Whole Business Securitizations Are Gaining Strength in Japan

In the last couple of years, whole business securitization has started to attract a lot of attention in Japan as a financing technique. Since there are no insolvency regimes in Japan similar to those of the UK, it was once argued that it would be difficult to set up a whole business securitization here. However, structures for these transactions have been developing under Japanese law.

By Hajime Ueno and Takashi Saito
Nishimura & Partners

Key Aspects

A whole business securitization (WBS) transaction is generally understood to be a securitization transaction that is backed by a future cash flow generated by a certain business operation. WBS transactions initially emerged and were developed in the UK. Underlying their development was the unique floating charge and administrative receivership regime under the laws of the UK. Since there is no legal system similar to that for floating charges and administrative receiverships in Japan, it was once argued that it would be difficult to set up a WBS in Japan. However, market participants have devised structures for setting up a WBS by using other features of the Japanese legal system, and several WBS and quasi-WBS transactions – although with characteristics that differ from their UK counterparts – have already been implemented in Japan.

WBS have often been described as falling midway between a standard asset securitization (ABS) and traditional corporate debt (straight debt). WBS are similar to ABS in that they are financing transactions backed by a specific cash flow. However, WBS differs from ABS in that it is not backed by cash flow generated by specified assets but instead by cash flow generated by each target business as a whole. In addition, investors in WBS and in straight debt are both subject to volatility risk with respect to the target business or the cash flow it generates and, therefore, it could be said that WBS and straight debt share similar characteristics. However, whereas in the case of straight debt such volatility risk is not usually structurally mitigated (or is mitigated insufficiently), in WBS, in principle, the business cash flow volatility risk is intended to be structurally mitigated by certain features.

Bankruptcy Remoteness

(i) Importance of Bankruptcy Remoteness

Under Japanese insolvency regimes, unlike in the UK, a secured party will have insufficient control over the insolvency proceedings and therefore the going concern value of the business of the debtor. Upon commencing corporate reorganization proceedings under the *Japanese Corporate Reorganization Law* (*kaisha kousei hou*), the business operation of the debtor corporation will be under the control of the reorganization trustee appointed by a court order and the exercise of security interests outside of corporate reorganization proceedings will be prohibited. Also, no secured party (*kousei tannpokensha*) will be entitled to receive payments until a reorganization plan (*kousei keikaku*) is approved by the creditors and a court. After approval of a reorganization plan, payments to a secured party are made only in accordance with the reorganization plan so approved. A deduction of the debt amount or deferral of payment could be made with respect to all debts of the debtor corporation subject to the reorganization plan. In addition, there being no form of security interest in Japan equivalent or similar to the floating charge in the UK, no creditor can be remote from the risk that other creditors having more control over the insolvency proceedings might appear after the implementation of the financing transactions. In addition, since the reorganization trustee rather than any particular creditor would be running the business operations due to the absence of UK-style administrative receivership, no creditor can be ensured that another creditor will not control business operations.

Accordingly, creation of security interests over the assets held by a debtor at the closing of the WBS will not be enough to ensure that going concern value of the securitized business rests with the investors in a WBS. Therefore, various measures need to be taken to ensure the remoteness of the secured business from the insolvency of related parties.

(ii) Impact of Related Parties' Insolvency

A WBS would usually involve a company (WBS vehicle) that owns the assets necessary to operate the target business, a company (Parent) that holds shares in the WBS vehicle and a company (Operator) that actually conducts operating functions with respect to the target business. It is important to examine how the insolvencies of the related parties will impact a contemplated transaction.

(a) *WBS Vehicle.* A WBS Vehicle owns assets necessary to operate the securitized business. If an insolvency proceeding commences against the WBS vehicle, management and disposal of such assets are restricted by the proceeding and, more likely than not, the cash flow to be generated by or from the securitized business will decrease. Accordingly, insolvency of the WBS vehicle must be prevented as much as possible by adopting certain structural features.

(b) *Parent.* In a WBS financing, the instrument would usually be loans (rather than bonds or notes) in order to make the instruments secured instruments (under Japanese law, there are certain obstacles to the issuance of secured bonds or notes). Security interests are generally created over all of the outstanding shares in the WBS vehicle. However, if a corporate reorganization proceeding commences against the Parent that holds the collateralized shares, exercise of such security interests would be restricted by the proceeding and the proceeding would prevent realization of the going concern value of the securitized business. Accordingly, in order to ensure the enforceability of the security interests over the shares in the WBS vehicle, it would also be important to make the Parent as remote as possible from corporate reorganization proceedings.

