Bankruptcy Remoteness and Securitization in Japan

As finance mechanisms based on the creditworthiness of securitized assets, securitizations are designed with the ultimate aim that the bankruptcy of the original owner of the assets (the originator) or other relevant transaction parties does not affect the securitization structure. Accordingly, it is important that securitized assets and the cash flow they generate are as remote as possible from the bankruptcy of the originator and other relevant parties.

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Securitization transactions, including asset-backed securities (ABS) transactions and limited-recourse loan transactions, can be viewed as transaction structures that connect cash flow-generating assets to the capital markets. For the funding parties, securitization is the process of removing assets from their control in order to generate proceeds based on the cash flow generated by the asset. For investors, securitization allows access to profits generated by the management and disposal of the assets.

Securitization is a finance mechanism based on the creditworthiness of securitized assets. Such mechanisms are created with the ultimate goal of ensuring that the bankruptcy of the original owner of the assets (the originator) or other relevant transaction parties will not affect the securitization structure. Accordingly, in a securitization transaction, it is important that securitized assets and the cash flow they generate are placed as remotely as possible from the bankruptcy of the originator or other relevant party. In this regard, it is important to examine whether or not a structure is affected by (i) the originator's bankruptcy proceedings, or (ii) the bankruptcy proceedings of a transferee receiving securitized assets. As is the case with securitization transactions in other jurisdictions, Japanese securitizations are not bankruptcy-proof but rather bankruptcy-remote.

Remoteness From a Bankruptcy

To ensure sufficient remoteness from a bankruptcy, significant issues to consider in the context of Japanese securitization transactions include true sales, avoidance (*hinin*) and the right to revoke fraudulent acts (*sagai koui torikeshi*), as well as commingling risks.

Asset Transfers and True Sales

To determine the remoteness of a securitization structure from an originator's bankruptcy, it is important to determine whether or not a transfer of assets from the originator to a transferee – which is typically either a special-purpose company (SPC) that is an ABS issuer; an SPC that borrows asset-backed, or limited recourse, loans; or a trustee as to the securitized assets – is a true sale. The term "true sale" has various meanings, but in a legal context in Japan, it means that even if bankruptcy proceedings, a corporate reorganization or other insolvency proceedings have commenced against the originator (or other former owner of the assets), the transfer will not be regarded by an insolvency trustee, an insolvency court or a similar body as an assignment for security purposes and the assets will not be treated as part of the originator's (or other former owner's) estate subject to the proceedings.

In the context of Japanese insolvency legislation, the recognition of a true sale becomes critically important in that a transferee's right over assets for securitization will not be treated as a reorganization security right (*kosei-tanpo-ken*) in corporate reorganization proceedings under the *Japanese Corporate Reorganization Law* (*Kaisha Kosei Ho*) if, in fact, the transfer is considered a true sale. In corporate reorganization proceedings, reorganization security rights are subject to the proceedings and payments to the security rights are not made until a court approves a reorganization plan. After the court's approval of a reorganization plan, payments to the reorganization security rights are made only in accordance with the approved plan. In addition, an approved reorganization plan may provide for a decrease in amount or a deferral of payment of the reorganization security rights. Therefore, if the rights held by a special-purpose vehicle (SPV) over securitized assets are deemed a reorganization security right by a court, the SPV would not be able to claim timely payments and/or payment in full against the securitized assets or from the originator.

On the other hand, true sale issues are less important in the context of other insolvency proceedings. In bankruptcy proceedings or civil rehabilitation proceedings, security rights are treated as rights of exclusive preference (*betsujyo-ken*) and, in principle, substantive aspects of the security rights are not affected by the proceedings. However, it should be noted that the procedural aspects of the security rights may be affected by the proceedings in that, in civil rehabilitation proceedings, a court may order a discontinuance of auction proceedings as an exercise of the security right. A rehabilitation debtor may, when assets are indispensable for the continuation of the rehabilitation debtor's business, apply to the court for an approval to extinguish all of the security rights existing on the properties by paying an amount of money equivalent to the value of the properties to the court. Therefore, even if a transfer of securitized assets was re-characterized as an assignment for security purposes rather than as a true sale, SPVs as transferees would likely be able to collect the cash flow generated by the securitized assets both in a timely manner and in full. There are cases in Japan in which investors and rating agencies do not emphasize the need for the true sale nature of the transaction because the relevant originator is an entity or person to which the *Corporate Reorganization Law* is not applicable; that is, a company that is not a stock company (*kabushiki kaisha*) or a natural person.

