Chapter 15

JAPAN

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I INTORODUCTION TO THE LEGAL FRAMEWORK

i Ownership of real estate

The basic ways in which real estate can be held are either holding ownership title to real estate directly or holding a beneficial interest in a trust that holds title to real estate in connection with large-scale commercial investments.

Land and buildings are considered separate and independent real estate. Therefore, one person can hold title to land while another person can hold the title to a building on the land. When different persons own a building and the parcel of land upon which the building is located, the two owners will typically enter into a contract such as a land-lease agreement where the building owner is permitted to use the land.

Joint title to real estate, which is governed by the rules under the Civil Code, is one form of title that can be held by multiple persons. Condominium title to a condominium that is part of a building, which is governed by both the rules under the Condominium Law and by the Civil Code, is another form of title that can be held by a single person separately from other condominium owners of the building.

Trust beneficial interests in real estate are typically issued when a real estate owner places the real estate in a trust. The trustee holds title to the real estate placed in the trust. The owner, on the other hand, holds a trust beneficial interest that represents a contractual relationship with the trustee under a trust agreement. Under this, the beneficiary may instruct the trustee to administer and manage the real estate in the trust and to distribute profits earned from the real estate (after deducting costs and expenses for administration and management of the real estate). Trust beneficial interests are used for various reasons including delegating administrative duties from the beneficiary to

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the trustee, and deferring taxes related to real estate transfers by transferring the trust beneficial interests instead.

ii System of registration
Ownership title and other property rights with respect to real estate are typically registered in the real estate registry maintained by local registration offices. Trustees are typically the registered owners of real estate that is placed in trust. The general rule is that transactions including the sale and purchase of real estate and creation of a mortgage on real estate take effect upon execution of agreements between the parties and that no formalities are required; however, the holder of ownership title or other property rights with respect to real estate must have its interest registered in the appropriate real estate registry to assert its rights against a third party. This means that generally, to perfect a right over real property, there must be a valid agreement between the parties and the right must be registered in the name of the holder. The registration is governed by the Real Estate Registration Law.

While registration of a real property right in the name of a certain person does not necessarily mean that the person actually holds the registered right, registration is usually considered strong evidence. Neither the local registration office nor the Japanese government guarantees the accuracy of the real estate registry. A registration in the real estate registry only reflects and records the transactional activities that private persons described in their applications for registration.

iii Choice of law
In the context of a cross-border transaction, choice of law rules are provided in the Act on General Rules for Application of Laws. Under the Act, if the subject matter is a property right or other right that can be registered in the real estate registry, the law of the jurisdiction in which the real estate is located shall be the governing law; however, under the Act, any law chosen by the parties can govern a contract. Despite the Act permitting the parties to choose the governing law of the contract, parties usually choose Japanese law as the governing law of a sale and purchase agreement with respect to real estate, because of the rule that Japanese law governs property rights in Japan.

II OVERVIEW OF REAL ESTATE ACTIVITY
Since the early 1990s, various innovative real estate investment structures have been developed in Japan.

The GK–TK structure and the specified-purpose company ("TMK") structure (discussed in detail in Section IV, infra) are frequently used for real estate investment. Japanese real estate investment trusts ("J-REITs") (also discussed in Section IV, infra), have made it possible for investors with smaller amounts of capital to invest in real estate through the purchase of listed J-REIT securities. The accumulated capital of the listed J-REITs has made them major players in the Japanese real estate investment market. The flow of capital through listed J-REITs into the real estate investment market has contributed to the growth of the real estate industry.
The increase in flexibility of such investment structures has resulted in a greater influx of domestic and foreign capital into real estate. The response to demand from an increasing number of participants has made the real estate investment market more sophisticated and attractive, so that a number of investors consider the Japanese real estate market an important strategic focus in their global investment strategy.

Although global economic turmoil has affected – and slowed down – activities in the Japanese real estate investment market (including activities by lenders), it has also prompted further regulatory developments. After the real estate market was hit by recent economic upheaval, the government adopted action plans to relax regulations and enhance market activities. The government has already started to implement its action plans and has brought in various measures to relax regulations and enhance market activities (recent key developments are highlighted in Section VII, infra).

