THE PROJECTS AND CONSTRUCTION REVIEW

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THE LAWREVIEWS

Chapter 13

JAPAN

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I INTRODUCTION

The main assets for project finance in Japan are power plants and public infrastructure.

After the first project financing transaction took place in the late 1990s in relation to conventional power projects, private finance initiative (PFI) projects were at the centre of the project finance field.

The Japanese government enacted the Act on Promotion of Private Finance Initiative Funds (Act No. 117 of 1999, as amended; the PFI Act), which initiated the boom of PFI projects. As PFI projects contemplated project finance debts, the project finance market developed in line with the expansion of the PFI market. Furthermore, after the PFI Act was amended in 2011 to introduce concession arrangements, project finance has been used for a wider class of infrastructure assets.

In addition, the Act on Special Measures on Procurement of Electricity from Renewable Energy Sources by Electricity Utilities (Act No. 108 of 2011, as amended; the Renewable Energy Act) boosted the development of the projects of renewable solar and wind plants nationwide.

II THE YEAR IN REVIEW

Investment in infrastructure is one of the core initiatives of the current administration, which aims to invest 21 trillion yen in infrastructure projects between 2013 and 2022. The government considers the concession scheme as a key tool to accomplish that goal. Since the privatisation of two international airports in the Kansai region in 2016, many airports have been or will be privatised by way of this scheme. Furthermore, the government advocates using the concession scheme for other assets, for example, toll roads, water purifying plants, sewerage facilities and convention centres. The procurement of concession has commenced for some of these assets.

Construction of new conventional power plants has been expected in recent years because it is not clear when the nuclear plants, whose operations have been suspended, will be allowed to resume operations and many of the current conventional power plants are facing renewal deadlines. However, owing to the global trend against coal-fired plants, and for commercial reasons, several projects to construct new conventional power plants were cancelled in 2017 and this year.

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The growth of the renewable energy sector is expected to continue. As projects from several years ago have now commenced operation, the secondary equity sale of these projects is active in Japan, and infrastructure funds that acquire these projects have been formed.

With respect to offshore wind farm projects, while a pilot project that the government launched in the Kashima region is still ongoing, a commercial-based project is expected to emerge in the next few years.

III DOCUMENTS AND TRANSACTIONAL STRUCTURES

i Transactional structures

Common vehicles used as project companies are joint stock corporations and limited liability companies. Sponsors inject equity by way of pure equity (or legal equity) as well as subordinated loans. Regarding subordinated loans, the Money Lending Business Act (Act No. 32 of 1983, as amended) does not fully exempt intra-group lending. Generally, a shareholder that owns less than 20 per cent would not be allowed to provide loans to the project company.

Recently, in addition to pure equity and subordinated loans, *tokumei kumiai* (TK) investments have often formed part of equity. A TK investment is an investment made under a TK contract, which is a bilateral contract whereby one party (the TK operator) receives funds from the other party (the TK investor) and with those funds conducts certain pre-agreed business, and shares the profit generated from this business with the TK investor. The business will be conducted in the name of the TK operator and the TK investor's liability is limited to the obligation to make an investment of the pre-agreed amount. The TK operator can enter into TK contracts for the same business with multiple TK investors, in which case, taken as a whole, the structure will be economically very similar to a limited liability partnership where the TK operator is a general partner and TK investors are limited partners. Under a TK contract, profit and loss allocated to TK investors is directly recognised by the TK investors, not by the TK operator.

Under the PFI Act, although various delivery structures have been adopted, the majority of PFI projects are availability-based accommodation projects, which use the build-to-order (BTO) structure. The ownership of an accommodation facility is transferred from the project company to the procuring authority upon its completion, and the accommodation facility is maintained by the project company thereafter.

