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# Structured Finance & Derivatives

**Japan**

Nagashima Ohno & Tsunematsu

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# Law and Practice

*Contributed by Nagashima Ohno & Tsunematsu*

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**Nagashima Ohno & Tsunematsu** has a Structured Finance & Derivatives team of more than 50 lawyers (including approximately 15 partners) who have extensive experience dealing with a wide variety of structures in Japanese and cross-border transactions, including – in addition to the traditional methods of structured finance – WBS (Whole Business Securitisation), CMBS (Commercial Mortgage Backed Securities), CDO (Collateralised Debt Obligations), BIS Finance (dealing with financial institutions' capital adequacy requirements under the Basel Accord) and other transactions involving derivatives. NO&T provides exceptional advice in all aspects of structured finance & derivatives transactions – eg, structure development, risk analysis, SPC or trust formation, documentation, negotiation, research and rendering of legal opinions. NO&T expertly represents clients that serve various functions in the structured finance & derivatives market, from arrangers, originators, fiduciaries (trust banks), and special purpose companies, to parties supplying supplementary financing and/or credit-enhancement (financial institutions), credit-rating agencies and investors.

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## 1. Structured Finance

### 1.1 Market Overview

The Japanese structured finance market continues to steadily increase in terms of both numbers and volume. According to a survey by the Japan Securities Dealers Association, the total number of disclosed issuances in 2017 was 153, and the total disclosed value of these was approximately JPY4.5 trillion. The main and traditional structured finance products offered in Japan are RMBS, CMBS, CDOs and securitisation of shopping credit card receivables, lease receivables, consumer loans and sales receivables (including commercial bills). A recent market trend is the increase of structured finance products using declaration of trust structures to enable the securitisation of receivables that are contractually prohibited from being assigned. Further, in order to prepare for the implementation of the Basel III regulations, Japanese banks are becoming more eager to be involved in CDO and synthetic CDO transactions to decrease their risk assets.

With respect to new laws, an amendment to the Civil Code of Japan will become effective on April 1, 2020. Please see **2.8 Reform** and **3.5 Reform**, below, for amendments that are especially important in the structured finance field.

## 2. Acquisition Finance/Leveraged Finance

### 2.1 Transaction Structure, Players and Legal Regime

Although structures used in Japan for acquisition finance/leveraged finance vary depending on the transaction, transactions are typically structured as senior debt only, or as a combination of senior debt and mezzanine financing. A revolving working capital facility is also commonly provided. The inclusion of mezzanine financing is becoming more common in Japan in order to bridge the gap when senior debt is insufficient for the full financing. Mezzanine financing is typically structured as subordinated debt or preferred shares, with warrants sometimes added as a sweetener.

Subordinated bonds and high-yield bonds are not commonly used for acquisition finance/leveraged finance in Japan.

In recent times, Japanese commercial banks have played big roles as senior lenders in the Japanese acquisition finance/leveraged finance market. In particular, the market is dominated by three major Japanese banks:

- MUFG Bank, Ltd.;
- Sumitomo Mitsui Banking Corporation; and
- Mizuho Bank, Ltd.

Certain mezzanine funds, bank subsidiaries and lease companies occupy the market as mezzanine financers. The types of mezzanine funds include:

- funds established by Japanese banks;
- funds established by Japanese insurance companies;
- funds established by securities companies; and
- independent funds.

There is no specific law or regulation governing acquisition finance/leveraged finance transactions in Japan. While the Financial Instruments and Exchange Act is the primary piece of legislation that governs financial markets in Japan, the Companies Act, Civil Code, Money Lending Business Act, Interest Rate Limitation Act and other relevant laws will often apply depending on the structure of the transaction.

### 2.2 Documentation

Usually the documentation procedure starts from the commitment letter phase. During this phase, the buyer asks candidate lenders to submit non-binding letters of intent, and proceeds to select one or two lenders as mandated lead arrangers (MLAs). After the selection of the MLA, the buyer and MLA commence negotiation of the commitment letter and the term sheet of the finance/leveraged finance. After the commitment letter phase, the buyer and the MLA commence negotiation of the definitive loan agreement and the security agreements. Such definitive agreements are usually drafted and handled by the MLA and its counsel.

Although there is no official standard form for the definitive agreements, in practice many lenders in the market use a similar form. In addition, if the finance for the transaction is purely corporate finance, MLAs almost always use the model syndicated loan agreement form published by the Japan Syndication and Loan-trading Association (the 'JSLA'). If the buyer is a US or European private equity fund, the Loan Market Association form is sometimes used.

### 2.3 Security

Security interests are created to seize control of the target and its group companies ('Targets'). The shares of the Targets are the most important security in order to acquire and dispose of control over the Targets. Furthermore, in addition to the share pledge, the lenders generally wish to enter into security arrangements over all, or substantially all, of the assets of the Targets.

The type of security used varies depending on the asset type and the overall financing structure. Typical types of securities are mortgages (teitou ken), pledges (shichi ken) and security assignments (jouto tanpo).