(c) *Operator.* The Operator is usually the originating business operator of the target business of a WBS before and after the implementation of the transaction. Being an ordinary business corporation, it is difficult to preclude the Operator structurally from satisfying the requirements for commencing insolvency proceedings. On the other hand, the idea behind WBS structures is to let the Backup Operator (or another third party or parties who is or are expected to be eligible to operate the securitized business properly) operate the securitized business continuously by properly replacing the Operator with the Backup Operator once an insolvency proceeding commences against the Operator. In other words, measures to minimize the impact the Operator's insolvency could have on the WBS are taken rather than trying the impracticable (i.e., making the Operator bankruptcy-proof).

Deal Structures

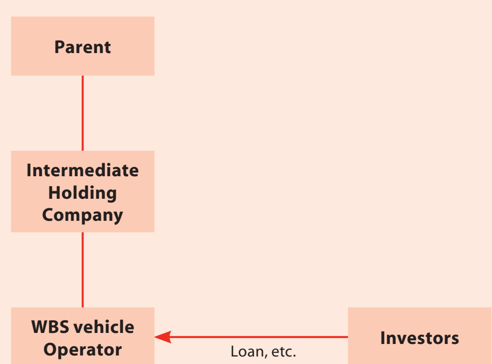
In terms of structural differences, published WBS transactions can largely be classified into three categories: (i) a structure in which the originating business operating company (an ordinary business corporation) is molded into a special-purpose company (SPC) or quasi-SPC form that is relatively remote from insolvency, and thereafter investors extend credits (via the extension of loans or an issuance of bonds) backed by the cash flow derived from the target business to such originating operating company (forming an SPC Structure); (ii) a structure that allows an existing ordinary business operating company to spin off of a target business (securitized business) into a newly incorporated entity (in many cases such entity is its subsidiary) *via* a company split (*kaisha bunkatsu*) under the Corporation Law (*kaisha hou*), and thereafter such entity borrows loans or issues bonds backed by the cash flow derived from the securitized business (Company Split Structure); and (iii) a structure in which the target business or assets necessary for the operation thereof will be transferred to a newly incorporated entity (in many cases such entity is a bankruptcy-remote SPC) by way of a business transfer (*jigyo joto*) or assets sale, and thereafter such entity borrows loans or issues bonds backed by the cash flow derived from the target business or assets necessary (True Sale Structure).

(i) Forming an SPC Structure

In forming an SPC structure, the Operator and the WBS vehicle are the same entity. Since it would be difficult to let the Backup Operator take over the operation of the target business upon the Operator's insolvency, the importance of making the WBS vehicle/Operator as remote from insolvency as possible greatly increases. It is therefore necessary to transform the WBS vehicle/Operator into an SPC or a quasi-SPC.

Measures to be taken to form the WBS vehicle/Operator into an SPC include the creation of security interests on all or substantially all of the business assets, restriction on business purposes in its governing documents, appointment of independent directors, mitigation of abuse of shareholders' rights by the Parent and the issuance of classified shares with veto rights (*kyohiken tsuki shurui*

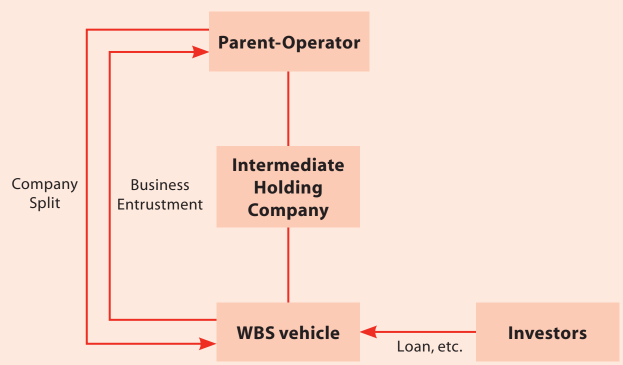
Figure 1: Forming an SPC Structure



kabushiki) so as to limit the ability of the management of the WBS vehicle/Operator, as well as various contractual arrangements including covenants to maintain its SPC or quasi-SPC form, to mitigate contingent liabilities (in some cases, the originating business operating company will be reincorporated in order to cut off contingent liabilities of the past as much as possible) and the establishment of business performance triggers and event-of-default provisions.

