Japan

Hajime Ueno and Maiko Kawato, Nishimura & Asahi

www.practicallaw.com/1-384-7123

REAL ESTATE

1. Please briefly state what is considered real estate in your jurisdiction. What are the most common forms of security granted over it? How are they created and perfected (that is, made valid and enforceable)?

Real estate

Under most statutes, land and any fixtures on land are regarded as real estate (immovable property) (*Article 86.1, Civil Code* (*Minpou*)). Buildings are the most common type of fixtures and are subject to a property registration system separate from that of land (*Article 44, Real Estate Registration Act* (*Fudousan-touki-hou*)).

Most common forms of security

Common forms of security interests over real estate are:

- Security interests under statutes, such as:
  - mortgages (*teito-ken*);
  - umbrella mortgages (which function like a revolving mortgage (*ne-teito-ken*));
  - pledges (*shichi-ken*) over immovable property;
  - statutory liens (*sakidori-tokken*) on immovable property;
  - repurchase arrangements (*kaimodoshi*); and
  - provisionally registered ownership transfers (*kari-touki-tanpo*).
- Security interests recognised by court precedents (without any statutes providing for these security interests), such as:
  - security interests by way of assignment (*joto-tanpo*) (security assignments);
  - pre-agreed re-sale transactions (*sai-baibai-no-yoyaku*); and
  - retentions of title (*shoyuuken-ryuuho*).

Among the above, the most commonly used forms are mortgages and revolving mortgages provided for under statute.

Mortgages (*Article 369, Civil Code*). A mortgage gives the secured creditor a preferential right relating to the value of the mortgaged property, and allows it to receive payments from the proceeds of the mortgaged property before other creditors.

Mortgages are created by agreement (not necessarily in writing) between the creditor and the owner of the immovable property, and are perfected by registration in the relevant property registry (*Article 177, Civil Code*).

Revolving mortgages (*Article 398-2, Civil Code*). A revolving mortgage is a type of mortgage, but differs in that claims secured by it are not specified at the time of its creation. However, the scope or types of claims to be secured, and the maximum amount to which the revolving mortgagee has preferential rights, need to be specified in the agreement creating the revolving mortgage. These claims are secured by the mortgaged property, but only up to the maximum amount.

TANGIBLE MOVABLE PROPERTY

2. Please briefly state what is considered tangible movable property in your jurisdiction, for example, machinery, trading stock (inventory), aircraft and ships? What are the most common forms of security granted over it? How are they created and perfected?

Tangible movable property

Any thing or item (tangible property) which is not real estate is regarded as movable property (*Articles 85 and 86.2, Civil Code*).

However, some movable property does not receive the general legal treatment for typical movable property.

For example, though mortgages cannot be created over typical movable property, construction machinery, as well as aircraft and registered ships, can be subject to mortgages under certain special statutes, providing exceptions to the Civil Code.

The concept of a thing (or an item (*butsu*)) under the Civil Code is determined on tangibility, and a pool of movable properties is not recognised as a single movable property. Further, under the legal doctrine that perceives a single right over only a single property, subject only to limited exceptions, a single right cannot be established over a pool of movable properties.

However, particularly in relation to trading stock (inventory), the Supreme Court has recognised that a pool of movable properties

can be subject to a single security interest, if the scope of the subject matter is specified in some way, such as by designating the type, location and quantity of the movable properties in the pool.

Most common forms of security

Common forms of security interests over movable property are:

- Security interests under the Civil Code, such as:
  - pledges of movables;
  - statutory liens on movables; and
  - repurchase arrangements.
- Security interests recognised by court precedents, such as:
  - security assignments;
  - pre-agreed re-sale transactions; and
  - retentions of title.

Among the above, the most commonly used forms are pledges under the Civil Code and security assignments.

Pledge. Pledges over movable property are created and granted by an agreement (not necessarily in writing) between the creditor and the owner of the movable property, and delivery (which includes actual delivery, summary delivery and transfer of possession by instruction, but excludes constructive delivery) of the subject matter to the creditor. Pledges over movable property are perfected by continuous possession of the subject matter of the pledge.

Security assignment. Security assignments for movables are created and granted by a granting contract (not necessarily in writing).

They are perfected by delivery (*Article 178, Civil Code*), but can also be perfected by registration if the assignor is a corporation (*Article 3, Act on Special Provisions of the Civil Code regarding Perfection on Transfer of Movables and Claims* (Perfection Act)).

For security assignments, in contrast to pledges, delivery of the subject matter can take the form of constructive delivery, as endorsed by the Supreme Court.

The Supreme Court has also decided that a creditor can perfect its security assignment over a pool of movable properties as soon as the assignor (usually the debtor) acquires possession of new or additional movable properties that are specified as part of the pool. This is possible if the assignor and the assignee (that is, the creditor) agree that the creditor is deemed to have acquired possession of the new or additional movable properties, by constructive delivery from the assignor to the creditor, when the assignor acquires possession of the movable properties.

SHARES AND FINANCIAL INSTRUMENTS

3. What are the most common forms of security granted over financial instruments, such as shares and other securities (both in certificated and dematerialised form)? How are they created and perfected?

The most common forms of security over financial instruments are pledges and security assignments.

Shares – unlisted companies

Certificated shares. Generally, there are the following four methods of granting a security interest over certificated shares:

- Unregistered pledge (*ryakushiki-kabushiki-shichi*).
- Registered pledge (*touroku-kabushiki-shichi*).
- Unregistered security assignment (*ryakushiki-joto-tanpo*).
- Registered security assignment (*touroku-joto-tanpo*).

In all these four methods, the security interest is only deemed created on delivery of share certificates to the secured creditor, in addition to the granting contract.