III FOREIGN INVESTMENT

There are no direct restrictions on acquisitions of commercial or residential real estate in Japan by foreign investors, either directly or through a vehicle. Similarly, establishment of a corporation by foreign investors to invest in commercial or residential real estate is not restricted. In theory, under the provisions of the Alien Land Law, a Cabinet Order may limit the rights of foreign investors related to land in Japan on the ground of reciprocity or national security. As of the end of December 2012, however, there has been no such limitation since no such cabinet order has been issued.

Under the Agricultural Land Act, an authorisation by the relevant authority is required to acquire certain agricultural land. This authorisation can only be granted if the purchaser is qualified as a farmer or an ‘agricultural production corporation’. It would not be easy for foreign investors to be granted such authorisation.

After a foreign investor’s acquisition of shares or equity of a corporation, or acquisition of real estate or a right related to real estate, a post-transaction report to the government authority may be required pursuant to the Foreign Exchange and Foreign Trade Law (‘the FEFTL’). A post-transaction report of payment or receipt of payment may be required in the case of cross-border payments or payments between a foreign investor and a Japanese resident in accordance with the FEFTL.

IV STRUCTURING THE INVESTMENT

When choosing an investment structure, one must consider the legal accounting and tax implications. This is because each can be a driving factor for the choice. The most popular structures and investment vehicles used for real estate investments in Japan are the GK–TK structure, the TMK structure and the J-REIT.

i GK–TK structure

A limited liability company (‘GK’) is one of the types of corporate entities under the Companies Act. In some respects, it is similar to an LLC in the United States; however, it is not itself a pass-through entity for tax purposes. When a GK is used as an asset investment vehicle, typically an investor leverages its investment by third-party loans
and makes its own investment in the GK through a contractual anonymous partnership (‘TK’) arrangement. The TK arrangement is a bilateral (not multilateral) contractual partnership relationship created for the investment purposes by the TK interest holder, called the TK investor. The other party to the contract is called the TK operator. Under the GK–TK structure, the TK operator is the GK. A TK arrangement qualifies for favourable tax treatment if the TK investor is a ‘passive’ investor with minimal control over the management of the GK and the contributed funds under the arrangement. If the TK arrangement qualifies, the GK is permitted to deduct distributions to the TK investor from its taxable profits in addition to deducting debt payments. This tax-efficient combination of a GK and a TK arrangement is called a GK–TK structure.

Typically, a GK–TK structure is used to make investments in trust beneficial interests in real estate, and loans backed by real estate. If a GK holds real estate directly by raising funds from TK investors, it will generally be subject to a licensing requirement under the Real Estate Specified Joint Enterprise Act (‘the REJEA’). Therefore, the GK–TK structure is usually structured to invest in trust beneficial interests in real estate, not real estate itself.

A GK–TK structure that is used to invest in a trust beneficial interest in real estate will subject the GK to the strict registration requirement under the Financial Instruments and Exchange Law (‘the FIEL’), unless an exception applies. One of the exceptions available under the FIEL is the ‘QII exemption’, which essentially requires that (1) there is at least one qualified institutional investor (‘QII’) under the FIEL among the TK investors, (2) the number of non-QII TK investors (if any) is 49 or less, (3) none of the TK investors is a disqualified investor as detailed in the FIEL, and (4) the GK, as the operator of the TK arrangement, files with the government authority a simple notification regarding the QII exemption.

ii  TMK structure

A TMK incorporated under the Asset Liquidation Law (‘the ALL’) is another type of corporate entity often used as a real estate investment vehicle. This entity may only be used to liquidate or securitise certain assets. This investment platform is used to make investments in real estate, trust beneficial interests in real estate, and loans and TMK bonds that are backed by real estate. A TMK is typically funded by issuing TMK bonds and preferred shares that meet certain tax qualifications required for preferential tax treatment of the TMK. If a TMK, its bonds, and its preferred shares are properly structured, and the TMK meets certain other requirements under the Tax Code, it is permitted to deduct distributions to the preferred shareholders from its taxable profits in addition to deducting debt payments.

One of the requirements for the preferential tax treatment is that its TMK bonds be purchased by an institutional investor or other similar person or entity (a ‘Tax II or equivalent investor’) as defined in the tax code. Certain QIIs under the FIEL and certain other QIIs meeting certain additional requirements fall under the definition of a Tax II or equivalent investor. One of the important steps in setting up a TMK structure is to find a TMK bondholder that is a QII and is a Tax II or equivalent investor.