In a concession project, the right to operate a subject infrastructure facility is granted to the project company while the ownership of the facility is retained by the public authority.

ii Documentation

A typical set of documents to be entered into in a project finance transaction are as follows:

a PFI (concession) contract between the project company and a procuring authority, or a power purchase agreement between the project company and a power utility;

b design-and-build (D&B) contract between the project company and a D&B contractor, or an engineering, procurement and construction (EPC) contract between the project company and an EPC contractor;

c operation and maintenance (O&M) contract between the project company and an O&M contractor;

d fuel supply contract between the project company and a fuel supplier;

e direct agreements between the lenders and the counterparties to various project documents;
f insurance agreement between the project company and insurance companies;
g finance agreements including senior credit facility agreements, interest rate swap agreements, intercreditor agreements and security agreements; and
h shareholders agreement between the project company's shareholders and the project company itself.

In relation to a construction contract, the Construction Business Act (Act No. 199 of 1949, as amended) (CBA) requires that a construction contract be made in writing, stipulating that there must be at least 14 items provided in the CBA to make the contract terms clear and unequivocal (Article 19, CBA).

iii Delivery methods and standard forms

Project finance lenders usually require that a construction contract be a date-certain, fixed-price and lump-sum contract. As a means of satisfying this requirement, construction agreements where project finance is involved often take the form of a D&B or EPC contract.

With regard to the delivery structure of construction projects, typically a contractor performs the works in accordance with the design provided by an owner or owner-retained designers. Typical standard forms for this delivery structure are the public work standard contract (PWSC) (last amended in 2017) published by the central government and providing the general conditions for public works; and the general conditions for construction contract (GCCC) (last amended in 2017) for the private sector. The GCCC was jointly drafted by several industry associations that respectively represented owners, developers, designers and contractors. It is the most widely used standard form, and is generally used together with special conditions prepared by the parties. Accordingly, when the GCCC is used in a project financing transaction, it is often amended by way of special conditions so that it will satisfy the project finance lenders' requirements.

For D&B-type contracts, the general conditions for design-build contract (GCDB) (last amended in 2012) drafted and published by the Japan Federation of Construction Contractors is the only published standard form. The GCDB was prepared by a contractor's association to promote the D&B delivery structure. Nonetheless, unlike D&B forms used in international construction projects, the design and construction parts are easily separable in the GCDB; the parties proceed to the construction phase only after the owner confirms the contractor's design products.

For industrial plant construction works, EPC contracts are widely used. The Engineering Advancement Association's General Conditions for Domestic Plant Construction Work (the ENAA-Domestic) (last amended in 2011), drafted and published by the Engineering Advancement Association, one of the contractors' associations, integrates design, construction and commissioning phases into a single contract; however, in reality, full turnkey EPC contracts are not frequently used for the construction of industrial plants, such as chemical process plants and power plants, unless project finance debt is procured. As a result, EPC forms are most commonly used in renewable energy projects, as they are usually financed by project finance debt. However, the ENAA-Domestic is not widely used in the market, and EPC forms that have been developed by contractors or project sponsors are more often used.

For PFI projects, the PFI Act does not specify any particular delivery structure. Various delivery structures have been adopted under this Act, including, in order of the most

common: BTO, build-operate-transfer, build-transfer and build-own-operate.[2] There are no publicly available standard forms of contract; however, for local governments' reference, the central government published a sample BTO contract, as well as the Guideline on Contracts – Notes for PFI Project Contracts (2003) and the Guideline for Risk Allocation in PFI Project (2001).

For design works and supervision services of construction works, the industry associations that jointly drafted the GCCC also publish the General Conditions for Design Work and Supervision (GCDS) (last amended in 2015).

IV RISK ALLOCATION AND MANAGEMENT

i Management of risks

Obstructions at the site

The GCCC provides that if the contractor discovers any obstructions to the construction work at the site, the contractor shall immediately notify the administrative architect of this in writing (Article 16, GCCC). It also provides that if it is necessary to vary the scope of work, the additional amount shall be agreed by the employer, the administrative architect and the contractor, through consultation.