They are perfected as follows:

- **Unregistered pledge.** Continuous possession of the share certificates.
- **Registered pledge.** Registration or recordation of the name and address of the pledgee in the company's shareholder registry.
- **Unregistered security assignment.** Continuous possession of the share certificates (against third parties other than the company), and registration or recordation of the name and address of the assignee (creditor) in the company's shareholder registry (against the company).
- **Registered security assignment.** Registration or recordation of the name and address of the assignee (creditor) in the company's shareholder registry.

Uncertificated company shares. Only registered pledges and registered security assignments can be created over uncertificated company shares. However, if uncertificated company shares are book-entry stock (a form of dematerialised shares), unregistered pledges and unregistered security assignments can also be created over these shares (*see below, Shares of listed companies*).

Shares of listed companies

Share certificates for all listed companies are automatically abolished from 5 January 2009 by law. Shares now accrue, transfer and extinguish, and therefore trade electronically, through accounts at the depository (at present, only the Japan Securities Depository Center, Incorporated) (*Act on Transfer of Bonds, Shares and so on*, *Shasai-kabushiki-tou-no-furikae-ni-kansuru-houritsu*) (Transfer Act).

The ways to create security interests over book-entry stocks are:

- Unregistered pledges.
- Unregistered security assignments.
- Registered pledges.
- Registered security assignments.

Both unregistered pledges and registered pledges over book-entry stocks are created by, in addition to the granting contract, registration and entry in the pledge section of the pledgee's account.

Although not explicitly provided in the Transfer Act, a pledge over book-entry stocks is interpreted to be perfected by registration and entry in the pledge section of the pledgee's account. A pledge over book-entry stocks is considered an unregistered pledge, unless the pledgee applies to the issuer to make the pledge registered.

Both unregistered security assignments and registered security assignments over book-entry stocks are created by, in addition to the granting contract, registration and entry in the holding section of the assignee's (creditor's) account.

A security assignment can be perfected against the issuer company only by registering and recording the name and address of the assignee in the shareholder registry, under the general rule to perfect assignments. In contrast to pledges, a security assignment over book-entry stocks is considered a registered security assignment, unless the parties agree and register otherwise.

Bonds

Bond certificates issued. Both a pledge and security assignment over bonds is created by, in addition to the granting contract, delivery of the bond certificates (*Articles 692 and 687, Companies Act*).

In a security assignment of bearer bonds (*mukimei-shasai*), the above suffices for perfection.

In a security assignment of registered bonds (*kimei-shasai*), perfection is registration or recordation of the name and address of the assignee in the bond registry (for perfection against the company), and continuous possession of the bond certificates (for perfection against third parties other than the company) (*Articles 688.1 and 688.2, Companies Act*).

Perfection of a pledge of bonds requires continuous possession of the bond certificates (*Article 693.2, Companies Act*).

Bond certificates not issued. A pledge and security assignment of bonds is created solely by a granting contract. Perfection of both a pledge and security assignment is registration or recordation of the name and address of the assignee in the bond registry (*Articles 693.1 and 688.1, Companies Act*).

Book-entry bonds. A pledge over book-entry bonds is created by, in addition to the granting contract, registration and entry in the pledge section of the pledgee's account.

A security assignment of book-entry bonds is created by, in addition to the granting contract, registration and entry in the holding section of the assignee's account.

Although the method of perfection for both a pledge and a security assignment over book-entry bonds is not explicitly provided for in the Transfer Act, each registration and entry (*see above*) is considered the method of perfection.

CLAIMS AND RECEIVABLES

4. What are the most common forms of security granted over claims and receivables (such as debts or rights under contracts)? How are they created and perfected?

The most common forms of security granted over claims and receivables are security assignments and pledges.

Security assignments

A security assignment of claims is created by a granting contract (not necessarily in writing). Perfection against the obligors of the claims is achieved by giving notice to, or obtaining an acknowledgement from, each obligor.

Perfection against third parties other than obligors of the claims is achieved by giving notice to, or obtaining acknowledgement from, each relevant obligor, using an instrument bearing a fixed date.

Pledges

A pledge over claims is created by a granting contract. However, creating a pledge over a claim represented by a claim instrument requires delivery of the instrument, in addition to the granting contract (*Article 363, Civil Code*).

The way to perfect a pledge over nominative claims (*shimei-saiken*) is the same as for security assignments of claims (*Articles 364 and 467, Civil Code*) (*see above, Security assignments*). A pledge over debts payable to order (*sashizu-saiken*) is perfected by an endorsement to this effect (*Article 365, Civil Code*).

Both a security assignment and a pledge over claims can also be perfected against third parties other than the obligors of the claims by registration, if the assignor/pledgor of the claims is a corporation (*Articles 4.1 and 14, Perfection Act*).

INTELLECTUAL PROPERTY

5. What are the most common forms of security granted over registered and unregistered intellectual property (such as patents, trade marks, copyright and designs)? How are they created and perfected?

The common forms of security interests over intellectual property are pledges and security assignments (security assignments are probably more practical due to reasons relating to registration fees).

Pledges

A pledge over rights to patents, trade marks, copyrights and designs is created and perfected by a granting contract and registration of it in the relevant register (*Article 98.1.3, Patent Act, Article 34.3, Trademark Act, Article 77.2, Copyright Act, and Article 35.3, Design Act*).

The right to obtain a patent, rights deriving from an application for trade mark registration and rights deriving from a design registration cannot be pledged, as the grant of pledge of such rights is restricted under the relevant statutes (*Article 33.2, Patent Act, Article 13, Trademark Act, and Article 15, Design Act*).