A blanket lien over all of the assets of the borrower, known in Japan as corporate collateral (kigyo tanpo ken), is not used in the context of acquisition finance/leveraged finance as it is limited by statute to securing only corporate bonds and not loans. Another weakness of corporate collateral is that, as a general security interest, it is subordinate to specific security interests. Accordingly, a lender holding a corporate collateral interest cannot assert priority over a creditor that subsequently obtains a security interest over a particular asset. This makes corporate collateral inappropriate for the purposes of holding a security interest in the context of acquisition finance/leveraged finance.

As a general principle, the asset to be used as security needs to be assignable. Typical types of assets used as securities are shares, real estate, receivables, bank accounts, movable assets and intellectual property. There are different limitations and restrictions depending on the type of assets to be secured and the type of security to be used for such asset. The procedures to grant security are as follows.

- Security over shares: a pledge or security assignment is commonly used by lenders to create a security interest over shares. The steps required to create and perfect the pledge will differ based on whether the issuer is a public company and if the articles of incorporation provide for the issuance of share certificates. The three most common scenarios are:

  (a) If the issuer of the shares is not a listed company and

the articles of incorporation of the issuing company provide that share certificates are to be issued, the execution of a pledge agreement and delivery of the share certificates to the pledgee is required to create the pledge. Continuous possession of the share certificates by the pledgee is then required to perfect the pledge against the issuing company and third parties. Usually, the security agent receives delivery of the share certificates and keeps them as proxy for all the pledgees.

(b) If the issuer of the shares is not a listed company and the articles of incorporation of the issuing company do not provide that share certificates are to be issued, execution of a pledge agreement is sufficient to create the pledge. Recording the pledge in the share ledger is required to perfect the pledge against the issuing company and third parties.

(c) If the issuer of the shares is a listed company, the pledge becomes effective when the pledgee has the relevant increase in the number of shares recorded in the pledge column of the pledgee's account through an application for the book-entry transfer. Approval by the board meeting (or shareholders' meeting) will be required to create and enforce a security interest over transfer-restricted shares.

- Security over property: a mortgage on real estate can be created by registering the mortgage with the public registry where the real estate is located. Security assignment of real estate is not so common, since certain registrations of the 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.

  A pledge or security assignment of property can be created by agreement among the relevant parties. To perfect such pledge or assignment, the borrower must deliver possession of the subject property to the security interest holder. The borrower can constructively deliver this by declaring its intention to keep possession of the assets for the security interest holder (senyu kaitei), or by instructing a third person who has direct possession of the property to retain possession for the assignee (sashizu ni yoru senyu iten). Further, under the Registration Act, the security interest holder can perfect the assignment by registering the transfer with the competent legal affairs bureau.

- Security over receivables: a pledge or security assignment of receivables can be created by contractual agreement between the security provider or borrower and the lender. There are three ways to perfect either a pledge or a security assignment:

  (a) notice with notarisation (kakutei hiduke) to the third-party debtor;
  (b) consent with notarisation from the third-party debtor; or
  (c) registry of the pledge or assignment with the competent legal affairs bureau.

  If method c) above is chosen, the perfection only relates to the perfection to third parties. In order for the pledge or assignment of receivables to be perfected regarding the debtor, in addition to the registration provided in method c):

  (a) the pledger/assignor or the pledgee/assignee must send to the debtor a notice stating that the pledge/assignment has been made, and that such pledge/assignment has been registered, together with a certificate of registered matters issued by the competent legal affairs bureau; or
  (b) the debtor must consent to the pledge/assignment and acknowledge the registration of such pledge/assignment.

  Cash collateral, or current or savings account collateral, has become more common in international finance transactions, but the validity of such security interests is not yet publicly recognised under any statutes or court precedents in Japan.

Statutory foreclosure is an option to enforce a security. However, the foreclosure price will usually be considerably lower than the sales price in a voluntary sale. Therefore, as long as the relevant parties agree, secured assets, typically mortgaged real estate, are often sold by voluntary sale rather than by statutory foreclosure.

Where a bankruptcy procedure or civil rehabilitation procedure is commenced, security interests will be treated as an 'out-of-procedure right' and, generally speaking, may be enforced outside of the procedure. However, in the case of the commencement of a civil rehabilitation procedure, the court may prohibit or suspend any foreclosure if certain requirements are satisfied.

In either procedure, the court may approve the expiry of certain security interests with certain compensation. Meanwhile, in the case of corporate reorganisation procedures, all security interests are subject to the reorganisation procedure and may not be separately exercised outside of the procedure (ie, security holders will only be entitled to receive dividends under the approved reorganisation plan).

### 2.4 Restrictions and Limitations

Japanese thin-capitalisation rules are only applicable to cross-border financing. Generally, the portion of interests paid to foreign controlling shareholders and foreign lenders corresponding to the excess amount is not deductible if:

- the gross amount of interest-bearing debts owed by the domestic entity exceeds three times the amount of capital of the domestic entity; and

- the gross amount of debts owed by the domestic entity to its foreign controlling shareholders and foreign lenders exceeds three times the amount of capital of the domestic entity multiplied by the ownership percentage of the foreign controlling shareholders.

Unlike in EU jurisdictions, there is no statutory financial assistance restriction in Japan. However, providing guarantees or security interests to a majority shareholder at the expense of minority shareholders can contradict the directors' general fiduciary duty. Therefore, only wholly owned subsidiaries of the borrower provide guarantees or security interests, except where certain corresponding benefits, such as guarantee fees, are provided, or all of the shareholders have given their consent.

