property. (At the time of writing it has been temporarily reduced to 1.5 per cent for land conveyances.) 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 single purpose entity (SPE) (a *tokutei mokuteki kaisha* or TMK) established under the Law Concerning Asset Liquidation is entitled to reduced tax rates, provided certain criteria are satisfied. Further, in order to reduce transaction tax costs, it is common in commercial real estate transactions to place the real property in trust, and to thereafter transfer the rights to that real property in the form of a trust beneficiary interest. The registration tax for transferring the subject's 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 transfers of land to the trustee) and once the subject's real property is so entrusted, the registration tax payable upon a change of the beneficiary is only ¥1,000. Subsequent changes in beneficiaries 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.

4 Foreign owners and tenants

What are the requirements for non-resident entities and individuals to own or lease real estate in your jurisdiction?

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, owning or leasing real property in Japan. Under the Foreign Exchange and Foreign Trade Law (the Foreign Exchange Law), there is a *post facto* reporting requirement that must be filed with the Ministry of Finance, through the Bank of Japan, for certain types of acquisitions of ownership rights or other rights in real property by non-residents.

5 Exchange control

If a non-resident invests in a property in your jurisdiction, are there exchange control issues?

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.

6 Legal liability

What types of liability does an owner or tenant of, or a lender on, real estate face? Is there a standard of strict liability and can there be liability to subsequent owners and tenants including foreclosing lenders? What about tort liability?

Generally, the owner or tenant of real property may face tort liability if it wilfully or negligently acts, or fails to act, causing a breach of its duty of care in connection with the property and, as a result thereof, damage is sustained by a third party. Generally, the lender on real estate is unlikely to face any tort liability in this kind of situation, as generally the lender would not have much control over the management of the property.

A person in possession of a building, tree or other structure on the land will be liable for any harmful conditions of structures existing as a result of his or her negligence. If, however, a person in possession establishes that he or she has taken due care in preventing such a 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 inadequately maintained asbestos.

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.

7 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 for this 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 an environmental problem.

8 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? Are contractual choice of law provisions enforceable?

Choice of law in Japanese courts is governed by the General Law Regarding the Application of Laws, which provides that the contracting parties can choose the a contract's governing law and, generally, such choice will be upheld by 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.

Generally, contractual choice-of-law provisions are enforceable in Japan.

9 Jurisdiction

Which courts or other tribunals 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 affect 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.

10 Commercial versus residential property

How do the laws in your jurisdiction regarding real estate ownership, tenancy and financing, or the enforcement of those interests in real estate, differ between commercial and residential properties?

Generally, there is no difference between commercial and residential properties with regard to real estate ownership, tenancy and financing, or the enforcement of those real estate interests.

11 Planning and land use

How does your jurisdiction control or limit development, construction, or use of real estate or protect existing structures? Is there a planning process or zoning regime in place for real estate?

The City Planning Law generally provides for rules on the use of the land. This law categorises the land into various zones and requires permits for certain developments of the land in certain zones, and provides certain limitations on the use of the land and on the buildings that can be built in each zone.

Further, the Building Standard Law generally provides detailed rules on the buildings that can be constructed.

There are more laws that regulate and control matters that relate to real estate. Advice from lawyers or real estate agents should be sought for additional details.

12 Government appropriation of real estate

Does your jurisdiction have a legal regime for compulsory purchase or condemnation of real estate? Do owners, tenants and lenders receive compensation for a compulsory appropriation?

The Land Expropriation Act provides rules regarding the compulsory purchase of real estate by the government, municipal governments and other authorities. Generally, a person who is expropriated of its rights, including the owners and tenants of the real estate and lenders with certain security rights over the real estate, would receive compensation. The valuation of the interests and the allocation of the compensation are determined by the expropriation commission.

13 Forfeiture

Are there any circumstances when real estate can be forfeited to or seized by the government for illegal activities or for any other legal reason without compensation?

A court may order the forfeit of real estate that it is related to, or a subject of, illegal activities.

14 Bankruptcy and insolvency

Briefly describe the bankruptcy and insolvency system in your jurisdiction.

