THE PROJECTS AND CONSTRUCTION REVIEW

TENTH EDITION

Editor
Júlio César Bueno

THE LAWREVIEWS

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PREFACE

La meilleure façon d'être actuel, disait mon frère Daniel Villey,
est de résister et de réagir contre les vices de son époque.
Michel Villey, *Critique de la pensée juridique modern* (Paris: Dalloz, 1976)

This book has been structured following years of debates and lectures promoted by the International Construction Law Committee of the International Bar Association, the International Academy of Construction Lawyers, the Royal Institution of Chartered Surveyors, the Chartered Institute of Arbitrators, the Society of Construction Law, the Dispute Resolution Board Foundation, the American Bar Association's Forum on the Construction Industry, the American College of Construction Lawyers, the Canadian College of Construction Lawyers and the International Construction Lawyers Association. All these institutions and associations have dedicated themselves to promoting an in-depth analysis of the most important issues relating to projects and construction law practice and I would like to thank their leaders and members for their important support in the preparation of this book.

Project financing and construction law are highly specialised areas of legal practice. They are intrinsically functional and pragmatic, and require the combination of a multitasking group of professionals – owners, contractors, bankers, insurers, brokers, architects, engineers, geologists, surveyors, public authorities and lawyers – each bringing their own knowledge and perspective to the table.

I am glad to say that we have a chapter from Turkey in this edition. Although there is an increased perception that project financing and construction law are global issues, the local knowledge offered by leading experts in 19 countries has shown us that to understand the world, we must first make sense of what happens locally; to further advance our understanding of the law, we must resist the modern view (and vice?) that all that matters is global and what is regional is of no importance. Many thanks to all the authors and law firms that graciously agreed to participate.

Finally, I dedicate this tenth edition of *The Projects and Construction Review* to a dear friend, the late Vinayak P Pradhan, who died on 8 March 2020. Vinayak Pradhan was an advocate and solicitor of the High Court of Malaya and the Supreme Court of Singapore. He was a partner and consultant at Skrine for more than 45 years, recognised throughout his legal career as a talented advocate, whose oratorical brilliance regularly outshone the best and was immensely respected in the arbitration world. Vinayak was appointed director of the Asian International Arbitration Centre in November 2018. The then Honourable

Attorney General of Malaysia, in announcing the appointment, described Vinayak as 'the doyen of arbitration in Malaysia and recognised the world over for his ability, experience and leadership in the field of arbitration'. He is survived by his wife, Varsha, and his two children, Avinash and Anisha.

Júlio César Bueno
Pinheiro Neto Advogados
São Paulo
June 2020

Chapter 10

JAPAN

Makoto (Mack) Saito and Rintaro Hirano[1]

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 a boom in 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 range 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 renewable solar and wind plant projects nationwide.

II THE YEAR IN REVIEW

Investment in infrastructure is one of the core initiatives of the Japanese administration, which aims to invest ¥21 trillion in infrastructure projects between 2013 and 2022. The government considers the concession scheme to be a key tool in accomplishing 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, such as cruise ship passenger terminal, MICE facilities, public hydropower plants and industrial water supply. The procurement of concessions 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 conventional power plants are facing renewal deadlines. However, owing to the global trend against coal-fired plants, and for commercial reasons, several projects to create new conventional power plants have been cancelled.

The growth of the renewable energy sector is expected to continue but government policy regarding the feed-in tariff (FIT) system is changing because of criticisms regarding the rapidly increasing public costs for maintaining the FIT system.

1 Makoto (Mack) Saito and Rintaro Hirano are partners at Nagashima Ohno & Tsunematsu.

With respect to offshore wind farm projects, while a commercial-based project has yet to emerge, a new act that provides for a legal framework in which a project company for an offshore wind farm can use the sea area for up to 30 years was passed by the parliament and its ancillary executive regulations have been promulgated. We hope this legislation will give some momentum to the offshore wind industry.

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) and subordinated loans. Regarding the latter, 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.

In addition to pure equity and subordinated loans, tokumei kumiai (TK) investments have often formed part of equity. A TK investment is 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 is conducted in the name of the TK operator and the TK investor's liability is limited to an 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 in which the TK operator is a general partner and the TK investors are limited partners. Under a TK contract, profit and loss allocated to the 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 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 a 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 an operation and maintenance (O&M) contract between the project company and an O&M contractor;

d a 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 an 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 a 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 in which 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 work in accordance with the design provided by an owner or owner-retained designers. Typical standard forms for this delivery structure are (1) the public work standard contract (last amended in 2019) published by central government and providing the general conditions for public works; and (2) the general conditions for construction contract (GCCC) (last amended in 2020) 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 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 contracts, the general conditions for design-build contract (GCDB) (last amended in 2020), drafted and published by the Japan Federation of Construction Contractors, is the only published standard form. The GCDB was prepared by a contractors' association to promote the D&B delivery structure. Nonetheless, unlike D&B forms used in international construction projects, the design and construction parts of the GCDB are easily separable; the parties proceed to the construction phase only after the owner confirms the contractor's design products.

For industrial plant construction work, 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; more often, EPC forms that have been developed by contractors or project sponsors are 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, central government has published a sample BTO contract, a Guideline on Contracts – Notes for PFI Project Contracts (last amended in 2018) and a Guideline for Risk Allocation in PFI Project (last amended in 2018).

For design work and supervision services for construction work, the industry associations that jointly drafted the GCCC also publish the General Conditions for Design Work and Supervision (amended in 2020).