In the typical acquisition finance/leveraged finance structure, the target does not provide any guarantee or security interest to the lenders until the target becomes the wholly owned subsidiary of the borrower acquisition vehicle.

Finally, there are no court precedents in Japan that have specifically adopted the 'corporate benefit' doctrine and preferential activities by a debtor, or a debtor attempting to reduce its assets, might be considered void by exercise of the avoidance right by the bankruptcy trustee.

### 2.5 Lender Liability

Under Japanese terminology, lenders' liability in the broad sense means any liability of a financial institution arising out of any negotiation, closing, administration or collection in connection with its lending. Lenders' liability in the narrow sense means the liability of a financial institution due to its excessive control of the borrower. There have been many court precedents relating to the former and a couple to the latter, however these are only general obligations of lenders and no special consideration with regard to lenders' liability in the context of acquisition finance has been actively addressed in Japan.

### 2.6 Debt Purchase Transactions and Debt Trading

Legally, the borrower or financial sponsor can purchase its own debt. If the borrower purchases its own debt, such debt will be extinguished at the time of purchase as a result of the creditor and debtor being the same.

The secondary market of debt has yet to grow in Japan. Therefore, debt buy-back is still uncommon.

### 2.7 Certain Funds Concept

In Japan there is no rule requiring certainty of financing for acquisitions of public companies, as is required in the UK. When the syndication includes foreign lenders and the LMA format is used for the credit facility agreement, a 'certain funds' provision is included, but this provision simply lists the conditions precedent to the drawdown of loans.

In the case of a tender offer bid being issued for a public target, a document that evidences the existence of funds, sufficient to settle the tender offer, must be attached to the tender offer registration statement. A credit certificate issued by the lenders is typically used for this purpose. Where a credit certificate is used to evidence the availability of funds, the Financial Services Agency requires it to clearly and specifically list the conditions precedent to the drawdown of funds.

### 2.8 Reform

A major amendment to a part of the Civil Code relating to contractual obligations has been scheduled. This amendment will affect all types of transactions in Japan, including acquisition finance. The amended code was promulgated on 2 June 2017, and will enter into force on 1 April 2020.

## 3. Securitised Debt

### 3.1 General

There is no specific law or regulation governing securitisation transactions in general. The Asset Securitisation Act is specifically dedicated to facilitating asset securitisation and authorises the use of two types of vehicle specifically designed for securitisation, namely the specific-purpose company (TMK) and the specific-purpose trust (TMS), and provides for relevant regulations applicable to them.

The following assets/receivables, among others, are typically involved in securitisation transactions in Japan: sales account receivables, promissory notes, electronically recorded monetary claims, equipment lease receivables, credit card receivables, auto-loan receivables, residential mortgage loan receivables and commercial mortgage loan receivables. Securitisation transactions in Japan are mostly comprised of performing debt; the use of non-performing debt is rare.

There are no laws requiring the originators' risk-retention. However, under the Japanese FSA's supervisory guidelines addressed to banks and financial institutions, it is recommended that banks and financial institutions invest in securitised products whose risks are partially retained by originators and, if not, that they should separately analyse the originators' involvement in the original assets or the quality of the original assets. In addition, rating agencies will usually require that originators retain a certain portion of interests/risks in the securitised products. In a typical debt securitisation transaction, originators will hold subordinated interests (usually between 10% and 30%) in the debt pool, which enhances the credit of investors' senior interests in the debt pool.

### 3.2 Asset Transfer

Typically, receivables are transferred to asset holding vehicles, such as SPCs or trusts, by assignment or entrustment. Assignment of receivables may be made by agreement

between the assignor and the assignee and does not require any other particular formalities.

To perfect an assignment to third parties, notice to or consent from the debtor, which bears the notarised date, is required. Additionally, if the assignor is a judicial person, registration of the assignment is also available.

To perfect the transfer to the debtor, notice to (together with a certificate of registration, if applicable) or consent from the debtor is required.

It is usually the case that registration of the transfer will be made at the same time or soon after the closing of the transaction. However, notice to a debtor is usually suspended until the occurrence of a contingent trigger event in the future, such as an originator's insolvency event.

If the debtors are consumers, consumer protection laws such as the Consumer Contract Act, the Instalment Sales Act and the Interest Rate Restriction Act may be applicable to the underlying contracts/receivables and, under such statutes, debtors could refuse to pay all or part of the receivables if they are entitled to do so under the applicable acts. To protect investors' interests from such non-payment in securitisation transactions, it is common for the originator to represent and warrant that no claim or cause of claim exists that may justify such non-payment.

Debtors' personal information is protected under the Personal Information Protection Act. However, according to the cabinet office's view, since receivables should be freely transferable under the Civil Code, we may assume that debtors give their implied consent to the assignor's disclosure of their personal information to the assignee to the extent necessary for management of such receivables.

Another issue arises in cases where a trust is used as an asset holding vehicle: whether or not the trustee may disclose personal information of debtors of the entrusted receivables to senior beneficiaries (investors). In such cases, the abovementioned exemption upon assignment will not apply. Therefore, practically speaking, any data relating to the asset pool that the trustee provides to the trust beneficiaries (investors) may not identify individual debtors.