There are several types of bankruptcy or insolvency proceedings in Japan. Bankruptcy and insolvency proceedings can be commenced either voluntarily or involuntarily. In the case of court proceedings, generally a bankruptcy trustee will be appointed. 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. Upon a seller's bankruptcy or insolvency, the seller's fraudulent conveyance can be voided (even if it is implemented before the bankruptcy) under certain statutory conditions.

Investment vehicles

15 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 a joint-stock companies (KKs), limited liability companies (GKs) 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 a branch office 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. Foreign investors prefer the TMK arrangement, as it is believed that Japan's tax authorities are less likely to challenge the legitimacy of a 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 re-characterising 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 KJs, GKs and TMJs have limited liability. Furthermore, a TK investor will have limited liability with respect to the TK's business conducted by the TK operator.

Among these alternatives, the TK arrangement may have a slight disadvantage in light of the possibility of being re-characterised as an ordinary partnership arrangement, which would result in the loss of limited liability.

16 Foreign investors

What forms of entity do foreign investors customarily use in your jurisdiction?

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

17 Organisational formalities

What are the organisational formalities for creating and maintaining the above entities? What requirements does your jurisdiction impose on a foreign entity? Does failure to comply incur monetary or other penalties? 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, and maintained without any further formalities. 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 TMJs).

Acquisitions and leases

18 Ownership and occupancy

Describe the various categories of legal ownership, leasehold or other occupancy interests in real estate customarily used and recognised in your jurisdiction.

Ownership (absolute interest similar to fee simple interest) is the primary right in real estate. The holder of the ownership right will have the right to dispose of and use the real estate. Land and buildings are construed as different types of real estate and ownership of the land and ownership of buildings constructed on that land can be dealt with independently.

Generally, there is no other type of ownership interest (such as leasehold rights given by the government for a limited time period) for real estate. Ownership interests can be transferred by contract and there is no requirement on the formality of the transfer instrument, and theoretically it can be transferred by verbal agreement, although that is not typical for real estate transactions.

Co-ownership is the typical way to allow real estate to be owned by more than one person. The right of the co-owner extends to the entire real estate and not only to part of the real estate.

In order to allow land to be owned by more than one person without using co-ownership, the land can be subdivided into more than one lot and each person can become the owner of a particular lot of the land.

In order to allow a building to be owned by more than one person without using co-ownership, the owners can subdivide one building into condominium units (by satisfying certain conditions that each condominium unit would have certain independence from the others).

The typical way to provide a right to use the land or building is through a lease, which can be created by a contract. Generally, there is no requirement regarding the formality of the lease contract except

for certain types of leases that provide for fixed terms. A master lease structure is commonly used.

Generally, other types of benefits to, and burdens on, real estate are created by contract with the owner of the real estate.

19 Pre-contract

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 (ie, ¥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 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 used to be reluctant to explicitly agree to take the subject property off the market while negotiating a definitive contract of sale. However, recently it became more common to give exclusivity and to take the property off the market before the execution of a binding agreement.

20 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 sale 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 to 20 per cent deposit at the time the contract is entered into. Generally, no escrow arrangement is used. The deposit will be forfeited if the purchaser cancels the transaction without cause, and an amount equal to double the amount of the deposit must be paid by the seller to the purchaser if the transaction is cancelled by the seller without cause.

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.

21 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. Exceptions exist in the case of real estate securitisation contracts and other commercial deals, 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.

If any environmental defect is discovered on a target real estate before the execution of a real estate sales contract, a purchaser usually requires a seller's covenant to cure that environmental defect before or after the closing, noting completion thereof as one of the closing conditions, or by setting that covenant as a post-closing obligation of the seller. Alternatively, a purchaser may require a price discount for the real estate, taking into consideration the environmental risks resulting therefrom while accepting that environmental defect.

In the case of a 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).

22 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 (eg, 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); and
- 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 a 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.

23 Leases and real estate security instruments

Is a lease generally subordinate to a security instrument pursuant to the provisions of the lease? What are the legal consequences of a lease being superior in priority to a security instrument upon foreclosure? Do lenders typically require subordination and non-disturbance agreements from tenants? Are ground (or head) leases treated differently from other commercial leases?