When using a TMK structure, it is also important for the TMK to comply with strict regulations under the ALL. These regulations include a requirement to file an asset
liquidation plan with the government authority. The asset liquidation plan of a TMK outlines how its assets are to be liquidated or securitised. A TMK structure requires paying close attention to the regulations regarding the asset liquidation plan.

iii  Japanese real estate investment trusts

A J-REIT is a type of investment fund formed under the Law concerning Investment Trusts and Investment Companies (‘the Investment Trust Law’). A J-REIT established to invest in and manage real estate assets uses investors’ funds to purchase real estate assets, in return for which investors receive investment units. The investment units of a J-REIT can be listed and traded on the stock exchange. If a J-REIT’s investment units are listed, the J-REIT must comply with the rules of the stock exchange in addition to the Investment Trust Law. Under the Investment Trust Law, a J-REIT must retain an asset management company (a registered financial instruments operator under the FIEL) to manage its investment. In practice, all investment decisions for a J-REIT are designed to be made by its asset management company.

Unlike an ordinary corporation, which is subject to corporation tax on its profits, a J-REIT is exempt from taxation if certain requirements are satisfied, including:

a the J-REIT is not engaged in any business other than that permitted for J-REITs;
b the J-REIT would not be classified as a family corporation as defined in the Tax Code at the end of its fiscal period;
c the J-REIT distributes more than 90 per cent of its profits as dividends to the holders of its investment units for each fiscal period; and

d more than 50 per cent of the investment units on an aggregate issued amount basis have been offered in Japan.

The basic concept underlying the J-REIT legislation is that unlike a GK–TK structure or a TMK structure, a J-REIT’s investments are not limited to certain assets specified at the time of its start-up. By raising long-term funds through a combination of debt and equity financing, a J-REIT can continue to accumulate and replace its investment portfolio for a longer term. At the same time, however, it would distribute most of its profits (more than 90 per cent of its profits) to the holders of its investment units for each fiscal period as described above and therefore may not have sufficient internal reserve funds. When structuring a J-REIT, it is important to mitigate the potential risks of not having sufficient funds to deleverage its debt during an economic downturn. Since a J-REIT would practically be restricted regarding the amount of reserves it may retain, it should adopt another financial strategy to mitigate the potential risks, such as keeping its debt-to-asset ratio at a conservative level.
V REAL ESTATE OWNERSHIP

i Planning

The City Planning Law

The City Planning Law is the primary national law that governs real estate development and zoning.

Under the City Planning Law, land development is strictly controlled in urbanisation control areas. Developers are required to obtain approval from local government authorities for developments in areas designated for urbanisation. Approval is given if the proposed development meets certain requirements under the City Planning Law.

There are various local laws established under the framework of the City Planning Law. Local government authorities are granted the power to control land use in accordance with the City Planning Law and the local laws.

Building Standards Law

The Building Standards Law provides regulations with respect to construction of a building, including regulations with respect to its use and the ratio of its total floor area to its site area.

Under the Building Standards Law, the appropriate local government authority must approve construction work for a building before the work commences; furthermore, a completion inspection of the building by the appropriate local government authority is required upon completion of work.

ii Environment

Under the Soil Contamination Countermeasures Law, if a manufacturing factory that uses certain hazardous materials ceases its operations, the owner, manager or occupant of the land (‘the landowner’) must examine the land and test for contaminants. In addition, in the case of the development of a large area of land (at least 3,000 square metres), the developer must notify the appropriate local government authority at least 30 days before any change is made to the land. After receiving such notice, if the authority determines that the land may be contaminated in the manner designated by the Soil Contamination Countermeasures Law, it may order the landowner to investigate. The local government authority also may order a landowner to examine land and conduct testing for contaminants if it determines that the land may harm the health of inhabitants in the neighbourhood through underground water or otherwise in the manner designated by the Soil Contamination Countermeasures Law. If the result of an examination of the land reveals that the relevant regulations have not been met, local government authorities will designate the land as a contaminated area and require appropriate measures, including cleaning up the land, in order to prevent public health from being impaired.

iii Tax

Stamp taxes, registration and licence taxes, and real estate acquisition taxes apply when ownership title of real estate is transferred.
General
Stamp taxes are paid by affixing a revenue stamp on a taxable document. An agreement to transfer ownership title to real estate requires a stamp tax of progressive amounts ranging from ¥200 to ¥600,000 based on the purchase price provided in the agreement.