Unless parties use such major contract forms, the contractor may have to bear the risk of unforeseen ground conditions. In a fixed-price contract, the court found that the contractor may not claim any additional costs, unless the court finds the situation to be extraordinarily unfair (Tokyo High Court, judgment of 29 March 1984, 1115 *Hanrei Jiho* 99). The court considered some factors in order to determine whether or not they were unfair, such as whether the conditions were unforeseeable to the parties and whether the conditions were not attributable to the contractor. It ultimately found that the conditions in question were foreseeable.

Force majeure

As a traditional civil law jurisdiction, Japan has the concept of *force majeure*, but does not have that of frustration. Most contract forms have provisions for *force majeure* as a cause of extension of time and termination.

Theoretically, the core effect of *force majeure* is to prevent the contractor from being liable for delays to the work. Except where the work is no longer possible because of *force majeure*, the contractor has to resume and complete the work once the influence of *force majeure* ceases to be in play. Whether the contractor is entitled to claim additional costs for resuming and recovering the work is a matter of debate. Contrarily, most major contract forms provide that parties have to consult each other first, and if the parties agree that the contractor's losses on the uncompleted works, materials and equipment were substantial, and good care of these was not taken, the employer shall indemnify the contractor for such losses (Article 21, GCCC). As such, solutions given by the major forms are still ambiguous and limited.

2 http://pfi-as.jp/case/cat4692/post_29.html.

ii Limitation of liability

The concept of limitation of liability is generally accepted under Japanese law. It is common in particular types of projects, such as renewable energy projects. Furthermore, liquidated damages, which are caused by breach of contract, including but not limited to delay in completion and non-accomplishment of the agreed level of performance, are also accepted under Japanese law and sometimes limit the amount of actual damages.

Foreign investors should note that a defaulting party may be liable for tort as well as for breach of contract. Where there are defects in a building that jeopardise its basic safety, and the defects are attributed to the design, the designer shall be liable for the damage caused by the defects incurred not only by the employer but also by a third party under the tort theory (Superior Court, judgment of 6 July 2007, 1984 *Hanrei Jiho* 34).

iii Political risks

The GCCC provides that either party may, by expressly stating its reason, make a claim for a necessary adjustment to the contract price if it is being used inappropriately or improperly owing to unexpected legislation (Article 29, GCCC); however, the GCCC does not provide an effective price adjustment mechanism, leaving it to the parties' negotiation and agreement. This kind of ambiguity is found in the majority of domestic project and construction contracts.

V SECURITY AND COLLATERAL

In project finance transactions, project finance lenders normally request security interests over most of the borrower's assets. For real property, mortgages and revolving mortgages are common forms of security interest created for the benefit of project finance lenders, and these mortgages and revolving mortgages may be perfected by registration. For shares of companies and rights (e.g., rights for account receivables, rights for bank accounts, rights for insurance proceeds and leasehold rights) pledges and revolving pledges or security by way of transfer are used depending on the type of assets. Generally, the pledge, revolving pledge and security by way of transfer may be perfected by consent from or notice to the obligor with a certified date.

Additionally, project finance lenders reserve rights to assign to themselves or third parties designated by the project finance lenders project-related contracts entered into by the borrower in order to enhance the step-in rights of the project finance lenders.

In traditional project finance transactions in Japan, sponsors often owe obligations to provide monetary support to project companies in recourse events, and pure non-recourse loans, in which sponsors owe no direct contractual liability to project finance lenders, are not common in traditional project finance in Japan. However, in recent years, there have been more non-recourse loans (rather than limited recourse loans) in project finance transactions for renewable energy power plants.

VI BONDS AND INSURANCE

With the exception of a construction agreement in relation to a conventional public procurement (without project finance debt being employed), performance bonds are not widely used in relation to construction agreements in Japan, except for projects where

international sponsors are involved. Where performance bonds are required in relation to those projects, they often take a form of demand guarantee under the Uniform Rules for Demand Guarantees published by the International Chamber of Commerce.