Generally, a lease agreement will not provide for its subordination with regard to security instruments. Priority between a lease and a security instrument is determined according to the chronological order of perfection of such right over the 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 a building, 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 security instrument, the lease will survive, and be unaffected by, the foreclosure of the security instrument. It is not typical for a lender to require subordination and non-disturbance agreements from a lessee. Generally, the business practices related to real estate leases and the statutes and legal framework to be applied to real estate leases are largely different from other commercial leases.

24 Delivery of security deposits

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

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.

25 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? Discuss the priority among the various interests in the estate. Is it customary to obtain government confirmation, a zoning report or legal opinion regarding legal use and occupancy?

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 real estate broker or a lawyer to assist in this.

For securitisation transactions, it is standard practice to have a lawyer perform a legal due diligence investigation. There is no practice relating to title insurance, legal title opinion or indemnity funds.

Japan provides 'statutory priority' for recorded documents at the real estate registries (which are prepared for each of the real estate lots managed by governmental registration offices) in the sense that the real estate registry is based upon a 'race' registration system (ie, first in time, first in right priority), irrespective of contracts between the parties. This priority system, which relies on the real estate registry, applies

to the order of priorities of various other interests with regard to the real estate.

For securitisation transactions, it is also common for the engineering review mentioned below to cover the legality of the structure, use and occupancy of the real estate. It is not customary to obtain government confirmation, a zoning report or legal opinion regarding legal use and occupancy, which generally would be reviewed through the engineering review.

26 Structural and environmental reviews

Is it customary to arrange an engineering or environmental review? What are the typical requirements of such reviews?

Is it customary to get representations or an indemnity? Is environmental insurance available?

It is common to arrange for an engineering and environmental review when acquiring high-value real property (ie, ¥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, asbestos, soil contamination and other environmental matters, as well as other physical conditions of the building.

When acquiring high-value real property, 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 legal opinion in relation to due diligence of real property.

27 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?

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 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. Disputes relating to commercial leases are not unusual. A lender will typically not object to 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.

28 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
- debt financing-related agreements, if applicable.

A judicial scrivener usually drafts documents necessary for registering the transfer of title upon closure of a sale.

29 Closing preparations

How does a lawyer customarily prepare for a closing of an acquisition, leasing or financing?

Lawyers are involved in closing high-value commercial real property transactions (including acquisition, leasing and financing transactions). In the case of a hard asset conveyance, the principal documents at closing will be:

- a purchase and sale agreement;
- the agreements listed in question 28;
- a property risk report – a statutorily required report from the seller to the purchaser explaining the material risks in relation to the target property;
- those required for registering the transfer of real property ownership (eg, 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 notary public will be the principal document.

In a typical lease transaction, a lease agreement and a property risk report are delivered. A typical real estate securitisation transaction could involve more than 100 closing documents (including lease documents, equity investor sponsor letters and borrower counsel's legal opinions).

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.

As a debt finance advancement is usually necessary for sourcing a part of the real estate purchase price, and a lender or other debt finance provider always requires immediate perfection of its security interest over the purchased real estate upon advancement of its loan, the timing of the closing and funding must normally be simultaneous. It depends on the case (sometimes the contract and closing occur on the same date); however, the typical period between the contract and closing is one month, due to debt financing arrangements, preparations for acquisition and debt financing closing documents, etc.

30 Closing formalities

Is the closing of the transfer, leasing or financing done in person with all parties present? Is it necessary for any agency or representative of the government or specially licensed agent to be in attendance to approve or verify and confirm the transaction?

Typically, a closing meeting for the transfer is held at the office of the purchaser's lender that is offering debt financing for part of the real estate acquisition price (ie, the purchaser's lender). At the meeting, the relevant parties and their respective legal counsel and a judicial scrivener confirm the various acquisition and debt financing closing documents. The parties are typically:

- the seller;
- the seller's lender;
- the purchaser;
- the purchaser's lender; and
- a trust bank (in a real estate trust beneficiary interest transaction).