It is generally construed that there are various factors to be considered in order to determine whether or not a transfer of assets is a true sale, including:

(i) the intentions of the parties;

(ii) the reasonableness of the purchase price;

(iii) whether the transferor has a right to the asset transferred, and the contents of such right;

(iv) whether the transferor bears the risk of the asset transferred, and the contents of the risk;

(v) whether or not the transferor has a right to repurchase the asset transferred, and whether or not the transferee has an obligation to repurchase the asset transferred and the contents of the repurchase right or obligation;

(vi) whether the transfer of assets is perfected; and

(vii) whether or not the assets are offset from the transferor's account book.

Because there is no controlling court precedent, there are various schools of thought on which of the above factors are important for defining a true sale.

There are also varying opinions on the importance or relevance of the independence of the SPV (that is, a transferee of the securitized assets) from the originator (transferor) in considering the true sale of a securitization transaction. It is certainly conceivable that, with respect to a structure in which the originator controls the transferee, there will be a concern that the originator will, in effect, have an absolute repurchase option that is exercisable at will and that such option would lead to a court's conclusion that the transfer is not a true sale. However, it would be erroneous to conclude that any and all sale and purchase transactions between a parent company and its wholly owned subsidiary are secured financing transactions. Similarly, in securitization transactions, a lack of independence need not always result in a denial of the true sale status of the transaction. In cases in which an SPV is not independent from an originator, that fact will often give rise not to the true sale issue but to the possibility of applying the "piercing the corporate veil" doctrine, in which shareholders may be held personally liable for debts.

Avoidance Rights and the Right to Revoke Fraudulent Acts

Under the Japanese *Bankruptcy Law* (*Hasan Ho*), *Civil Rehabilitation Law* (*Minji Saisei Ho*) and *Corporate Organization Law*, an act performed by a bankrupt entity – with the knowledge that it would prejudice the creditors in bankruptcy proceedings, or performed subsequent to the suspension of payment or an application for the commencement of bankruptcy procedures – may be avoided by the relevant insolvency trustee. Under the Japanese *Civil Code*, an act performed by a debtor with the knowledge that it would prejudice its creditors may be canceled by an exercise of the creditor's right to revoke a fraudulent act.

If a transfer of assets from an originator to an SPV was avoided in accordance with the *Bankruptcy Law*, *Civil Rehabilitation Law* or *Corporate Organization Law*, or canceled in accordance with the *Civil Code*, then the assets would return to the originator and therefore belong not to the SPV but to the originator. In this regard, with respect to maintaining remoteness from the originator's bankruptcy, it is necessary to structure the transaction so that the assets are not subject to avoidance rights or the right to revoke fraudulent acts.

Commingling Risks

In a securitization transaction, an SPV does not often, by itself, either service or collect the cash flow generated from securitized assets but rather entrusts another party to perform these roles. If the servicing or collecting entity becomes bankrupt, under Japanese law the SPV

would only have a non-secured claim to demand delivery of the collected amounts from the servicing or collecting entity. Because the non-secured claims of a bankrupt entity are almost always subject to a reduction during insolvency proceedings, the SPV will not usually receive its claim in full.

In Japanese securitization transactions backed by monetary claims, an SPV will usually require the originator to act as the primary servicer and to service or collect any cash flow generated by the monetary claims after such claims have been transferred from the originator to the SPV, knowing that there would be a commingling risk in connection with the servicing functions to be undertaken by the originator.