Forming an SPC Structure often seems to be chosen when an ordinary business operating company contemplates securitizing its subsidiary's business, in which case the Parent is also an ordinary business corporation. It would be important to note, therefore, that taking on the entire outstanding shares of the WBS vehicle/Operator as collateral (via the creation of security interests over them for the benefit of investors) will not result in sufficient investor protection as the security interests would be subject to reorganization proceedings if the Parent (the grantor of the security interests) becomes subject to the proceedings. In this regard, it is very important for the conclusion of a WBS to include structural features that remove, as much as possible, the impact that the Parent's insolvency could have on the securitized business. One way of doing this is to establish an intermediate holding company that holds shares in the WBS vehicle/Operator between the Parent and

Figure 2: Structure of a Company Split



the WBS vehicle/Operator by way of a stock transfer (*kabushiki iten*) or stock-for-stock exchange (*kabushiki koukan*), and to make such intermediate holding company a bankruptcy-remote SPC. Another way would be to make investors, directly or indirectly, the holders of the classified shares with veto rights (separately from their taking over the security interests over the common shares of the WBS vehicle/Operator).

(ii) Company Split Structure

As the result of a company split, the originating business operating company that is the transferor will come to hold all of the outstanding shares in the newly incorporated entity that is the transferee. Therefore, in order to ensure the enforceability of security interests over shares in the transferee in the event of the insolvency of the Parent-Operator, establishment of an intermediate holding company should be considered in this structure as well.

In the Company Split Structure, if correctly structured and created through the proper company split process, contingent liabilities of the Parent-Operator, even if related to the target business, will not be assumed by the transferee. Therefore, the Company Split Structure has an advantage in the level of bankruptcy remoteness over forming an SPC Structure. However, it should be noted that the Company Split Structure has certain disadvantages, such as heavy procedural and administrative burdens and considerable amounts of time and effort.

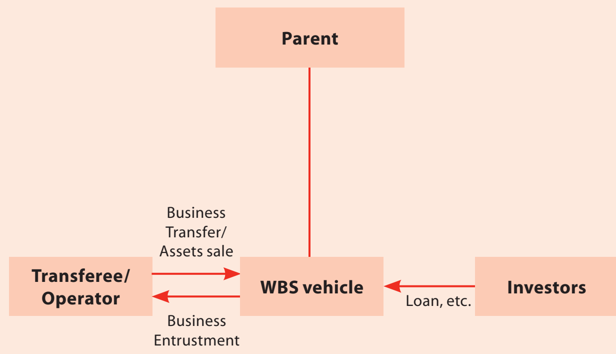
If certain approvals, licenses or permissions are required to operate the target business, it needs to be determined how such approvals should be dealt with; in particular, whether such approvals can be or will be transferred to the transferee through a company split. If not, in order to prevent suspension of the target business, it is necessary to establish a new subsidiary prior to a company split and such subsidiary must obtain the necessary approvals beforehand. Thereafter, it must transfer the target business to the transferee by spinning off the business to such subsidiary through an absorption-type company split (*kyushu bunkatsu*).

(iii) True Sale Structure

Transactions under the True Sale Structure, obviously and especially if only the assets are transferred, would be more similar to an ABS. In the True Sale Structure, the aim is to make remote the relevant target business or assets from the transferor's or transferee's insolvency. However, at the same time, it has some characteristics of a straight debt, especially if the assets are less liquid, since the generation of cash flow could depend largely on the creditworthiness of the Operator.

As is the case in the Company Split Structure, if certain approvals are required to operate the target business, determinations need to be made as to how such approvals should be dealt with. In addition, it should be noted that with respect to certain assets, such approvals are required to own them. Particularly if the transferee is a trust or other SPV, it might be difficult, or practically impossible, for the transferee to obtain such approval.

Figure 3: The True Sale Structure



About the authors

Hajime Ueno is an associate working predominantly on structured finance and acquisitions at Nishimura & Partners, which he joined in 1999. Ueno is a graduate of the University of Tokyo (LL.B., 1997) and Harvard Law School (LL.M., 2004), and has worked on secondment at the New York firm of Skadden, Arps, Slate, Meagher & Flom (2004-2005). Fluent in both Japanese and English, Ueno has co-authored a number of international and domestic journals and publications. He is a member of the Japan Bar as well as the New York Bar, having been admitted in 1999 and 2005, respectively.

Takashi Saito is an associate at Nishimura & Partners specializing in structured finance. His area of practice focuses on structured finance, especially securitizations of receivables and real properties and whole business securitizations. He joined the firm in 2002 after receiving an LL.B. from Waseda University in 2000. He was admitted to practice in Japan in 2002. He is co-author of Corpus Juris Finance Update (Shoujihomu, 2006).