In cases where an SPC is used as an asset holding vehicle, payment of part of the purchase price will sometimes be deferred until the actual collection of receivables, whereupon the deferred purchase price and collected payment amount will be set-off. The maximum ratio of the deferred purchase price against the total purchase price will be determined case by case, taking into consideration the default risk of the asset pool and other factors but only to the extent that the credit enhancement effect of such deferred payment will not harm any 'true sale' status. In the case of transactions involving a trust, a subordinated beneficial interest will be retained by the originator for the purpose of credit enhancement.

If a sale of receivables is re-characterised as a secured loan, rather than a 'true sale', and a corporate reorganisation proceeding is commenced against the debtor, such receivables may not be exercised outside of the reorganisation proceeding and will be paid only after the court approves the reorganisation plan, and in accordance with it. In addition, in corporate reorganisation proceedings, civil rehabilitation proceedings or bankruptcy proceedings, the bankruptcy trustee (or appropriate person as the case may be) may petition the court to extinguish such 'security interest'.

Therefore, for securitisation purposes, a sale of receivables ought to be recognised as a 'true sale' to protect investors' interests. Since there is no statutory provision or published judicial precedent clearly addressing the criteria of 'true sale', in practice, deal lawyers will issue a 'true sale' legal opinion considering various factors, such as:

- the relevant parties' intentions as set forth in the relevant transaction documents;
- whether or not the risk and/or interest of the assets or the right to control the assets have been fully transferred from the originator to the asset holding vehicle;
- whether the originator is entitled or obligated to repurchase the asset;
- whether the transfer of the asset has been perfected;
- the appropriate level of the purchase price;
- whether or not the asset will remain on the originator's balance sheet; and
- other additional factors.

### 3.3 Issuance Vehicle

Both SPCs and trusts are often used as vehicles for the issuance of securities or other interests to investors. TMK (tokutei mokuteki kaisha) and GK (godo kaisha) are the forms of SPC most often used for asset securitisation. Customarily, a Cayman company is also used as a vehicle issuing ABCPs or other short-term financial products backed by a pool of sales receivables or promissory notes. A trust can also be used as a vehicle for asset securitisation. A trust's beneficial interest (categorised as a 'type two security' under the Financial Instruments and Exchange Act) is sometimes held directly by investors or indirectly through other SPCs backed by investors. A trust (acting through its trustee) may issue debt securities (ie, trust bonds) the recourse asset of which is typically limited to trust assets. Recently, a declaration of trust or self-trust has been used as a vehicle for the securitisation of assignment-prohibited receivables or other similar assets, and such structures are increasing.

There are no minimum capitalisation requirements for SPCs.

Desirable aspects of an SPC include bankruptcy remoteness, described in **3.4 Bankruptcy Remoteness**, below.

There is no statute which specifically allows the establishment of different 'segregated portfolios' or 'compartments' within one single corporate entity. Moreover, the validity of any contractual ring-fencing or an investor's 'limited recourse' covenant with the issuer (whereby the assets of a particular segregated portfolio would be attributable and available only to the creditors of such portfolio) has not been tested and remains uncertain under Japanese insolvency laws. In addition, the validity of a non-petition covenant has not been tested and also remains uncertain under Japanese insolvency laws.

Therefore, to ensure such ring-fencing, a creditor will be required to create a security interest over the portfolio assets or establish a single issuing vehicle for each issuance. As a result, multi-issuance vehicles are unlikely to be used for securitisation transactions on a limited recourse basis.

There is no concept of consolidation of the assets of a company with those of another company under Japanese insolvency laws. However, if the 'piercing the corporate veil' doctrine, which applies with respect to Japanese tax law or civil law, is applicable then a similar result will occur. In general, under this doctrine, the corporate veil will be pierced when the legal entity is only a sham, or when the legal entity is misused to circumvent the application of law.

### 3.4 Bankruptcy Remoteness

The issuance vehicle for securitisation is usually set up as a bankruptcy-remote entity. To achieve bankruptcy remoteness, an SPC itself must not be bankrupt and the assets of the SPC must be managed separately from the originator's other assets. For this reason, in the articles of incorporation of an SPC, the objects, powers, debt amount and right to amend its articles of incorporation, recourse assets and other similar provisions should be restricted. In addition, a certified accountant or other third party is usually appointed as its independent director, and all the equity interests of the SPC are held by an independent party such as a Cayman SPC owned by a charitable trust or a general incorporated association (ippan shadan houjin). Additionally, the sale of assets from the originator to the SPC is made on 'true sale' basis. It should be noted that TMKs are not subject to corporate reorganisation proceedings where secured creditor's rights cannot be exercised outside of the reorganisation proceedings. Further, a trust will not be affected by its trustee's bankruptcy, since the Trust Act provides statutory guarantees of the independence of trust assets. However, in order to also achieve remoteness from the originator's bankruptcy, the entrustment of assets from the originator to the trustee must be made on a 'true sale' basis.

Under the Civil Code, the originator's creditors may demand a court to rescind the originator's sale or transfer of assets if:

- the originator sold or transferred assets knowing at the time that such sale or transfer would be harmful to the creditors; and
- the counterparty of such sale or transfer, or the subsequent purchaser or transferee, knew at the time that such sale or transfer would be harmful to the creditors as of the time of such sale or transfer or subsequent purchase or transfer, respectively.