Security assignments

A security assignment of rights in patents, trade marks, copyrights and designs is created and perfected by a granting contract and registration of it in the relevant register (*Article 98.1.1, Patent Act, Article 35, Trademark Act, Article 77.1, Copyright Act, and Article 35.3, Design Act*).

PROBLEM ASSETS

6. Are there types of assets over which security cannot be granted or is difficult to grant? Consider the following and give brief details of any additional requirements:

- **Future assets.**
- **Fungible assets (a pool of assets indistinguishable from each other that may change over time).**
- **Other assets.**

Future assets

For future claims, the Supreme Court has ruled that a transfer of future claims is allowed, if the parties can specifically identify the claims through, for example, the cause and time of accrual of the claims, their amounts, and by clearly providing for the period in which the subject claims need to be generated. The Supreme Court also ruled that the possibility of accrual of a claim being low does not in itself make a transfer of the future claim invalid (*Supreme Court judgment of 29 January 1999*).

However, the Supreme Court also implied that it may deny all or part of the validity and/or effect of a security interest over future claims as being against Japanese public policy if there is a special reason (for example, if the granting contract provides too long a period in which the future claims could be generated, or if the transfer would unjustly disadvantage other creditors).

In light of this, to the extent a transfer of future claims is valid, it is generally seen as possible to create a pledge or security assignment for such future claims. In practice, there may be difficulty in matters such as specifying the pool of future claims.

The method of perfection is the same as that for a pledge or security assignment of accrued claims (*see Question 4*).

Fungible assets

A pool of movable properties can be collateralised by granting a security assignment, and the security can be perfected as indicated in *Question 2*.

A pool of current claims and future claims can also be collectively collateralised by granting a security assignment, if the subject claims are specified (*see above, Future assets*).

Other assets

Assets over which the creation of security is legally and explicitly prohibited cannot be collateralised, for example the rights to receive pensions (*Article 24, National Pension Law, with exceptions*) and national health insurance (*Article 67, National Health Insurance Law*).

Since security interests over assets which are not transferable are not enforceable, even if collateralised, they are considered incapable of being collateralised.

Assets which are not transferable can be classified into the following three categories:

- Assets which are by their nature not transferable (for example, a claim the performance of which is inherently only possible if provided to a specific obligee, such as a claim against a painter to paint a portrait of the obligee).
- Assets the transfer/disposition of which is legally prohibited (for example, the right to receive public assistance (*Article 59, Public Assistance Act*) and the right to receive wages (*Article 83.2, Labour Standards Act*).
- Assets for which the parties agree to prohibit the transfer/disposition by contract.

COMMERCIAL SECURITY

7. What types of commercial or quasi-security (that is, legal structures used instead of taking security) are common in your jurisdiction? Is there a risk of such structures being recharacterised as a security interest? Consider the following and give brief details:

- **Sale and leaseback.**
- **Factoring.**
- **Hire purchase.**
- **Retention of title.**
- **Other structures.**

The following legal structures are used in Japan and all of them function as a kind of security interest. Therefore most if not all of them are treated as such under insolvency statutes and other laws.

Sale and leaseback

Sale and leaseback transactions have long been extensively used, due to the advantages of the off-balance sheet treatment of assets, the possible enhancement in terms of the liquidity of fixed assets and so on. Aircraft, a company's self-owned office buildings, machines and facilities, and medical equipment, are assets for which sale and leaseback structures have been commonly used.

Factoring

Factoring has long been used in Japan. If, for example, a factoring transaction has a structure where the client repays the factor the amount equivalent to the sales price of the claim purchased from the factor, and owes an obligation to repurchase the claim on default of the customer, there is a risk that it will be viewed as a loan secured by the purchased claim.

Hire purchase

Hire purchases are widely used in the sale of consumer products (such as cameras, sewing machines and automobiles). The seller usually retains ownership of the subject matter until and unless full repayment is achieved.

Retention of title

Retention of title is often used in sales of automobiles and so on. The seller retains a right to terminate the sale agreement and demand return of the subject matter, based on the title retained by the seller, in cases of default by the buyer.

Other structures

Repurchase arrangement (*Article 579, Civil Code*). This is a repurchase agreement for real estate, under which the seller can cancel the sale by refunding the purchase money and buyer's costs in connection with the sale. It is entered into simultaneously with the initial sale and purchase agreement. Under the Civil Code, asset classes other than real estate can also be subject to a repurchase arrangement.

Finance lease and so on. Other secured transactions include finance leases and trusts for security purposes. Generally these, together with those listed above, are deemed as security interest arrangements under insolvency proceedings as well as, in certain circumstances, other laws.

RISK AREAS

8. Do company law rules affect taking security? In particular:

- **Financial assistance rules. For example, if a company grants security to secure debt used to purchase its own shares (or the shares of its holding company), does this breach such rules?**
- **Corporate benefit rules. For example, if a subsidiary grants security relating to a loan to its parent, does this breach such rules?**
- **Other rules?**

Unlawful financial assistance

Under the Company Act (*Kaisha-hou*), there are no financial assistance rules. However, in relation to acquisitions of treasury stocks, there are restrictions on the required process, permitted acquisitions and so on.

Also, acquisitions of a parent company's shares by a subsidiary are prohibited, with very limited exceptions (*Article 135, Company Act*).

Corporate benefit rules

The granting of security by a subsidiary in connection with a loan extended (whether or not by a third party) to its parent would not violate the Company Act (with limited exceptions), and there is no provision in it about corporate benefit rules. However, if a subsidiary's director is considered to be in breach of his prudent manager's duties, which include duty or loyalty, by for example providing security, with no benefit provided to the subsidiary in return, the subsidiary's director could be liable for damages to the subsidiary.

