



Amended Japanese Trust Law Legalizes Security Trusts

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A security trust is a trust established for security purposes, of which the trustor (*itakusha*) is an obligor, the trustee (*jutakusha*) is the holder of the security interest and the beneficiary (*juekisha*) is a creditor secured thereby.

It has long been the general understanding that the holder of a security interest and a creditor need to be the same entity or person under the Japanese *Civil Code* unless particularly allowed by a statute (e.g., the *Secured Bonds Trust Law* (Law No. 52 of 1905) allows the creation of a security trust for the benefit of secured bond holders). However, in recent years, especially owing to the dynamic increase in the number of syndicated loan transactions, market participants have begun calling for a structure that allows a security trustee to hold and foreclose security interests on behalf of the lenders. However, it has been unclear whether a security trust could generally be established under the existing *Trust Law* (Law No. 62 of 1922).

A new Trust Law (Law No. 108 of 2006) was promulgated on December 15 2006 that will replace the existing law, most likely in September 2007. Article 3 of the new Trust Law provides that a trust can be established by the creation of a security interest, and clarifies that a security trust can be established. In addition, Article 55 of the new Trust Law provides that, in a security trust, a trustee as the holder of a security interest may file a foreclosure or enforcement of such interest and receive dividends from the proceeds of their sale or repayment as trust affairs.

Issues Related to Security Trusts

With respect to security trusts, some interpretational and practical issues still need to be considered.

(i) Need for the consent of creditors

There is an argument that the consent of creditors as beneficiaries would be required to establish a security trust. On the other hand, since no beneficiary consent is generally required to establish a trust for the benefit of third parties (Article 88, paragraph 1 of the new Trust Law), the view that no creditor's consent is required to establish a security trust, which is a kind of trust for the benefit of third parties, has also been argued. This issue will likely be examined in the future; however, in practice it could be dealt with through the provisions in loan agreements that a security trust in favour of lenders shall not be created without their consent.

(ii) When secured obligations are extinguished

In a security trust, the holder of a security interest and the creditor are separate. Based on this structure, it is a logical interpretation that secured obligations will be extinguished by the receipt of dividends by the trust beneficiary as the creditor in respect of the secured obligations. However, it has been argued that secured obligations should, because of the nature of security trusts, be extinguished by the receipt of proceeds of or from the collateral by the trustee, and that the language in Article 55 of the New Trust Law makes this point clear. New developments regarding this interpretation are expected.

(iii) Trusts for litigation purposes

Article 10 of the new Trust Law provides that a trust may not be established if its main purpose is to conduct litigation. There is a fear that this provision will hinder the establishment of security trusts because it is expected that the trustees of security trusts will be involved in civil litigations. However, it has been argued that the scope of application of Article 11 of the existing *Trust Law* (which is similar to Article 10 of the new Trust Law) should be limited. Accordingly, it could be interpreted that the creation of a security trust would not contravene Article 10 of the new law to the extent that it is used as part of a legitimate financing transaction.

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