Under the Bankruptcy Act, the Civil Rehabilitation Act and the Corporate Reorganisation Act, the sale or transfer of the originator's assets may be avoided in the interest of the originator's insolvency estate if and after an insolvency proceeding has commenced, and if:

- such sale or transfer was made by the insolvency originator knowing at the time that it would be harmful to the originator's creditors; and
- the counterparty of such sale or transfer knew at the time that such sale or transfer would be harmful to the originator's creditors as of the time of such sale or transfer.

In addition, any gratuitous or similar act conducted by the originator within six months prior to becoming insolvent or thereafter may be rescinded in the interest of the originator's insolvency estate if an insolvency proceeding has commenced, regardless of whether the originator or the counterparty of the sale or transfer knew at the time that the transaction would be harmful to the creditors of the originator.

Separately from the above avoidance of fraudulent transfers, any preferential payment or provision of collateral to certain creditors for outstanding debts, which was made after the originator became insolvent or a petition for commencement of any insolvency proceeding was filed with the court, may also be avoided in the interest of the originator's insolvency estate if and after an insolvency proceeding has commenced. In addition, payment or provision of collateral to certain creditors for outstanding debts may be avoided if such payment or provision of collateral was made within 30 days before the originator became insolvent and the relevant creditor knew at the time that such payment or provision of collateral would be harmful to other creditors of the originator.

If the originator and the purchaser of assets have executed a bilateral asset sale contract, but have not completed the performance of their obligations thereunder (such as the payment of the purchase price and the transfer of receivables) by the time of commencement of an insolvency proceeding, then the insolvency trustee of the originator may elect either to terminate such sale contract or to perform its obli-

gation thereunder (ie, transfer of receivables) and demand that the purchaser perform its obligation (ie, the payment of the purchase price). In securitisation transactions, practically speaking, it is rare for both obligations (ie, the payment of the purchase price and the transfer of receivables) to be outstanding when an insolvency proceeding is commenced against the originator.

### 3.5 Reform

Under the current Civil Code, an assignment of assignment-limited receivables is invalid unless the assignee has no knowledge of the restriction (this exception is not available if such lack of knowledge is due to the assignee's gross negligence). Therefore, currently, funding using assignment-limited receivables can be only structured by using a declaration of trust or participation structure. However, it is expected that the entry into force of the amendment described in **2.8 Reform**, above, will help companies by facilitating their use of assignment-limited receivables as an asset for securitisation under an asset transfer structure. Further, under the current law, although there is no statutory provision to such effect, court precedents allow the assignment of future receivables. Statutory confirmation of the assignment of future receivables will contribute to the legal certainty of securitisation structures using future receivables.

## 4. Other Asset-based Lending

### 4.1 Factoring

There is no specific law or regulation governing factoring transactions. Factoring is a sale of sales receivables, nursing care fee receivables or other commercial receivables between a creditor (assignor/client) and a factoring company (assignee/factor), and is governed by the Civil Code. However, factoring of certain receivables arising from legal services concerning a legal case, or conducts, through a suit, mediation, settlement, or any other means shall be handled by a company licensed under the Act on Special Measures Concerning Claim Management and Collection Businesses.

Factoring may be done on either a recourse or non-recourse basis. If it is done on a recourse basis, the client continues to bear the credit risk of the debtor; if it is done on a non-recourse basis, the factor assumes the credit risk of the debtor. Typically, the purpose of a factoring transaction is to provide financing to the creditor/assignor in advance, and up to the maturity date of the sales receivables. 'Maturity funding' is not popular in Japan. Instead, a debt assumption scheme is sometimes used for providing financing to debtors of receivables. Under such a scheme, the financer assumes the debt obligation jointly with the original debtor and pays such obligation on the original maturity date, while the original debtor will pay the financer the original payment amount plus a certain interest/fee amount on an extended maturity date that has been separately agreed between the financer and the original debtor.

In a usual factoring transaction, receivables are transferred from the client to the factor by way of assignment. Meanwhile, in a 'guarantee-type' factoring transaction, receivables will not be assigned and the factor will simply guarantee the payment of receivables and will assume the credit risk of the debtor. Assignment of receivables can be made with only an oral or written agreement between the assignor (client) and the assignee (factor) and does not require any other particular formality.

To perfect an assignment, notice to or consent from the debtor, which bears the notarised date, is required. Additionally, if the assignor is a judicial person, registration of the assignment is also available.

To perfect the transfer against the debtor, notice to (together with a certificate of registration, if applicable) or consent from the debtor is required.

Whether or not a factoring transaction is made on a 'true sale' basis is not often discussed, since sales receivables are usually satisfied within a short period. Nonetheless, a recent lower court judgment held that an alleged 'factoring' transaction was substantially a loan transaction between the factor (lender) and the client (borrower) after considering various issues, such as:

- the factor barely assumed the default risk of debtor;
- the amount of money transferred and received between the factor and the client was not linked to the face amount of the receivables;
- the client was for all intents and purposes obligated to repurchase the receivables; and
- payment of the repurchase price was deemed to be repayment of the loan in substance.