Under the Company Act, if and when a stock company is to carry out a transaction with a person other than a director, that results in a conflict of interest between the stock company and that director (conflict case), the director must disclose the facts material to the transaction at a shareholders' meeting or a board of directors' meeting, and obtain their approval. Such a transaction, if concluded without the approval, would be construed as invalid.

The Supreme Court has judged that if a company (A) guarantees the debt of another company (B), whose representative director is A's director, this falls within the conflict case. Therefore, in circumstances where there is a person who is both the parent company's director and the subsidiary's director, if the director enters into a security agreement representing the subsidiary with a creditor of the parent company, this may be considered to fall within the conflict case.

9. Can a lender holding or enforcing security over land be liable under environmental laws, even if it did not cause any pollution of the land?

The Soil Contamination Countermeasures Act (*Dojyo-osen-taisaku-hou*) (SCCA) is the main environmental law concerning land. Under the SCCA, the duties of investigation and reporting are imposed on the owner, manager, or occupier (extended owner) of land that falls in any of the categories of land set out in Articles 3 and 4 of the SCCA, even if the extended owner is not itself responsible for causing the pollution.

In addition, in relation to land that falls in any of the categories set out in Article 7 of the SCCA, the prefectural governor can order the extended owner to take action to remove pollution, prevent dispersion of pollution, or any other necessary measures (action for removal).

Although it is not clear whether a person who owns, manages or occupies the relevant land as a secured creditor is included in the definition of extended owner, if the SCCA is strictly applied to a security interest over land, there may be a risk of the above

duties being imposed on secured creditors, even if they are not responsible for causing the pollution.

However, a person who has only temporarily become the owner through, for example a foreclosure of a security interest, would only be ordered, if at all, to examine water quality and take appropriate measures to ensure no one enters the site, and would not be ordered to take other actions for removal (*Article 30, Enforcement Regulations of the SCCA*).

Further, if the requirements in the proviso to Article 7.1 of the SCCA are fulfilled, any actions for removal are not imposed on the extended owner, but on the person responsible for causing the pollution.

THE COMMERCIAL DEBT MARKET

10. Is contractual subordination of debt possible and common? If so, how can it be achieved, for example by an inter-creditor agreement between senior, mezzanine and junior creditors? Is structural subordination possible?

There are two types of subordination clauses:

- Absolute subordination clause (*zettaiteki-retsugo-tokuyaku*) (a contractual term under which a creditor agrees that its claims are subordinate to all claims of other creditors, except those holding the same kind of claims as the subordinated creditor).
- Relative subordination clause (*soutaiteki-retsugo-tokuyaku*) (a contractual term under which a creditor agrees that its claims are subordinate to claims of certain creditors specified by the clause).

An absolute subordination clause is often used to enhance the capital adequacy ratio of financial institutions or the solvency margin of insurance companies. Claims subject to an absolute subordination clause are recognised in insolvency procedures as a contractually subordinated bankruptcy claim (*yakujo-restugo-hasan-saiken*) (*Article 99.2, Bankruptcy Law (Hasan-hou), Article 43.4, Corporate Reorganisation Law (Kaisha-kousei-hou), and Article 35.4, Civil Rehabilitation Law (Minji-saisei-hou)*).

In a contractually subordinated bankruptcy claim, a bankruptcy creditor and a bankrupt debtor, before the start of a bankruptcy procedure, agree that if the bankruptcy procedure is started against the bankrupt debtor, the claim is made subordinate to all subordinated bankruptcy claims, in the order of priority of receiving liquidation distributions in the bankruptcy procedure.

A relative subordination clause is often used in structured finance to create a senior-junior tranche in terms of distributions from cashflow generated by securitised assets. Such a relative subordination clause is often included in inter-creditor agreements in the case of syndicate loans, or in waterfall provisions under trust agreements and/or conditions of bonds in securitisations. However, there is no guarantee that distributions will be made fully in accordance with the clause in a bankruptcy procedure, since there is no binding legal precedent on this point.

11. Is secured debt traded in your jurisdiction? If so, what transfer mechanisms are used? How do buyers ensure that they obtain the benefit of the security associated with the transferred debt?

Secured loans made by financial institutions such as banks and non-banks are traded and transferred. Under Japanese law, where a transfer of a secured loan is made, security interests securing the loan (excluding revolving or umbrella security interests) are, or are deemed to be, transferred automatically to the assignee with the secured loan by law. However, there are cases where such automatic transfer of security interests needs to be separately perfected.

In a transfer of a revolving security interest before the secured obligations are "crystallised" or fixed, the revolving security interest cannot be transferred even if any of the secured obligations are transferred, unless the grantor approves the transfer of the revolving security interest (*for revolving mortgages, see Article 398-12, Civil Code*).

12. Is the trust concept recognised in your jurisdiction? If not:

- **Is a trust created under the law of another country recognised in your jurisdiction?**
- **Can a security trustee enforce its rights in the courts in your jurisdiction?**

The trust concept is recognised in Japan under statutes such as the Trust Law (*Shintaku-hou*). Under the Trust Law, a security trustee can claim enforcement of a security interest entrusted with it, and can receive distributions from the proceeds of the sale and other dispositions (*Article 55, Trust Law*).

13. Do the different types of security in your jurisdiction need to be documented separately or does your jurisdiction allow a single security document?

Under Japanese law, the creation or granting of security interests only requires verbal agreement (no written agreement is required), except for instances where documented evidence would prove useful for registration. Therefore, Japanese law does not require separate security documents for each security interest and it is possible to prepare a comprehensive, single set of security documents that include different types of security interests.

ENFORCEMENT AND INSOLVENCY

14. Please briefly state the circumstances in which a secured creditor can enforce its security, for example, when an event of default occurs? What requirements must the creditor comply with?