Remoteness from Transferee's Bankruptcy

Measures for achieving bankruptcy remoteness in connection with a transferee's bankruptcy can be classified into three categories: (i) measures to prevent the transferee from becoming insolvent, (ii) measures to prevent the commencement of insolvency proceedings against the transferee if, in fact, the transferee becomes insolvent, and (iii) measures to protect investors upon the commencement of the transferee's insolvency proceedings.

Measures to prevent the transferee from becoming insolvent include the following: (i) making the transferee an SPV by prohibiting it from engaging in business other than the securitization of assets in its articles of incorporation and other organizational documents; (ii) prohibiting the transferee from hiring employees; and (iii) prohibiting the transferee from launching mergers, etc.

With respect to making the transferee a special-purpose vehicle described in item (i) above, an SPV is usually a stock company (*kabushiki kaisha*), limited liability company (*godo kaisha*) or special-purpose company (*tokutei mokuteki kaisha*) under the *Securitization Law* (*Shisan no Ryudo-ka ni Kansuru Horitsu*), established specifically for the relevant securitization transaction. Stocks or equities in an SPV are usually held by a limited liability intermediate corporation (*yugen sekinin chukan hojin*) under the *Intermediate Corporation Law* (*Chukan Hojin Ho*) or by a Cayman corporation whose ordinary shares are held by a charitable trust, etc. When the Japanese *General Incorporated Association and General Foundation Law* (*Ippan Shadan Hojin oyobi Ippan Zaidan Hojin ni Kansuru Horitsu*), promulgated on June 2 2006, goes into effect (the law will be effective within two years and six months after that date), limited liability intermediate corporations will become general incorporated associations (*ippan shadan hojin*), without any additional steps required, and thereafter will be subject to this law.

A general incorporated association is mainly different from a limited liability intermediate corporation in the following ways: (i) the cause for a compulsory winding-up (a limited liability intermediate corporation will be wound up if there is only one corporate member [*shain*] of the corporation; on the other hand, a general incorporated association will be wound up if a corporate member of the corporation ceases to exist), (ii) the requirement to publicize financial statements (a limited liability intermediate corporation is not required to make its financial statements public, while a general incorporated association will be required to publicize its financial statements), and (iii) the requirement to appoint an accounting auditor if it is a large-scale corporation (*daikibo ippan shadan hojin*), with debts on its balance sheet exceeding ¥20 billion (US$169 million), is applicable only to a general incorporated association.

A rating agency expressed the opinion that even if a limited liability intermediate corporation becomes a general incorporated association by enforcement of the *Japanese General Incorporated Association and General Foundation Law*, the bankruptcy remoteness of a securitization transaction to which the limited liability intermediate is a party would not be affected, provided that the rating agency may request to reserve money for the payment of additional expenses for the publication of financial statements and appointment of an accounting auditor described in items (ii) and (iii) above.

Measures to prevent the commencement of insolvency proceedings against the transferee, in the case that it becomes insolvent, include the following: (i) appointing an independent director of the transferee (in Japanese securitization transactions, an accountant or judicial scrivener is often appointed as a director) and (ii) obtaining waivers of rights to petition for the commencement of bankruptcy proceedings, civil rehabilitation proceedings, corporate reorganization proceedings and other insolvency proceedings of the transferee. The waivers described in item (ii) above can be split into two categories, i.e., waivers by creditors of the SPV and waivers by the transferee itself and/or its directors.

A waiver issued by the creditors of a transferee is generally considered valid. However, a waiver issued by creditors is considered valid only if the scope of the waiver is reasonable, based on factors such as the period of the non-petition covenant and other conditions that are limited to the extent necessary for the purposes of the relevant transaction. As such, creditors often waive their rights to commence insolvency proceedings until one year and one day after all securitization products (e.g., asset-backed securities and asset-backed liabilities) have been redeemed or repaid in full. Furthermore, there is an argument that if anyone applies for the commencement of bankruptcy proceedings in violation of a waiver, the transferee or other parties cannot request a court to reject the

proceedings and can only ask for compensation for damages.