Registration and licence taxes are imposed when registering certain matters with respect to real estate with the appropriate local registry. The tax rate to register a transfer of ownership title to real estate is generally 2 per cent. A rate of 1.5 per cent will apply to registration regarding a transfer of land occurring between 1 April 2012 and 31 March 2013. The transfer of ownership title to certain qualified residential buildings that are acquired by an individual to reside in will be 0.3 per cent or 0.1 per cent.

Real estate acquisition taxes are imposed on a purchaser of real estate at the rate of 3 per cent (for land and for residential buildings) or 4 per cent (for non-residential buildings).

Beneficial treatment
Transfer to TMK
If a TMK meets certain requirements, it may qualify for certain tax benefits when acquiring real estate, such as reduced rates of registration and licence taxes and real estate acquisition taxes.

Transfer of trust beneficial interest
Using a trust structure where the trustee holds ownership title to real estate provides certain tax benefits. Stamp taxes for real estate trust agreements and for sale and purchase agreements for a trust beneficial interest in real estate is ¥200, which is substantially less than stamp taxes for a sale and purchase agreement of real estate itself. While registration and licence taxes and real estate acquisition taxes will be imposed on a purchaser of real estate, the following reduced registration and licence taxes will be imposed on real estate being placed in trust and on a trust beneficial interest in real estate being transferred from the initial holder to the purchaser:

a on placing the real estate in trust: 0.3 per cent or 0.4 per cent (for land) or 0.4 per cent (for buildings); and

b on transfer of the trust beneficial interest: ¥1,000 for each building and piece of land.

Real estate acquisition taxes are not imposed on real estate when it is placed in trust or on transfer of the trust beneficial interest.

When the holder of a trust beneficial interest in real estate (other than the initial holder), however, terminates the trust agreement and receives delivery of the real estate from the trustee, registration and licence taxes at a rate of 2 per cent will be imposed upon registering the transfer of real estate. Upon such transfer, real estate acquisition taxes will also be imposed on the beneficiary at the tax rate of 3 per cent (for land and for residential buildings) or 4 per cent (for non-residential buildings).

By applying the tax benefits of a trust structure as described above, a substantial amount of taxes related to a real estate transfer can be deferred until the trust agreement is terminated and the real estate is delivered to the beneficiary.
iv  Finance and security

Mortgages on real estate are the most frequently used form of security interest in real estate.

In general, once the mortgage is registered, the mortgage is granted priority over unsecured creditors; however, even a registered mortgage is subordinate to tax claims against the mortgagor that became due prior to the registration of the mortgage. The registered mortgage will also be subordinate to any previously registered mortgages or other previously registered security interests on the same real estate.

Another form of security interest in real estate that is frequently used is a pledge over a trust beneficial interest in real estate. If real estate is held in the form of a trust beneficial interest in real estate, the lender would create a pledge over the trust beneficial interest and not a mortgage on the real estate itself. Perfection of the pledge is made by obtaining the consent of the trustee with a date certified by a notary public.

See Section VII.iii, infra, with respect to the statutory general security interest that is granted by operation of law on the assets of a TMK in favour of the holder of the bonds of the TMK under the ALL.

VI  LEASES OF BUSINESS PREMISES

The Land Lease and Building Lease Law (‘the LLBLL’) and the Civil Code regulate real estate leases. The general rule is that the LLBLL is applicable to land leases that are made for the purpose of the lessee owning a building on the land, and to building leases. The LLBLL takes precedence over the Civil Code when their provisions overlap.

i  Types of lease

The LLBLL provides for various types of lease, including the following:

Land lease for the purpose of a lessee owning a building on the land

Ordinary land lease

Under the LLBLL, a land lease made for the purpose of the lessee owning a building on the land (other than a fixed-term land lease as discussed below) has a 30-year term, unless the parties agree to a longer term. Such land leases are automatically renewed for a term of 20 years for the first renewal and 10 years for subsequent renewals unless otherwise agreed by the parties. The lessor cannot object to such renewal without a justifiable reason. Generally, a justifiable reason is not easy to establish, and the lessor’s refusal to renew the lease is strictly restricted.