After the confirmation of the documents, the purchase payment is wired from the seller's bank account to the purchaser's bank account. Then, documents for registering the cancellation of the security interests of the seller's lender and for registering the real estate title transfer to the purchaser are released to the purchaser. Application documents for those registrations as well as application documents for the registration of the security interests of the purchaser's lender are immediately filed with the relevant governmental office managing the real estate registry. Registration taxes levied on those registrations must be paid at the time of the registration applications.

31 Contract breach**What are the remedies for breach of a contract to sell or finance real estate?**

In the case of a seller's breach of the contract, a purchaser is entitled to request a court order for specific action (ie, an order to deliver the real estate title to the purchaser and to register the title transfer to the purchaser). In this case, the purchaser is entitled to claim compensation for damages and, instead of specific action, to terminate the contract.

In the case of a purchaser's breach of contract, the seller is entitled to claim payment of the purchase price or terminate the contract, and claim compensation for damages.

In the case of a borrower's material breach of the debt finance documents (including the borrower's misrepresentation or breach of any of its covenants under such documents), a lender is typically entitled to:

- accelerate the maturity date of the debt;
- demand payment of default interest; and
- exercise its foreclosure rights under the mortgage(s) over the underlying real estate.

Sometimes, a contract provides a monetary penalty payable by the breaching party, irrespective of the actual damage incurred by the non-breaching party. Japanese courts generally respect those monetary penalty clauses.

32 Breach of lease terms**What remedies are available to tenants and landlords for breach of the terms of the lease? Is there a customary procedure to evict a defaulting tenant and can a tenant claim damages from a landlord? Do general contract or special real estate rules apply? Are the remedies available to landlords different for commercial and residential leases?**

Upon breach of the terms of the lease by the tenants or landlords, the non-breaching landlords or tenants are entitled to claim compensation for damages against the breaching tenants or landlords. If the breach is material, the non-breaching party is even entitled to terminate the lease. However, Japanese case law requires that the tenant's material breach must be substantial enough to destroy the trust between the landlord and the tenant for the landlord to terminate the lease for the tenant's material breach.

In other words, Japanese courts tend to interpret landlords' rights to terminate the lease restrictively (irrespective of the wording of the contract) and are reluctant to affirm termination of leases due to minor breaches by tenants. For example, Japanese courts tend to require two to three months' worth of rent to be unpaid for a landlord to be able to terminate the lease for the tenant's failure to pay rent. The remedies available to landlords are the same for commercial and residential leases.

Financing**33 Secured lending****Discuss the types of real estate security instruments available to lenders in your jurisdiction.**

Typical security instruments available to lenders in Japan are mortgages and revolving mortgages over real estate (in the case of hard asset transactions), and pledges over real estate trust beneficiary interests (in the case of real estate trust beneficiary interest transactions). Under these security instruments the lenders are granted certain rights similar to those rights held by holders of liens or charges. Historically, a defeasible conveyance over real estate that has been affirmed under Japanese case law has also been widely used for real estate security instruments. However, due to the lack of detailed written rules regarding defeasible conveyances, there remains uncertainty in the foreclosure, etc of defeasible conveyances. These days, the above-mentioned statutorily defined security instruments are more widely used.

34 Leasehold financing**Is financing available for ground (or head) leases in your jurisdiction? How does the financing differ from financing for land ownership transactions?**

In Japan, the rights of lessees to ground leases are generally well protected by the Land Lease and Building Lease Law (see question 27); therefore, it is standard for financial institutions to grant debt financing to borrowers that are secured by mortgages over buildings located on leasehold land. Certainly, a ground lessee's transfer of its rights, interest and position in and under a ground lease typically requires consent from the landowner (ie, the lessor of the ground lease), and the landowner usually requires payment of a fee for such consent or may even refuse to give such consent. This can be a hurdle for the financial institution to overcome when it seeks to exercise its foreclosure rights under the mortgage over the building.