Under the current Civil Code, if an assignment of receivables is prohibited by agreement between the creditor and the debtor, the assignment of such receivables will be void unless the debtor's consent is obtained. However, in typical sales transactions, the purchasers (debtors) are often large corporations and the sellers (creditors) are often small/mid-sized companies. Debtors are often reluctant to give the necessary consent, and this is a big obstacle with respect to promoting financing to small/mid-sized companies by way of factoring of sales receivables. As stated in **3.5 Reform**, above, if the Civil Code is amended, even if the assignment of receivables is prohibited or limited by the agreement between creditor and debtor, the assignment of such receivables may be valid subject to some limitations and conditions (even after the amendment to the Civil Code becomes effective, an agreement to prohibit or limit the assignment of receivables between the creditor and the debtor may be valid. As a result,

it is not clear whether or not a breach of such agreement will constitute a ground for the termination or non-renewal of the underlying contract). Hopefully, after such amendment to the Civil Code, the factoring of sales receivables will become a more popular fund-raising method for small/mid-sized companies.

### 4.2 Covered Bonds

There is no specific legislation for statutory covered bonds. Therefore, only contractual (structured) covered bonds may be issued.

No conventional contractual (structured) covered bonds have been issued in Japan. However, recently, there have been a few transactions which have satisfied investors' appetite for covered bonds, as well as banks' funding needs, by ensuring investors double recourses to the issuer banks and the cover pools by using total return swap (the 'TRS') eligible for a close-out netting under the Act on Close-out Netting of Specified Financial Transactions Conducted by Financial Institutions (the "Netting Act").

Hypothetically, residential mortgage receivables, loan receivables against the public sector or certain other bank loan receivables may comprise the covered pool.

Several types of covered bond schemes might be used to ensure that investors have recourse to the cover pool in the event that the issuer defaults:

- the originator issues bonds and entrusts the cover pool by a declaration of trust;
- the originator issues bonds and assigns the cover pool to an SPC and the SPC becomes the guarantor of the bonds;
- the originator assigns the cover pool to an SPC, which issues bonds, and the originator guarantees the payment of the bonds;
- the originator assigns the cover pool to an SPC, which issues bonds, and the originator borrows the bond issuance proceeds from the SPC; or
- the originator entrusts the cover pool, which trust issues bonds (trust bonds), and the originator guarantees or otherwise ensures the payment of the trust bonds.

In all of the schemes mentioned above, an investor's double recourse to the issuer and the cover pool is possible. However, so long as the originator continues to owe the debt obligation, the assignment of the cover pool from the originator to the SPC or the trust might be re-characterised as creation of collateral to secure the originator's debt obligation and might be subject to any insolvency (especially corporate reorganisation) proceedings. TRS being eligible for a close-out netting under the Netting Act might mitigate such re-characterisation risk. In addition, it is possible that such an assignment may be rescinded or deemed void as a harmful act to the creditors of the originator under the Civil Code or Japanese insolvency laws.

Similarly, when an SPC is used as an SPV in a regular securitisation transaction to insulate the cover pool from the financial risk of the originator, it should be structured to minimise the risk of bankruptcy by:

- restricting its business purposes and its powers to borrow money, pursue M&A, and amend its governing documents (such as its articles of incorporation);
- appointing accountants or other independent professionals as its directors;
- including 'limited recourse' provisions in any agreements to be executed by the SPC;
- having equity interests with voting rights held by an independent party, such as a general incorporated association (ippan shadan houjin) established specifically for such purpose; and
- having the relevant persons and entities execute non-petition letters.

Where a trust is used as an SPV, a trust's remoteness from the trustee's bankruptcy risk is statutorily assured by Japanese trust law, which also ensures that the trustee owes a fiduciary duty and imposes other strict duties on the trustee.

There is no pending reform that will have an impact on covered bond transactions.

### 4.3 Other Secured Bonds

Secured bonds are rarely issued in Japan, since, according to a traditionally prominent view, the issuance of secured bonds by Japanese companies, within or outside Japan, is subject to onerous rules and burdensome procedures under the Secured Bond Act, such as mandatory entrustment of collateral, mandatory holding of bondholders' meeting for disposition or replacement of collateral.

Notwithstanding the strict regulations under the Secured Bond Act, practically speaking, the 'double SPC scheme' is sometimes used for the issuance of bonds by Japanese companies to foreign investors. This relies upon the following not yet established but prominent view: if the governing law of the bonds is foreign law, the place of issue of the bonds is foreign country and the issuer is a foreign company, then the Secured Bond Act will not be applicable to the bonds even if the governing law of the collateral is Japanese law. The 'double SPC scheme' proceeds as follows:

- the originator sells the asset to a Japanese SPC;
- the Japanese SPC issues notes to, or borrow loans from, a foreign SPC; and
- the foreign SPC issues bonds secured by either the notes issued by the Japanese SPC or the loan receivables against the Japanese SPC.

Furthermore, according to another prominent view, the Secured Bond Act will be applicable only to the bonds that are governed by Japanese law. According to such view, the Secured Bond Act will not be applicable to secured Euro bonds issued by Japanese companies so long as the governing law is non-Japanese law.