A secured creditor can enforce its security in cases where:

- Secured receivables have been accelerated (a mere event of default is not enough without a declaration of default, if such declaration is required to accelerate).
- Secured receivables have matured (that is, repayment dates have passed).

A secured creditor must submit a document that proves the existence of the security interest (for example, a duplicate copy of a final and conclusive judgment by a court proving the existence of the security interest) to the enforcement court or the enforcement officer, in order to foreclose on the collateral property, except if the collateralised assets are movable properties (*Articles 181.1, 189, and 193.1, Civil Enforcement Act*), in which case no such document is required.

15. How are the main types of security interest usually enforced? What requirements must a creditor comply with (for example, a mandatory public sale of the secured asset through the courts)?

There are two methods to foreclose/enforce security interests over immovable property (*Article 180, Civil Enforcement Act*):

- Auction of a collateral property (*Tanpo-fudousan-keibai*).
- Foreclosure by receipt of revenues from a collateral property (*Tanpo-fudousan-shueki-sikkou*).

Enforcement of security interests over movable property is made through an auction procedure specifically for movable property (*Article 190, Civil Enforcement Act*), and this procedure is applied, *mutatis mutandis*, to other compulsory executions against movables (*Article 192, Civil Enforcement Act*).

For the enforcement method of security interests over receivables and other assets, many of the provisions of the Civil Enforcement Act about compulsory executions against receivables and other assets are applied *mutatis mutandis* (*Article 193.2, Civil Enforcement Act*).

In practice, an auction process supervised by courts generally results in a heavily discounted sale price (in some cases 40% or more less than the market value of the collateral). To achieve a higher price, interested parties usually all consent to a voluntary sale (rather than a court-supervised auction sale).

16. Are company rescue or reorganisation procedures (outside of insolvency proceedings) available in your jurisdiction? If yes, please give brief details, including voting requirements to approve such procedures. How do they affect a secured creditor's rights to enforce its security?

Private liquidation

Separate from insolvency proceedings, business entities often use a process usually referred to as a private liquidation procedure (*nin-i seiri tetsuzuki* or *shiteki-seiri tetsuzuki*), that starts when all the interested creditors have agreed to it and it is initiated, customarily, by attorneys-at-law of the insolvent debtor. Under this procedure, the debtor company is liquidated and dissolved, and prioritised payments are made to satisfy tax claims and preferred receivables. Remaining assets are distributed among the general creditors. As it is voluntary and non-legislative, it is not mandatory for a creditor to consent to or accept it.

In terms of legislation, although generally viewed as types of insolvency proceedings, there are two non-liquidating, reorganisation-type proceedings in Japan:

Civil rehabilitation proceedings

These proceedings (*saisei-tetsuzuki*) are based on the Civil Rehabilitation Law, which is available to all types of debtors (regardless of corporate form, including J-REITs, and is also available to individuals).

Its aim is to rehabilitate the debtor, the management of which can continue to run its operations and manage or dispose of assets, while reorganising its business operations. However in practice, a supervisor or supervisors (*kantoku-iin*) is/are appointed by the competent court because there is a risk, by offering an opportunity to the debtor-in-possession to rejoin the business community, of sacrificing the lawful rights of creditors to receive payments from the rehabilitating debtor (*Article 54.1, Civil Rehabilitation Law*).

The court accepts the petition (brought by, for example, the debtor or a creditor) and orders the start of the rehabilitation proceedings (*Article 33, Civil Rehabilitation Law*), if there is sufficient grounds for starting the proceedings (*Article 21, Civil Rehabilitation Law*), and there is no grounds to dismiss the petition (*Article 25, Civil Rehabilitation Law*).

Grounds for starting the proceedings are:

- The debtor being unable to pay its debts as they become due.
- Excessive liabilities being incurred by the debtor.
- The debtor being unable to pay its debts as they become due without materially endangering the continued business operation of the debtor (only the debtor can petition the court to start the proceedings on this ground).

A proposed rehabilitation plan, prepared initially by the debtor-in-possession, is approved when both the following are obtained (*Article 172-3.1, Civil Rehabilitation Law*):

- The consent of the majority, in terms of head-count, of creditors holding voting rights.
- The consent of creditors holding voting rights no less than half of the aggregate amount of the claims of the eligible creditors.

When a proposed rehabilitation plan is approved by the creditors, the court decides whether to permit the plan. If it does, the court will order that the rehabilitation plan is permitted (*Article 174, Civil Rehabilitation Law*). The rehabilitation plan becomes effective when the permitting court order becomes final and binding (*Article 176, Civil Rehabilitation Law*).

Corporate reorganisation proceedings

These proceedings (*kaisha-kousei-tetsuzuki*) are based on the Corporate Reorganisation Law. They are only available to joint-stock companies (*kabushiki-kaisha*) and are strictly court-supervised. A reorganisation trustee (*kanzai-nin*) is appointed by the supervising court.

The court accepts a petition brought by an eligible petitioner (the debtor corporation, creditors or shareholders satisfying certain thresholds) (*Article 17.2, Corporate Reorganisation Law*), and orders the start of reorganisation proceedings if there are sufficient grounds for doing so (*Articles 17.1 and 41.1, Corporate Reorganisation Law*), and if there are no grounds to dismiss the petition.

Grounds for starting the proceedings are roughly the same as those for civil rehabilitation proceedings (*see above, Civil rehabilitation proceedings*).

A proposed reorganisation plan must be approved by a resolution of each class of the creditors meetings, the voting rights for which are set out by statute (*Article 168.1 or Article 196.2, Corporate Reorganisation Law*). The court then decides whether to permit the plan. If it does, it orders that the reorganisation plan is permitted (*Article 199.1, Corporate Reorganisation Law*).