However, in such a case, the financial institution may petition a court for an order consenting to the transfer of the ground lessee's rights, interest and position in and under a ground lease, upon the foreclosure of such financial institution's mortgage over the building. The court will usually issue such an order, subject to the payment of a certain amount, as a consent fee, to the landowner. Thus, this landowner consent requirement is not an insurmountable hurdle to prevent debt financing secured by mortgages over buildings located on leasehold land.

As long as the ground lease is subject to the Land Lease and Building Lease Law and has the minimum term as provided for in this statute, financing would generally be available. However, if the ground lease is a lease that falls under some exceptions to the protection under this statute (such as a lease for temporary use), then it is unlikely that financing will be available. There are no specific lease provisions required in a ground lease to make it financeable.

35 Form of security**What is the method of creating and perfecting a security interest in real estate?**

Mortgages and revolving mortgages are the typical methods for creating security interests over real property. They are perfected by registration in the relevant real estate registry. In the case where the transaction is accomplished by way of an acquisition of real estate trust beneficiary interests, a pledge is created over the real estate trust beneficiary interests, and such pledge is perfected by way of written consent of the trustee (with a certified date stamp by a notary public).

Security interests over moveables are generally perfected through transferring possession of the same to the secured party or registration. In order to create a pledge over a borrower's right to a bank account, the written consent (with a certified date stamp from a notary public) of the bank where the bank account is maintained is required.

Security interests can be created for some categories of intangible property (such as patents) and they are generally perfected through registration.

36 Valuation**Are third-party real estate appraisals required by lenders for their underwriting of loans? Must appraisers have specific qualifications?**

Usually, lenders of real estate loans obtain third-party real estate appraisals to evaluate the underlying real estate. This is absolutely necessary in the case of real estate non-recourse loans (in Japan, real estate loans are generally recourse loans unless a specific non-recourse carve-out clause is provided in a loan document), where lenders will not have recourse to other assets of borrowers. Real estate appraisers must obtain a business licence from the government.

Update and trends

In anticipation of the Olympics to be held in Tokyo in 2020, investment in accommodation and recreational facilities is booming in Japan. Numerous major or new hotel brands are planning to open new hotels in Tokyo and other areas of Japan. Further, there was a legal breakthrough in the area of home sharing-type business (eg, Airbnb). On the one hand, it was said that there was a regulatory risk associated with home sharing, in that it might be a violation of hotel regulation in Japan, while on the other hand home sharing itself was becoming more and more popular in Japan, especially for travellers from abroad. A new law was passed in June 2017 allowing building owners to rent their homes and apartments Airbnb-style for up to 180 days per year.

37 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 makes loans as its business to residents of Japan are found to be engaging in the business of moneylending and thus, be subject to rules under the Money Lending Business Law and be required to register thereunder 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. In the case of a pledge over a real estate trust beneficiary interest, no registration tax is applicable because it can be perfected with the trustee's consent without registration.

Separate from registration tax, stamp duties are applicable to loan and bond documents signed by a borrower. However, the amount of stamp duties is small in comparison with the amount of registration tax and should not affect the lender's choice of a debt financing structure.

38 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 legally impermissible in your jurisdiction and what are the consequences if a loan exceeds the legally permissible rate

Reference to Tokyo Interbank Offered Rate (Tibor) or Libor to determine a floating rate loan's interest rate is common. Interest rates established as a spread amount over Libor, Tibor or central bank interest rate indexes are basically enforceable in Japan. However, interest rates exceeding 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.

39 Loan 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 on each type of collateral. Japan does not have concepts similar to the 'one-action' or 'one at a time' rules - namely, a rule prohibiting a lender from bringing an action on a note or guarantee if they have commenced a foreclosure action against collateral securing the borrower's payment obligations under the said note or guarantee; or that prohibits a lender from bringing an action on a note or guarantee simultaneously with the lender's filing of said foreclosure action - provided that once a lender's claim has been satisfied through the foreclosure of its lien on collateral securing the debtor's obligations under the note, the lender is required to suspend all other actions to collect on the said note, enforce obligations under a guarantee, or otherwise.

40 Loan deficiency claims

Are lenders entitled to recover a money judgment against the borrower or guarantor for any deficiency between the outstanding loan balance and the amount recovered in the foreclosure? Are there time limits on a lender seeking a deficiency judgment? Are there any limitations on the amount or method of calculation of the deficiency?