The following are typically procured in relation to project finance:

a erection all-risk insurance (during construction);
b third-party liability insurance (during construction and operation);
c delay in start-up insurance (during construction);
d all-risk insurance (during operation);
e business interruption insurance (during operation); and
f any other insurance statutorily required for the business that the project company conducts.

In Japan, project finance debt is predominantly procured by banks, and project bonds are rarely used. In some projects where non-bank financial institutions provide project finance debt, those financial institutions participate in a bank-debt syndicate, rather than subscribing for project bonds.

VII ENFORCEMENT OF SECURITY AND BANKRUPTCY PROCEEDINGS

Project finance lenders normally ensure their step-in rights with a combination of (1) security interests created over most of the assets and rights in connection with the project and (2) reservation of rights to assign project-related contracts to the project finance lenders or designated third parties. In exercising such step-in rights in case of an event of default, project finance lenders first try to assign the project to a third party designated by the project finance lender with voluntary cooperation by the project company and its sponsors using the pressure of the step-in rights. If the project company and its sponsors are not cooperative, the project finance lender will unilaterally exercise its step-in rights, which may include foreclosure of security interests.

Generally, in a bankruptcy proceeding and civil rehabilitation proceeding, secured creditors may still foreclose their perfected security interests outside the bankruptcy or civil rehabilitation proceeding and collect proceeds of foreclosure. However, in a corporate rehabilitation proceeding that is applicable to stock companies (not limited liability companies), secured creditors may not exercise their security interests outside the corporate rehabilitation proceeding.

VIII SOCIO-ENVIRONMENTAL ISSUES

i Licensing and permits

In developing power plants or other infrastructures, all the applicable permits, certifications and notifications relating to the development must be obtained and implemented. In addition to nationwide regulations, in most cases there are multiple layers of local regulations set by prefectures, cities, towns, villages and wards that may include a requirement to conduct an environmental impact assessment.

ii Equator Principles

Some leading Japanese banks have adopted the Equator Principles and typical covenants and representations required by the Equator Principles commonly appear in project finance documentation.

IX PPP AND OTHER PUBLIC PROCUREMENT METHODS

i PPP

Before the concession scheme was introduced in 2011, most of the PFI projects were availability-based accommodation projects (e.g., schools, government offices, public housing, hospitals, school catering service facilities and libraries) and projects in the transportation sector, such as Haneda International Airport, were exceptions (although PFI can be employed to various types of infrastructure and is flexible). The amendment of the PFI Act in 2011 aimed to change this situation and to develop the PFI regime to accommodate broader PPPs that can be used in various types of infrastructure projects. Under the concession scheme, a concessionaire is allowed to collect from the general public a commission, toll, fee or other moneys for use of the infrastructure that it operates. As such, the concession scheme is considered an appropriate form for a project where the private sector assumes all or part of the revenue and demand risk.

In most PFI and PPP projects, the bidding process has two stages, and only the bidders that passed the first stage are invited to the second stage, and the winner of the second stage becomes a preferred bidder. In recent projects, a competitive dialogue has been conducted in the second stage. Proposals of bidders are evaluated by scoring various aspects of the proposal based on the standards prescribed in the tender documents. The preferred bidder is usually not allowed to further negotiate a contract with the procuring authority after it has been chosen as the preferred bidder. As such, it does not take much time to conclude the contract once the preferred bidder is selected. Most of the work done after the preferred bidder is selected is in relation to the finance documents, and the project finance lenders are usually required to accept the terms of the contract agreed between the bidder and the procuring authority.

ii Public procurement

There is no legislation in Japan that deals directly with public procurement; the Public Account Act (Act No. 35 of 1947, as amended) (in relation to procurement by the central government) and the Local Autonomy Act (Act No. 67 of 1947, as amended) (in relation to procurement by local governments) refer to the permitted forms of public procurement (i.e., open competitive tender, restricted competitive tender and negotiated procedure) and their respective procedures.