Currently there is no limitation on the types of collateral. Under the previous version of the Secured Bond Act, the types of eligible collateral were strictly limited to pledges on receivables or real estate mortgages. However, such limitation was abolished in 2006.

## 5. Credit-linked Notes

### 5.1 Main Structures

A credit-linked note ('CLN') is a structured product offered to investors who expect a higher return (ie, higher interest rates) in consideration for accepting the credit risks of a particular reference entity. As for the main structure of a CLN, by entering into a credit default swap ('CDS'), the issuer of the CLN, as protection seller, assumes the credit risks of the reference entities' obligation and, in consideration, receives regular payments of the premium from the protection buyer. Until the redemption of the CLN, such premium is passed on from the issuer to investors as a part of payment of interest on the CLN. The principal amount of the CLN is paid by the issuer to investors on the scheduled redemption date if no credit event has occurred. On the other hand, an occurrence of any of the credit events specified in the CDS (in general, bankruptcy, failure to pay or restructuring of the reference entity) will trigger the settlement process of the CDS. Generally in that case, the issuer will pay the protection buyer the principal amount minus the auction price of the reference portfolios after the credit event, and the CLN will typically be redeemed at the amount less than the principal amount of the CLN (eg, at the auction price of the reference portfolios after the credit event subject to certain adjustments), which will result in the investors incurring a credit loss.

If the issuer is a special purpose company or a trust, the issuer often acquires risk-free assets (eg, Japanese government bonds) as collateral for both payments to investors and a contingent payment to the protection buyer.

A credit-linked loan ('CLL') is often structured in a similar way to a CLN, and used when investors prefer to extend loans rather than acquire notes. The explanation provided in this section regarding CLNs is generally also applicable to CLLs.

### 5.2 Parties Acting as Protection Seller/Issuer/Investors

Please refer to **5.3 Structures Involving Issuances via an SPV and/or a Trust**, below, for information about types of parties typically acting as a protection seller/issuer.

### 5.3 Structures Involving Issuances via an SPV and/or a Trust

The issuer of CLNs is often a special purpose company or a trust. It is also common for financial institutions, such as banks and securities companies, to issue CLNs. The credit risks are transferred from protection buyers to the special purpose company, trust issuer or issuer financial institutions as protection sellers through a CDS, as explained in **5.1 Main Structures**, above.

### 5.4 Reference Portfolios

Reference portfolios include bonds or loans of a single or multiple corporations.

### 5.5 CLN Transactions

If a bank is a protection buyer and executes a CDS with the issuer of a CLN, the bank is permitted to reduce its risk-weighted assets in relation to the reference entity as specified in the CDS, under certain conditions set forth in the capital adequacy regulations. Among other factors, the remaining period of the CDS and the types of credit events specified in the CDS affect the effectiveness and the amount of reduction of the relevant risk-weighted assets.

### 5.6 Privately Placed or Publicly Offered CLNs

CLNs are normally privately placed.

### 5.7 Main Transparency Requirements

While there are no specific transparency requirements applicable to CLNs, each aspect of the transaction is regulated separately. For example, the FIEA regulates the issuance and offering of notes (see **6.2 Legal and Regulatory Regime**, below) and the execution of a CDS, as an OTC non-commodity and non-securities-related derivative (see **7.1 Regulatory Restrictions**, below). In CLLs, the loans extended from non-bank lenders (investors) to the borrower are regulated under the Money Lending Business Act of Japan (the 'MLBA').

### 5.8 Pending Reform

We are not aware of any incoming reform that will have a specific impact on CLN transactions.

## 6. Structured Products – Notes, Warrants and Certificates

### 6.1 General
Typically, structured products are issued in the forms of bonds (including commercial papers), trust beneficial interests and loans.

Financial institutions, such as securities companies and banks (including trust banks), are the main players in the structured finance market in Japan and often undertake the role of arranger of structured products, private placement agent or underwriter in charge of distributing the structured finance products.

### 6.2 Legal and Regulatory Regime
The FIEA regulates the issuance and offering of structured finance products that fall under its definition of 'securities', such as bonds and trust beneficial interests. The borrowing of asset backed loans is regulated by the MLBA and the Interest Rate Limitation Act.

In general, with respect to structured finance products that fall under its definition of securities, providing intermediary services for the issuance and offering of structured finance products as a business is a regulated activity under the FIEA (as a type i or type ii financial instruments business). Only those registered as a type i or ii financial instruments business operator (and, depending on the type of securities and services, a registered financial institution) under the FIEA are permitted to act as intermediaries (eg, as a private placement agent or underwriter) for the issuance and offering of structured finance products.

As for asset backed loans, the lenders (investors) are required to be a licensed bank or money lending business operator under the MLBA.

Generally speaking, to the extent that the issuance and offering are in compliance with applicable laws and regulations, including the FIEA, the regulator has no power to prevent or intervene in such issuance and offering. There is no prohibition or restriction on the issuance and offering of specific types of structured products.

### 6.3 Documentation
With respect to the private offering of bonds, the key documents are the terms and conditions and a subscription agreement. With respect to the private offering of beneficial trust interests, a trust agreement and a sales and purchase agreement for beneficial trust interests are usually prepared. When a private placement agent or underwriters are involved, they are required to deliver explanatory documents to investors.