If the proposed plan is not approved because of dissent by some of the creditor class(es), the court can permit the plan by including clauses that substantially protect the dissenting creditor(s) (*Article 200.1, Corporate Reorganisation Law*).

The reorganisation plan becomes effective when the permitting order becomes final and binding (*Article 201, Corporate Reorganisation Law*).

Effect on secured creditors

As a private liquidation procedure is not court supervised, it has no effect on a secured creditor's rights to enforce its security interests, unless the secured creditor voluntarily agrees otherwise.

Under the Civil Rehabilitation Law, security interests are treated as rights to exclusive enforcement (*betsujo-ken*), which can be exercised outside the civil rehabilitation proceedings (*Article 53, Civil Rehabilitation Law*).

Under the Corporate Reorganisation Law, generally no secured party is allowed to exercise its security interests following the start of the corporate reorganisation proceedings (*Article 50.1, Corporate Reorganisation Law*), nor are they entitled to receive payments outside the reorganisation plan (*Article 47.1, Corporate Reorganisation Law*). However, if it is apparent that the subject matter collateral is not necessary for the reorganisation of the debtor's business, the court can terminate the prohibition on enforcement of the relevant security interest (*Article 50.7, Corporate Reorganisation Law*).

Both in civil rehabilitation proceedings and corporate reorganisation proceedings, if the collateral is indispensable for continuation of the rehabilitation or reorganisation of the debtor's business, the court can extinguish the relevant security interest (*Article 148 et seq., Civil Rehabilitation Law, and Article 104, Corporate Reorganisation Law*). In this case, the secured creditor is entitled to receive distributions from the proceeds of the sale in exchange for the extinguishment (*Article 153.1, Civil Rehabilitation Law, and Article 110, Corporate Reorganisation Law*).

If a right of avoidance (*hinin-ken*) of a security interest is permitted by the court, the validity of the creation and perfection of the security interest is lost (*see Question 18*). For avoidance of doubt, perfection could be separately avoided from the creation of a security interest (*see Question 18*).

17. How does the start of insolvency procedures affect a secured creditor's rights to enforce its security?

For civil rehabilitation proceedings and corporate reorganisation proceedings, *see Question 16*.

In bankruptcy proceedings (*hasan-tetsuzuki*), secured creditors have rights to enforce security interests outside the bankruptcy procedures, even if such proceedings have started (*Article 65, Bankruptcy Law*). These rights are basically the same as those rights to exclusive enforcement available to secured creditors under the Civil Rehabilitation Law (*see Question 19*).

Avoidance (*hinin*) system

If security interests are avoided due to a court approving a claim for avoidance, those security interests, and the validity of their perfection, are lost (*see Question 18*). For avoidance of doubt, perfection could be separately avoided from the creation of a security interest (*see Question 18*).

Extinguishment of security interests

If a bankruptcy administrator (*hasan-kanzai-nin*) claims termination of security interests and the court approves this, the administrator can sell the collateral asset at its discretion and terminate the security interests.

If the secured party objects to the termination of the security interest, it can petition to the court to enforce its interest, or offer to buy the collateral. Even if the collateral is sold by the administrator, the secured party is entitled to receive distributions from the proceeds of the sale (*Articles 186, 187, 188 and 191, Bankruptcy Law*).

18. What transactions granting security can be made void if the entity that granted the security becomes insolvent? Please briefly state the time limits that apply and the conditions that must be met for the security to be made void.

Under Japanese insolvency law, security can be made void under the avoidance system (*Article 160 et seq., Bankruptcy Law, Article 85 et seq., Corporate Rehabilitation Law, and Article 127 et seq., Civil Reorganisation Law*).

The following acts of the insolvent debtor can be avoided (*see Article 162, Bankruptcy Law*):

- Granting a security interest after the insolvent debtor becomes unable to pay its debts as they become due

(provided the secured creditor, at the time of grant, knew that the insolvent debtor became unable to pay its debts as they became due, or the insolvent debtor did not generally pay its debts as they became due).

- Granting a security interest after a petition has been made for the start of the insolvency procedure (provided the secured creditor, at the time of grant, knew that the petition had been made).

- Granting a security interest without there being an obligation on the part of the insolvent debtor, or if the grant is based on an obligation of the insolvent debtor that has not become due by the time of the grant, which was conducted within 30 days before when the insolvent debtor had become unable to pay its debts as they became due; provided that this does not apply if the creditor did not know, at the time of the grant, that it would prejudice other creditors.

Perfection of a security interest after suspension of payments, or an insolvency petition, is lost if perfection is made 15 days after the security interest is granted, and the claim for avoidance is accepted by the court (*see, for example, Article 164, Bankruptcy Law*).

19. Please list the order in which creditors are paid on the borrower's insolvency, assuming the security interests have been validly perfected. Consider:

- **The secured creditors considered in *Questions 1 to 5* (please set out any order of priority applying between the security interests).**

- **Statutory claims (such as tax or other government claims, expenses of the insolvency proceedings and employee claims).**

- **Unsecured creditors.**

- **Subordinated creditors.**

In bankruptcy proceedings, the main types of rights to receive payments from the bankruptcy estate are:

- Right to exclusive enforcement (*betsujyo-ken*). A right to enforce a security interest over a specific asset, that is otherwise part of the bankruptcy estate, outside the bankruptcy proceedings (*Article 2.9, 65, Bankruptcy Law*).

- Superior obligations (*zaidan-saiken*). A claim to receive payments from the bankruptcy estate outside the bankruptcy proceedings, and such payments can be received, with priority over general bankruptcy claims (*Articles 2.7 and 151, Bankruptcy Law*).