Next, with respect to a waiver made by a transferee, there remains the possibility that the waiver would not be valid because the insolvency proceedings are believed to be in the public's best interests, and the waiver of the right to petition for insolvency proceedings could be viewed as hindering such interests. With respect to a waiver being personally issued by the director of a transferee, there is the possibility that the waiver would not be deemed valid because it conflicts with the director's obligation to act as a prudent manager owing fiduciary duties.

Although there are legal risks, as noted above, involved in Japanese securitizations, measures are often adopted to minimize the risks presented by a transferee's insolvency proceedings.

Measures to protect investors upon the commencement of insolvency proceedings include (i) the creation of security rights for the benefit of investors and (ii) subordination agreements.

With respect to security rights, if bankruptcy proceedings or civil rehabilitation proceedings are commenced against a transferee, substantive aspects of the security rights held by investors are not, in principle, affected by the proceedings. By contrast, if a transferee is a stock corporation, corporate reorganization proceedings may be launched. As mentioned above, if corporate reorganization proceedings are begun for a transferee, the security rights held by investors are treated as reorganization security rights and become subject to the proceedings, in which case payments on the rights are subject to the reorganization plan. Since a limited private company (*yugen kaisha*) under the *Limited Private Company Law* (*Yugen Kaisha Ho*) is not subject to the *Corporate Reorganization Law*, a limited private company has often been used as an SPV in the past. However, the *Limited Private Company Law* was abolished upon the enforcement of the *Japanese Corporate Law* (*Kaisha Ho*) on May 1 2006, and limited private companies established under the *Limited Private Company Law* are now treated as stock companies. Therefore, if relevant parties want a limited private company that was established under the *Limited Private Company Law* not to be subject to the *Corporate Reorganization Law*, they should restructure the limited private company as a limited liability company.

For cases in which securitization products are corporate bonds, the *Japanese Secured Bonds Law* (*Tanpo Tsuki Shasai Shintaku Ho*) is applicable. As the requirements and restrictions of the Secured Bonds Law are stringent and inflexible, rarely is a secured bond seen in the capital markets. The same applies to the securitization market; for bonds issued by a special-purpose company incorporated under

the *Securitization Law*, bonds can be secured by general security (*ippan tanpo*), although the rights and interests granted to the holder of a general security are undesirably weak.

A subordination agreement is an agreement whereby creditors of a transferee (other than investors) agree to subordinate their rights to investors' rights. If the subordination agreement is valid upon the commencement of the transferee's insolvency proceedings, the investors would be able to receive payments prior to the payment of other creditors and their rights would be somewhat protected. The amendment of the *Japanese Bankruptcy Law*, the *Civil Rehabilitation Law* and the *Corporate Reorganization Law* in 2004 created "agreed subordinated bankruptcy claims" (*yakujo retsugo hasan saiken*), "agreed subordinated rehabilitation claims" (*yakujo retsugo saisei saiken*) and "agreed subordinated reorganization claims" (*yakujo retsugo kosei saiken*), collectively known as the Agreed Subordinated Bankruptcy Claims. These are claims with respect to which it is agreed between creditors – before the commencement of bankruptcy proceedings, civil rehabilitation proceedings or corporate reorganization proceedings – that the claims rank second not just to general claims but also to general subordinated bankruptcy claims in the distribution of a bankrupt estate.

Because the priority ranking of the distribution for these claims is secondary to that of general subordinated bankruptcy claims, general subordinated rehabilitation claims and general subordinated reorganization claims, investors – who are usually general creditors with priority over the creditors of the above claims – will receive any distribution prior to the creditors of agreed subordinated bankruptcy claims, agreed subordinated rehabilitation bankruptcy claims and agreed subordinated reorganization claims. If the rights held by creditors (other than investors) are all agreed subordinated bankruptcy claims, investors will receive distribution prior to other creditors in the transferee's bankruptcy, civil rehabilitation or corporate reorganization proceedings.

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