Fixed-term land lease

A fixed-term land lease made for the purpose of the lessee owning a building on the land is not renewable under the LLBLL; however, the parties are not prohibited from entering into a new lease agreement at the expiry of the lease. Fixed-term land leases were introduced because concerns of landowners about the strict restrictions on the ability of the owners of land to refuse to renew a land lease were considered to inhibit effective use of real estate. There are three types of fixed-term land leases:
a general fixed-term land lease available for either residential purposes or business purposes (the fixed term is 50 years or longer);

b a land lease with a special agreement by which the lessee assigns the building on the land to the lessor (the lease agreement can provide for the lessor’s right to obtain the building on the land from the lessee at a reasonable price in order to terminate the lease after 30 or more years following the commencement of the lease); and

c a fixed-term land lease for business purposes (the fixed term is 10 years or more but must be shorter than 50 years).

**Building leases**

**Ordinary building lease**

A building lease usually has an agreed term. Under the LLBLL, a building lease with an agreed term (other than a fixed-term building lease as discussed below) is automatically renewed and the lessor cannot object to the renewal of the building lease without a justifiable reason. Generally, a justifiable reason is not easy to establish and the lessor’s refusal to renew the lease is strictly restricted.

**Fixed-term building lease**

A fixed-term building lease is not renewed under the LLBLL; however, the parties are not prohibited from entering into a new lease agreement at the expiration of the lease term. The parties can agree on the fixed term without restriction on its duration.

**ii Typical provisions**

There are typical provisions for leases of business premises in Japan regarding: increase or reduction of rent; termination; and assignment of lease or sublease.

**Rent increase or reduction**

Under the LLBLL, if the amount of rent payable becomes inappropriate (for example, if it differs significantly from the market rent), the lessor or the lessee may request that it be increased or reduced. This applies both to land leases made for the purpose of the lessee owning a building on the land and to building leases. The parties to the lease agreement, however, can eliminate the right to request an increase in rent by agreeing not to increase the amount of rent for a certain period. The right to request a reduction cannot be eliminated from a lease that is not a fixed-term building lease.

**Termination**

Under the Civil Code, if one party breaches an agreement, the other party can terminate it; however, under the Supreme Court precedents, a lessor cannot terminate a real estate lease agreement if the lessee can establish the existence of a special circumstance where a relationship of mutual trust remains between the lessor and the lessee even after the breach. Failure to pay rent for several months would usually entitle the lessor to terminate the lease because such non-payment would usually be regarded as destroying the relationship of mutual trust.
Assignment of lease or sublease
Lease agreements usually prohibit the lessee from assigning the lease or subletting without the consent of the lessor.

VII DEVELOPMENTS IN PRACTICE

i Amendment to the Financial Instruments and Exchange Law
The definition of QII includes various types of QIIs. Financial institutions such as banks, securities companies and insurance companies are included. The definition also permits investment vehicles, such as any entity that holds ¥1 billion or more of securities and an investment business limited partnership under the Investment Business Limited Partnership Act, to become QIIs.

The recent amendment to the FIEL effective from 1 May 2011, expanded the definition of QII to include two new types. The first is a TMK, which is granted the status of QII by filing a simple QII notification after satisfying any of the following requirements:

a. it has filed an asset liquidation plan, which describes ¥1 billion or more of securities as its assets;
b. it has entered into a trust agreement regarding its assets (the assets must be limited to securities offered only to QIIs) with a trust company or other financial institution that is a QII, to delegate management and disposition of its assets, and has obtained approval from its shareholders’ meeting to file a QII notification; or
c. it has delegated management and disposition of its assets (the assets must be limited to securities offered only to QIIs) to a registered discretionary investment manager under the FIEL that sold the assets to it or that has the financial and human resources to appropriately manage and dispose of the assets, and has obtained approval from its shareholders’ meeting for its filing of a QII notification.

The second is a foreign pension fund, which is granted the status of QII by filing a simple QII notification, if it satisfies the following requirements:

a. it operates outside Japan and is primarily engaged in managing and making payments under retirement pensions, retirement allowances or other similar arrangements; and
b. it holds net assets of ¥10 billion or more as reflected in its balance sheet or another equivalent financial statement for its most recent business year.