- Bankruptcy claim (*hasan-saiken*). An unsecured claim arising from a cause that took place before the start of the bankruptcy proceedings, and which is not a superior obligation claim (*Article 2.5, Bankruptcy Law*). Bankruptcy claims are further divided, in terms of the order of priority, into:
  - preferred bankruptcy claims (*yuusenteki-hasan-saiken*);
  - general bankruptcy claims (*ippan-hasan-saiken*);
  - subordinated bankruptcy claims (*retsugoteki-hasan-saiken*); and
  - contractually subordinated bankruptcy claims (*yakujyo-retugo-hasan-saiken*).

There are the following statutory claims:

- Tax or other government claims. Tax claims and other tax collection rights (tax claim rights) which arise before the start of bankruptcy proceedings and are not past their due date, or are less than one year past their due date at the start of the bankruptcy proceedings, are classified as superior obligations. Other tax claim rights are classified as preferred bankruptcy claims (*Articles 148.1.3 and 98.1, Bankruptcy Law*). If tax claim rights arising after the start of bankruptcy proceedings fall in the scope of items (2) and (4) of Article 148.1 of the Bankruptcy Law, they are classified as superior obligations. If not, they are classified as subordinated bankruptcy claims (*Articles 148.1.2, 148.1.4, 99.1.1 and 97.4, Bankruptcy Law*).

- Bankruptcy proceeding costs and expenses. Generally, bankruptcy proceeding expenses are considered to be superior obligations, as they are deemed to have arisen for the common interest of the creditors (*Article 148.1.1, Bankruptcy Law*).

- Labour claims. The salary claims of employees of the bankrupt debtor for the three months before, or after the start of, bankruptcy procedures, are classified as superior obligations (*Articles 149.1, 148.1.4 and 148.1.8, Bankruptcy Law*).

Secured parties considered in *Questions 1 to 5* have rights to exclusive enforcement. Generally, the order of priority among holders of exclusive enforcement rights over the same collateral is determined by the order of perfection of their respective security interests (*Articles 177, 178, 355, 373 and 467, Civil Code*). However, the order of priority for statutory liens differs, and is set out in Articles 329 to 340 of the Civil Code and other relevant statutes. Those claims which cannot be paid by enforcement of exclusive enforcement rights can be exercised as bankruptcy claims (*Article 108, Bankruptcy Law*).

Unsecured creditor claims are bankruptcy claims (*Article 2.5, Bankruptcy Law*). The rules for priority of bankruptcy claims are set out in detail in the Bankruptcy Law (*Articles 97 to 99, Bankruptcy Law*).

Subordinated creditor claims ranking junior in terms of priority to general bankruptcy claims are called subordinated bankruptcy claims.

Contractually subordinated bankruptcy claims rank junior in terms of priority to subordinated bankruptcy claims, and are the lowest ranked bankruptcy claims.

20. If more than one creditor holds the same security interest over the same asset, how is priority between them determined? Please briefly set out any specific ranking rules that apply.

For security interests requiring perfection, the order of priority is, generally decided by the order of perfection. Therefore, if all the secured creditors have perfected their security, priority is determined by the order of perfection (*Articles 177, 178, 355, 361, 373 and 467, Civil Code*).

However, the order of priority for statutory liens differs, and is set out in Articles 329 to 332 of the Civil Code.

21. If a security interest has not been validly perfected, where does the security holder rank on the borrower's insolvency?

If a security interest has not been validly perfected, the security holder is treated as an unsecured creditor. This is because, although no perfection is necessary for a secured party to assert its security interest against the debtor, to assert its security interest against a bankruptcy administrator or other insolvency officer, perfection is required, since the bankruptcy administrator and other insolvency officers are regarded as third parties in relation to the secured creditors.

CROSS-BORDER ISSUES

22. Are there restrictions on granting security (over all forms of property) to foreign lenders? If yes, please give brief details, for example registration requirements.

Although there is no law generally prohibiting foreign nationals or foreign companies from acquiring security interests directly, there are some cases where acquisition of rights by foreign nationals and foreign companies is restricted or limited by individual laws (for example, Article 52-8, Broadcasting Law (*Housou-hou*)). In such cases, even if a relevant right can be made subject to a security interest (there may be cases where security assignments cannot be created), secured parties cannot acquire the secured assets through enforcement of the security.

In addition, if an acquisition of a security interest falls in the scope of a capital transaction or inward direct investment, as defined under the Foreign Exchange and Foreign Trade Law (*Gaikoku-kawase-oyobi-gaikoku-boueki-hou*) (FEFT), an after-the-fact report must be filed with the authorities, except for certain statutory exceptions or exemptions.

23. Are there exchange controls that restrict payments to a foreign lender under a security document or loan agreement?

Execution of security documents or loan agreements, or the foreclosure of security, must be reported retrospectively to the Minister of Finance, if they fall in the scope of a capital transaction or inward direct investment (*Articles 20 and 26, FEFT*), although there are cases where no after-the-fact report nor permission is required.

In addition, certain payments or transfers of money as provided in the FEFL, such as where a resident has made a payment to a non-resident, would require an after-the-fact report to the authorities, unless otherwise exempt or an exception is available (for example, a payment equal to or below JPY30 million (about US$209,000)) (*Article 55, FEFT*).

24. Is a foreign choice of law clause in a security document recognised and applied by the courts in your jurisdiction? Does local law always apply in certain circumstances?