In Japan, real estate loans are generally recourse loans unless a specific non-recourse carve out clause is provided in the loan documents.

Lenders are generally entitled to recover (until the claim becomes unenforceable because of the statute of limitations) any deficiency between the outstanding loan balance (and permitted additions) and the amount recovered in the foreclosure from the borrower or guarantor (if any), except in cases of non-recourse loans that explicitly provide a non-recourse carve-out clause. In the case of recourse loans, upon default, lenders are entitled to either foreclose the security instruments and recover the deficiency separately from the borrower or guarantor, or request the full amount of payment owed by the borrower or guarantor without foreclosure.

In the case of non-recourse loans, lenders are only entitled to foreclose the security instruments and are not entitled to recover deficiencies that are not recovered in the foreclosure.

Under the Interest Regulation Act, the maximum amount of loan interest (applicable to both recourse and non-recourse loans) is restricted to about 15 per cent per annum of the loan principal (where the loan principal amount is ¥1 million or more).

Any excessive amount of interest provided under the loan documents is not legally enforceable, and should be returned to the borrowers or guarantors even if they voluntarily paid that excessive amount.

41 Protection of collateral

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

Generally, the lender will not have possession of the property unless the security agreement provides for the contractual right of the lender to obtain possession and make a private sale. In order for the mortgagee to collect rent during a foreclosure, the mortgagee must obtain a judicial order to appoint a receiver and have the receiver collect rent

and distribute the rent as dividends or obtain a judicial order for the attachment of rent and require that the tenants of the mortgaged property pay their rent over to the mortgagee.

42 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 or insolvency filing? Is personal recourse to guarantors limited to actions such as bankruptcy filing, sale of the mortgaged or hypothecated property or additional financing encumbering the mortgaged or hypothecated property or ownership interests in the borrower?

Unless otherwise provided in the loan agreement, a lender will have recourse against all 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.

43 Cash management and reserves

Is it typical to require a cash management system and do lenders typically take reserves? For what purposes are reserves usually required?

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, insurance payments, return of tenant security deposits (tenant security deposits need to be returned to tenants upon termination of the leases), repair and maintenance costs) and to require the borrower to open an account at a lender bank to manage all cash flow of the borrower. It is relatively rare to require cash management systems and reserves for other types of loans.

44 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. After the amendment to the Civil Code, which is expected to become effective in a few years, it is expected that a guarantee by a natural person (as opposed to a company or other legal entities) to cover a loan or

other obligations indebted for business will be generally void unless the guarantee agreement is notarised.

Upon notarisation, the guarantor will be required to report details about the guarantor and the guarantee agreement to a public notary. Additionally, a revolving guarantee by a natural person will be required to set a maximum amount of such guarantee (unlimited revolving guarantee will be prohibited). 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 enforceable. Use of completion guarantees in development transactions is relatively rare except for a constructor's completion guarantee in a project finance deal.

45 Loan covenants

What covenants are commonly required by the lender in loan documents?

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 predesignated cash flow 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.

46 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 affect such financial covenants, it is common to require that the borrower submit financial reports and update collateral appraisal reports periodically. The above-mentioned financial covenants are relatively rare in a recourse loan.

47 Secured moveable (personal) property

What are the requirements for creation and perfection of a security interest in moveable (personal) property? Is a 'control' agreement necessary to perfect a security interest and, if so, what is required?

Typically, mortgages or revolving mortgages over real property in the case of hard asset financing transactions, and pledges over real property trust beneficiary interests in the case of trust beneficiary interest transactions, serve as the key security interests for lenders. In addition to these key security interests, sometimes security interests in moveable (personal) property assets, such as pledges over the furniture, fixtures and equipment and other moveable assets that are necessary or useful

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for real property operation are also provided to the lender. Pledges over moveables are perfected by the transfer of possession to the lender or registration. No 'control' agreement is required for perfection.

48 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 or insolvency 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.

Getting the Deal Through

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Merger Control
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