This amendment provides more structural options for foreign investors to invest in Japanese real estate.

ii Amendment to the Asset Liquidation Law
Amid an increase in the use of the TMK structure for real estate investment, TMKs were generally considered less flexible, particularly in light of the regulations related to asset liquidation plans. As part of recent efforts by the Japanese government to make TMKs more flexible, the ALL was amended in 2011, inter alia, to relax the regulations on amending asset liquidation plans, and relax the regulations on acquiring assets.
Relaxing the regulations on amending asset liquidation plans
Before the amendment to the ALL, generally, a TMK needed to obtain the consent of all the interested parties, such as its common shareholders, preferred shareholders, lenders and bondholders, in order to amend its asset liquidation plan. A TMK was additionally required to file every amendment with the relevant government authority.

Since the amendment to the ALL, it provides for a new exception to the foregoing general rule that allows a TMK to amend certain items in its asset liquidation plan if the plan itself indicates that such items may be amended merely by decision of the TMK (i.e., its director). Additionally, after the amendment, a TMK no longer needs to file certain minor amendments to its plan with the government authority. These amendments allow more efficient administration of real estate investments using a TMK structure.

Relaxing the regulations on acquisition of assets
Acquisition of additional real estate
Before the amendment to the ALL, a TMK was generally considered prohibited from acquiring additional assets after the initial acquisition except where the additional assets were closely related to the initial assets.

The ALL now allows an asset liquidation plan to be amended in order for a TMK to acquire additional assets. However, this is generally understood to vary as outlined below:

a. If the additional assets are trust beneficial interests in real estate, a TMK is generally permitted to acquire such additional assets.

b. If the additional assets are real estate (not trust beneficial interests in real estate), a TMK may only acquire such additional assets if it has a plan to convert the real estate to trust beneficial interests in real estate before it sells it to another party. Such a plan would typically be evidenced by a description in the asset liquidation plan (i.e., a plan that the real estate will be converted to trust beneficial interests in real estate and then sold).

Irrespective of the type of additional assets, a TMK may acquire additional assets if they are closely related to the already acquired assets. This rule has been in place since before the amendment to the ALL. Factors to consider in determining whether the additional assets are closely related include the geographical proximity and function of the additional assets, and the background of the additional acquisition.

This flexibility to acquire additional assets is expected to contribute to increased use of the TMK structure for investment into Japanese real estate.

Reinvestment of sales proceeds into real estate
Before the amendment to the ALL, a TMK was generally considered prohibited from acquiring additional assets using proceeds from sales of its assets (i.e., reinvestment was generally prohibited). Sales proceeds generally had to be distributed to the shareholders of the TMK after creditors were repaid. The shareholders could then invest the proceeds into a new TMK to acquire new assets.

The Financial Services Agency has indicated in its comments during the legislative process that, following the amendment, TMKs are no longer prohibited from acquiring
additional real estate assets using sales proceeds. This too is expected to contribute to increased use of the TMK structure.

Acquisition of TK interests
Previously the ALL generally prohibited a TMK from acquiring an interest in a TK, except where the TMK did not become a TK operator; the business conducted by the TK operator was limited to certain licensed real estate transactions under the REJEA; and the TK operator had no plan to acquire additional real estate.

A TMK may now acquire an interest in a TK, if the TMK does not become a TK operator; the TK operator conducts its business by acquiring, managing and disposing of real estate, trust beneficial interests in real estate or certain other real estate related assets; and the TK operator has no plan to acquire additional real estate assets. Under this new rule, a TMK can be used as a holding vehicle for GK-TK structures investing in real estate assets. This is expected to provide more structural options for investors in Japanese real estate.

iii Redevelopment projects using TMK structures
The number of redevelopment projects in large cities in Japan has recently increased. In such redevelopment projects, GK-TK structures and TMK structures have frequently been used.

Given the flexibility now provided to the TMK structure by the recent amendment to the ALL, TMKs are expected to be used more frequently for redevelopment projects. If a TMK structure is used and third-party debt financing is obtained from the commencement of the project, there are multiple major phases, as outlined below, up to the completion of the project.

Phase 1 – acquisition of land
A TMK acquires the project land. The acquisition is funded by third-party debt financing such as an issuance of TMK bonds (see Section IV.ii, supra) or a combination of TMK bonds and a loan, and by equity funding such as issuance of preferred shares. The financing agreement between the TMK and the lender typically provides for multiple draw-downs of debt financing for this phase and the subsequent phases to be made upon satisfaction of certain conditions precedent.