Although criminal sanctions apply to persons who commit serious violations of procurement procedures (e.g., graft or cartel activity) there is no specific cause of action available to losing bidders that can stop the procurement procedure or the conclusion of the contract.

X DISPUTE RESOLUTION

i Special jurisdiction

Generally, litigation at court is the most popular dispute resolution procedure. Although there is no special jurisdiction of special courts for projects and construction disputes, district courts in Tokyo and Osaka have a department called the Building Division. Nonetheless, foreign investors should note that Japanese courts, even with building divisions, are generally not familiar with expert analysis on delay because there are almost no experts in this area. District courts also provide court-sponsored mediation services (private mediation services are rarely used in any of the industry sectors).

ii Arbitration and ADR

Additionally, the CBA designates the Construction Dispute Board (CDB) as the government-sponsored alternative dispute resolution procedure (Article 25, CBA). There are local CDBs and a central CDB. The jurisdiction of each CDB is determined by the registered office of the claimant, or the construction site in question. Central and local governments appoint a panel of mediator-arbitrators. The CDB is not a dispute board frequently used in international construction practices, but a kind of conciliation tool purely formulated for domestic disputes. It is not advisable for foreign investors to rely too much on the CDB procedure.

The most recommended dispute resolution is arbitration. Although use of arbitration for domestic disputes is quite infrequent in Japan, the Arbitration Act (Act No. 138 of 2003, as amended) is modelled after the 1985 UNCITRAL Model Law. The Japan Commercial Arbitration Association is the most reliable arbitration institution in Japan, but any foreign arbitration institution can be chosen instead. The language of arbitration as English.

XI OUTLOOK AND CONCLUSIONS

The project finance market in Japan still has room for potential expansion but, in the areas of concession-type PFI projects and offshore wind farm projects (among others), potential expansion depends on the level of deregulation by the national government.

The role of local governments is also important as they have the power to initiate or support various projects that are potential targets for project financing.

Appendix 1

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Naoki Iguchi is a partner in the international projects and arbitration practice team of Nagashima Ohno & Tsunematsu. He has been advising construction companies, investment companies and infrastructure management companies in construction, transportation, crude oil pipeline and other infrastructure projects in various jurisdictions including Asia, the Middle East, Africa and the Americas. Mr Iguchi also provides advice to national and foreign construction and investment companies that have projects in Japan, including advising construction projects of famous entertainment facilities. Mr Iguchi has represented many companies in international arbitration in Asia. He was the representative for Japan on the Dispute Resolution Board Foundation and is a regular workshop lecturer of the Overseas Construction Association of Japan, Inc.

Mr Iguchi also taught international project law at Keio Law School. He studied at the University of Tokyo (LLB; LLM), Stanford Law School (LLM) and the Beijing Language University (Mandarin training), and has worked at law firms in Japan, China, Taiwan and the United States. Mr Iguchi is a member of the Japan ICC Arbitration Committee and was a member of the ICC Workforce on Costs. He is fluent in Japanese, English and Mandarin, and he also understands Spanish.

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Rintaro Hirano is a partner at Nagashima Ohno & Tsunematsu. He has advised Japanese clients in a number of international projects, and he has experience in negotiating with host-country governments, international lenders, and contractors and sponsors in those projects. In particular, Mr Hirano was involved in large-scale infrastructure projects during a two-year secondment to the Japan Bank for International Cooperation (JBIC). The sectors he covers range from transportation, such as rolling stock, light-rail concession, airports and toll roads, and telecommunications, such as submarine cable systems, to power and energy including conventional power projects, renewable power projects (solar, wind, etc.) and LNG projects. Mr Hirano earned an MBA from INSEAD in 2009, an LLM from Columbia Law School in 2007 and an LLB from the University of Tokyo in 2000. He is admitted to the Bar in Japan (2001) and New York, United States (2008).

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