The General Act Related to the Application of Laws (*Hou-no-tekiyou-ni-kansuru-tsuusoku-hou*) (GARAL) provides that the governing law of legal acts (including execution of a contract) is the law chosen by the parties as the governing law at the time of the legal act (*Article 7, GARAL*). However, a choice of governing law is not upheld for certain matters in the GARAL, including the following (the governing law is determined in these cases by rules in the GARAL):

- Matters concerning ownership rights and other property rights (including security interests) requiring registration or recordation relating to movable or immovable property are subject to the laws of the jurisdiction where the property is located (*Article 13, GARAL*). If the property is located in Japan, Japanese law applies, irrespective of the law chosen by the parties, in connection with matters relating to those property rights.
- The effect and validity of a transfer of a receivable against the obligor or other third parties is determined by the law governing the receivable (*Article 23, GARAL*). Therefore, if a security assignment is created over receivables governed by Japanese law, Japanese law also governs matters concerning the effect and validity of the security assignment.
- If application of the foreign law chosen by the parties would result in drawing a conclusion that would contradict or fall foul of Japanese public policy and/or public morals (*Koujyo-ryouzoku*), the foreign law will not be upheld as the governing law (*Article 42, GARAL*).

TAX AND FEES

25. Are taxes or fees paid on the granting and enforcement of security? Consider the following and state the tax rates and fee amounts, if they are more than a nominal amount:

- **Documentary taxes (for example, stamp duty).**
- **Registration fees.**
- **Notaries' fees.**

Documentary taxes

These taxes, for example, stamp duty, are not generally imposed on mortgage agreements and/or relevant documents.

If a mortgage agreement and/or relevant documents also include a provision concerning an assignment of compensation claims arising, for example, in condemnation of mortgaged properties, stamp tax of JPY200 (about US$2) is imposed on it, as a document containing an agreement about an assignment of receivables (*Schedule 1-15, Stamp Tax Law (Inshi-zei-hou)*).

If a mortgage agreement and/or relevant documents also include provisions about the loan that is secured, stamp tax is imposed on it as a document relating to a loan (*Schedule 1-1, Stamp Tax Law*). The amount of the stamp tax may differ depending on the amount of the loan.

Registration fees

A registration and license fee (registration fee) is imposed when a registration and/or licence system is used for perfection. For example, in the creation of an immovable property mortgage, the registration fee for a permanent registration of the mortgage is 0.4% of the amount of the claim secured by it (*Article 9, Schedule 1-1-(5), Registration and Licence Tax Law (Touroku-menkyo-zei-hou)*).

Fees for enforcement procedures

For the enforcement of security interests under the Civil Enforcement Law, the petition fee payable to the court is JPY4,000 (about US$42) per security interest for an auction of the collateral (*Article 3, Schedule 1-11, Law Concerning Civil Litigation Costs (Minji-soshou-hiyou-tou-ni-kansuru-houritsu)*).

The registration fee for registration of an attachment resulting from foreclosure is 0.4% of the secured claim (*Article 9, Schedule 1-1-(5), Registration and License Tax Law*).

For prepayment to the court of enforcement fees, the current fees in the Tokyo District Court are:

- For a claim below JPY20 million (about US$209,000): JPY600,000 (about US$6,300).
- For a claim over JPY20 million but less than JPY50 million (about US$524,000): JPY1 million (about US$10,500).
- For a claim over JPY50 million but less than JPY100 million (about US$1 million): JPY1.5 million (about US$15,700).
- For a claim over JPY100 million: JPY2 million (about US$21,000).

Notaries fees

The parties can prepare a security document in the form of a notary deed, but they are not required to do so. The notary fee is set out in the relevant statute (*Articles 9 and 12, Cabinet Order for Notary Fees (Koushounin-tesuuryou-rei)*).

26. If such taxes and fees make granting security too expensive, are there strategies to minimise costs?

The real property registration system allows registrations to be made as provisional registrations. Fees for provisional registrations are less than those for permanent registrations. For example, the registration fee for a permanent registration of a mortgage is 0.4% of the claim secured, but the provisional registration fee is only JPY1,000 (about US$10) per property. If there is no need for permanent registration, the registration cost can be reduced by choosing to use, at least temporarily, provisional registration.

However, as a security interest needs to be perfected as a permanent registration to foreclose on the collateral property through a court-supervised civil enforcement procedure, a provisional registration would need to be converted into a permanent registration. The permanent registration fee would then be imposed in addition to the provisional registration fee.

REFORM

27. Please summarise any proposals for reform and state whether they are likely to come into force and, if so, when.

The Ministry of Justice (*Houmu-shou*) publicly announced in 2006 that it will begin to examine the need, as well as the contents of, a fundamental reform of the Civil Code, particularly the law concerning contractual rights and obligations.

The Japanese Civil Code (Law of Obligations) Reform Commission (*Minpou(saiken-hou)kaisei-iinkai*), consisting of academic volunteers from civil law academia, was established in October 2008 (*see www.shojihomu.or.jp/saikenhou/*). The commission plans to finalise the basic reform plan by the end of March 2009, and the Ministry of Justice is scheduled to hold a legislative council using the basic reform plan finalised by the commission as a working draft.

CONTRIBUTOR DETAILS

Hajime Ueno and Maiko Kawato
Nishimura & Asahi

T + 81 3 5562 8575
+ 81 3 5562 8781
F + 81 3 5561 9711/12/13/14
E *h_ueno@jurists.co.jp*
m_kawato@jurists.co.jp
W *www.jurists.co.jp/ja/*

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Ark Mori Building
1-12-32 Akasaka, Minato-ku, Tokyo 107-6029 JAPAN
Tel: 81-3-5562-8500
Fax: 81-3-5561-9711/12/13/14
URL: www.jurists.co.jp Email: info@jurists.co.jp

Contact Person: Mr. Akira Kosugi (Managing Partner)
Total Number of Lawyers (Including Partners): over 400
Languages Spoken: Japanese, English, Chinese (Mandarin) and French