TMK bondholders are granted security interest by operation of law, which is a statutory general security interest on all the current and future assets of the TMK granted in their favour under the ALL. The statutory general security interest will also secure (by operation of law under the ALL) all the TMK bonds subsequently issued. In many cases, therefore, holders of TMK bonds do not create a mortgage or pledge on the real estate or trust beneficial interest in real estate held by the TMK. This is mainly because the mortgage and pledge securing the bonds need to be held by a trustee in accordance with the Secured Bond Trust Law, and additional costs to establish such a trust arrangement are not considered economically justified in many cases.

Lenders typically require the TMK to create a first priority revolving mortgage on the land to secure the loans made in this phase and the subsequent phases. If the land is acquired in the form of a trust beneficial interest in the land, lenders typically require the
TMK to create a first priority revolving pledge on the trust beneficial interest instead of a revolving mortgage on the land.

**Phase 2 – commencement of construction**
The TMK obtains approval from the relevant government authority for construction of a new building on the project land. The TMK also enters into a construction contract with a construction company in connection with the new building in a form satisfactory to the TMK bondholder or lender. In accordance with the contract, the construction company commences construction of the new building upon its receipt of the first instalment payment from the TMK. This first instalment is funded by debt financing, and by equity funding, in accordance with the financing agreement between the TMK and the TMK bondholder or lender.

In this phase, TMK bondholders or lenders frequently require the TMK to provide additional security to ensure completion of the construction, such as the sponsor’s indemnity, the shareholders’ commitment to purchase preferred shares in the TMK, or the construction company’s guaranty for completion of construction.

**Phase 3 – subsequent instalment payments to the constructor**
The TMK must pay subsequent instalments to the construction company in accordance with the construction contract. These instalment payments are funded by debt financing and by equity funding, in accordance with the financing agreement between the TMK and the TMK bondholder or lender.

**Phase 4 – completion of construction of the new building**
Construction of the new building is completed. The TMK makes its final instalment payment to the construction company when the newly constructed building is delivered. The instalment payment is funded by debt financing and by equity funding, in accordance with the financing agreement between the TMK and the TMK bondholder or lender.

TMK bondholders are granted by operation of law under the ALL a statutory general security interest on all the assets of the TMK including the new building, and the statutory general security interest also secures all the TMK bonds issued in this phase and the preceding phases.

Lenders typically require the TMK to create a first priority mortgage on the new building to secure the loans made in this phase and the preceding phases. If the TMK owns a trust beneficial interest in the land, lenders also typically require the TMK to entrust the building to the same trust to extend the coverage of the first priority revolving pledge already created on the trust beneficial interest.

**VIII OUTLOOK AND CONCLUSIONS**
In 2012, J-REITs were relatively active in acquiring and disposing of real estate assets. The Bank of Japan decided to purchase J-REIT investment units in late 2010, and started the purchases in December 2010.

In addition, the Financial Services Agency is working to improve the legal framework for J-REITs by trying to amend the relevant laws and regulations within the
next few years. The goals of the amendments include achieving greater financial stability for J-REITs, such as diversifying methods for financing and methods for capitalisation available to J-REITs (e.g., through the introduction of rights offering, capital reduction without compensation and purchase of their own investment units).

It is hoped that enhancement of J-REIT activity by means of these financial policy and legislative measures, together with the recent amendments to the FIEL and ALL (see Section VII, supra), will further stimulate the entire Japanese real estate market.
Appendix 1

ABOUT THE AUTHORS

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Norio Maeda is a partner with expertise in transactions involving the acquisition of, investment into, and financing of, Japanese real estate assets. He has represented domestic and foreign investors, including investment funds, financial institutions, investment managers and developers from the United States, Europe and Asia, in numerous investment and development projects involving sophisticated structures. He has also represented lenders in numerous structured finance transactions involving real estate assets. His expertise extends to the restructuring of distressed real estate asset investments. He is admitted to the Bars of Japan and New York.

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Tomohiro Kandori is an associate whose practice focuses mainly on real estate finance and ship finance. He has advised on numerous transactions as counsel for lenders, arrangers, trustees, general contractors, real estate developers, equity investors and sponsors. He has also worked as an in-house counsel at a Japanese bank in London. He was admitted to practise in Japan in 2002.

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