In the case of a public offering, the securities registration statements must be filed by the issuer and the statutory prospectus needs to be prepared and delivered to investors.

### 6.4 Distribution
It is common for a financial institution to enter into a private placement agency agreement or an underwriting agreement with an issuer or an originator of a structured product. Under these agreements, the parties agree on, among other things, the duties and roles of the agent or underwriter, and the agency or underwriting fees and costs.

Under a private placement agency agreement or an underwriting agreement, the agent often agrees to engage in sales and marketing activities, to execute contracts with investors for the sale of securities and to prepare the documents necessary to comply with the applicable laws and regulations.

Distributors are compensated by the issuer for their distribution activities.

### 6.5 Listing and Trading Distribution
Normally, structured products are privately placed and are not listed or traded on an exchange in Japan.

### 6.6 Prospectus Liability, Regulatory and Criminal Sanctions
With respect to the statutory prospectus, which is required to be delivered to investors of structured products that are issued and publicly offered as securities under the FIEA, among others, a failure to deliver the statutory prospectus, or a false statement of a material fact therein, may lead to criminal proceedings against certain persons including the issuer and relevant individuals. These violations, as well as an omission of a material fact therein, may trigger an administrative surcharge and may constitute grounds for civil liability (the grounds for civil liability also include an omission of a fact that is necessary to prevent investors from being misled).

### 6.7 Reform and Trends
We are not aware of any incoming reform that will have a specific impact on the issuance and offering of structured finance products.

## 7. OTC Derivatives

### 7.1 Regulatory Restrictions
In general, entering into OTC non-commodity derivatives as business is a regulated activity under the FIEA as a type i financial instruments business, and only those registered as a type i financial business operator (and, depending on the type of derivatives, as a registered financial institution) are permitted to enter into OTC non-commodity derivatives. OTC commodity derivatives are separately regulated under the Commodity Derivatives Act of Japan (the 'CDA')

as a commodity derivative business, and a licence as a commodity derivatives business operator is generally required thereunder for executing such derivatives.

It should be noted that these registration or licence requirements of non-securities-related OTC derivatives are not applicable under the FIEA or the CDA when, among others, the counterparty is a derivative professional, such as a certain type of financial institution, qualified institutional investor or a joint stock company with a stated capital equivalent to or greater than JPY1 billion. With respect to securities-related OTC derivatives under the FIEA, the scope of the exemption is generally more limited and depends on whether the transaction is conducted onshore or offshore.

There is no restriction on OTC derivatives with specific types of counterparties. However, financial business operators, registered financial institutions or commodity derivatives business operators are generally required to refrain from soliciting OTC derivatives from a customer if such solicitation is inappropriate from the perspective of the customers' knowledge, experience, the status of the property and purposes for executing the OTC derivatives.

### 7.2 Standardised Master Agreements/Security Agreements

We understand that each major Japanese bank has developed its own template of derivative master agreements in Japanese. The general structure of such Japanese master agreements follows that of the ISDA master agreements, but there is no uniform industry template.

While there is no uniform industry template, and accordingly the details of any legal opinion would depend on each bank's template, a legal opinion on the validity and enforceability of the close-out netting provisions is required so that the derivatives agreement constitutes a legally valid bilateral netting contract for capital adequacy purposes, irrespective of whether the derivatives transactions are conducted under the forms of the ISDA master agreement or the Japanese master agreements.

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### 7.3 Netting and Close-out Provisions

It is recommended that automatic early termination is applied to a counterparty when the counterparty is a Japanese entity, to ensure that the close-out provisions are enforceable upon insolvency.

In general, it is understood that the close-out netting provisions are valid and enforceable, and legal opinions are often given on such validity and enforceability. To ensure the enforceability of the close-out netting provisions, it is important to apply automatic early termination, as described above.

### 7.4 Stay Acknowledgment

With respect to derivative agreements governed by Japanese law, under the circumstances discussed below, the Prime Minister is authorised to exercise the stay powers under the Deposit Insurance Act of Japan (the 'DIA') to suspend the close-out netting provisions under derivative agreements, even if such agreements do not refer to or acknowledge the stay powers.

In terms of derivative agreements governed by foreign (non-Japanese) laws, Japanese financial institutions are required to ensure that a counterparty of certain types of agreements (including OTC derivative agreements) adheres to an international protocol or gives consent to a contractual clause to the effect that, among others, the Prime Minister's aforementioned stay powers are applicable to such agreements.

Under the DIA the Prime Minister may, after convening the financial system council, determine that it is necessary to take recovery or resolution measures for financial institutions where, without such measures, there is a risk of material impediments to maintaining the credit stability systems of Japan or relevant regions, or there is a risk of extreme disruption to the Japanese financial market or other financial systems. In these circumstances, the Prime Minister may further invoke, after convening the financial system council, the stay powers on the financial institutions subject to these recovery or resolution measures. The subject of the stay powers is limited to certain termination provisions under certain financial agreements (including the close-out netting provisions under derivative agreements) that are triggered upon the exercise of recovery or resolution powers under the DIA. There is no statutory limitation on the stay period; however, the Prime Minister is only permitted to exercise the stay powers as far as is necessary to avoid any potential extreme disruption to the Japanese financial system.