IV RISK ALLOCATION AND MANAGEMENT

i Management of risks

Obstructions at the site

The GCCC provides that if a contractor discovers any obstructions to construction work at a site, the contractor shall immediately notify the administrative architect 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 the parties use these types of major contract forms, a contractor may have to bear the risk of unforeseen ground conditions. In a fixed-price contract, Tokyo High Court found that the contractor may not claim any additional costs, unless a court finds the situation to be extraordinarily unfair (Tokyo High Court, judgment of 29 March 1984, 1115 Hanrei Jiho 99). The Court considered certain factors to determine whether or not they were unfair, such as whether the conditions were not foreseeable by 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 not that of frustration. Most contract forms have provisions for *force majeure* as a cause of extension of time or termination.

Theoretically, the core effect of *force majeure* is to prevent a 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. However, 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 work, materials and equipment were substantial, and good care of these was not taken, the employer shall indemnify the contractor for those losses (Article 21, GCCC). As such, solutions provided 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. Furthermore, liquidated damages, which are caused by breach of contract, including but not limited to delay in completion and the agreed level of performance not being achieved, 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. If 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 to negotiate and agree. This kind of ambiguity is found in the majority of domestic projects and construction contracts.

V SECURITY AND COLLATERAL

In project finance transactions, project finance lenders normally request security interests on most of a 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 asset. Generally, the pledge, revolving pledge and security by way of transfer may be perfected by acknowledgment by or notice to the obligor with a certified date. However, in case of shares of companies, the means to perfect the security interest varies, depending on a corporate form of the company – that is, joint stock corporations (kabushiki kaisha, (KK)) or limited liability company (godo kaisha (GK)) and on whether the shares are certificated. Where the company is a GK, then the security interest may be perfected by acknowledgment by or notice to the company with a certified date. In case of a KK, if the KK's shares are not certificated, the security interest may be perfected by way of recordation of that security interest on the shareholder register of the company; if the KK's shares are certificated, the security interest may be perfected by delivery of share certificates (the security interest holders may request that the security interest be recorded on the shareholder register, in order to secure additional protection). Additionally, project finance lenders reserve the rights to assign to themselves, or third parties designated by the project finance lenders, project-related contracts entered into by a borrower to enhance the step-in rights of the project finance lenders.

In traditional project finance transactions in Japan, sponsors are often obliged to provide monetary support to project companies in recourse events. In the past, pure non-recourse loans, in which sponsors owe no direct contractual liability to project finance lenders, have

not been widely used. However, in more 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 construction agreements, except for projects in which international sponsors are involved. If performance bonds are required for such a project, they often take the form of a 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 conducted by the project company.

VII ENFORCEMENT OF SECURITY AND BANKRUPTCY PROCEEDINGS

Project finance lenders normally safeguard their step-in rights through 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 its step-in rights in the event of a default, a project finance lender will first try to assign the project to a third party that it has designated, 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 or a civil rehabilitation proceeding, secured creditors may still foreclose their perfected security interests outside the bankruptcy or civil rehabilitation proceeding and collect the proceeds of foreclosure. However, in a corporate rehabilitation proceeding that is applicable to joint stock corporations (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

For the development of 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 of the leading Japanese banks have adopted the Equator Principles, and typical covenants and representations required by the 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 PFI projects were availability-based accommodation projects (e.g., schools, government offices, public housing, hospitals, school catering service facilities and libraries); transport sector projects, such as Haneda International Airport, were exceptions, although PFI can be used for 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 for various types of infrastructure projects, i.e., the concession arrangement. Under the concession scheme, a concessionaire is allowed to collect from the general public a commission, toll, fee or other moneys for the use of the infrastructure it operates. As such, the concession scheme is considered an appropriate form for a project in which the private sector assumes all or part of the revenue and demand risk.

In most PFI and PPP projects, the bidding process is in two stages. Only the bidders that pass 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 during the second stage. Proposals from 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 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 section called the building division. Nonetheless, foreign investors should note that Japanese courts, even those 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

The CBA designates the 'construction dispute board' (CDB) as the government-sponsored alternative dispute resolution (ADR) 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 most widely recommended dispute resolution is arbitration. Although arbitration is seldom used for domestic disputes 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 national arbitration institution, but any foreign arbitration institution can be chosen instead. The language of arbitration may be English.

XI OUTLOOK AND CONCLUSIONS

The project finance market in Japan still has room to expand but, in the areas of concession-type PFI projects and offshore wind farm projects (among others), the potential for 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

ABOUT THE AUTHORS

MAKOTO (MACK) SAITO

Nagashima Ohno & Tsunematsu

Makoto (Mack) Saito is a partner at Nagashima Ohno & Tsunematsu (NO&T). He has represented domestic and international energy companies in solar, wind and various other renewable energy project finance transactions. He started his practice in 2000 and has vast experience in project finance, real estate finance and other types of structured finance. Since the feed-in tariff system was first introduced in Japan in 2012, Mr Saito and other NO&T infrastructure practice team members have dynamically taken the lead role in creating new project finance structures designed for renewable energy projects using their extensive knowledge of energy regulations, real estate regulations, securities regulations and corporate laws. He also regularly advises engineering, procurement and construction contractors, financial institutions and trading companies in energy and infrastructure areas.

He earned an LLB from the University of Tokyo in 1999 and an LLM from University of Michigan Law School in 2006.

RINTARO HIRANO

Nagashima Ohno & Tsunematsu

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. The sectors he covers range from transport, such as rolling stock, light-rail concessions, 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 liquefied natural gas 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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