A specified purpose company (tokutei mokuteki kaisha - TMK) is an investment vehicle incorporated under the Asset Liquidation Law (shisan no ryudouka ni kansuru kōritsu) of Japan. Such vehicles, TMKs, have frequently been used as investment vehicles to acquire real estate and obtain debt financing in real estate finance transactions in Japan. In this article, we would like to provide an introductory outline of selected issues with respect to the general security interest (ippan tanpo) created on all the assets of a TMK by operation of law under the Asset Liquidation Law. Such statutory general security interest is created to secure the specified bonds of the TMK. Specified bonds have been the typical way of financing TMKs in real estate financing transactions. Due to the growing number of defaults in real estate financing transactions, there are a growing number of cases where statutory general security interest is a subject of discussion in connection with defaulting TMKs.

The statutory general security interest will be created by operation of law under the Asset Liquidation Law whenever a TMK issues the specified bonds, unless the asset liquidation plan of the TMK provides that there will not be any such statutory general security interest created.

To better understand the unique bond structure mentioned above, the following two factors should be noted:

First, a TMK can deduct its payment of dividends on its preferred shares from the profits earned from its investment into real estate - a pay-through tax treatment. To achieve such beneficial tax treatment, a TMK must satisfy certain requirements provided in the Act on Special Measures Concerning Taxation (sozei tokubetsu sochi hō). Although there are ways to satisfy such requirements, the most popular way is for a TMK to issue specified bonds to an institutional investor as defined in the Act (such as a licensed Japanese bank), and to satisfy certain other requirements.

Second, when a TMK issues specified bonds to a third party financier, the way of creating a security interest to secure the specified bonds is restricted due to a statute called the Secured Bond Trust Law (tanpo tsuki shasai shintaku hō) of Japan. The Law requires that a trustee hold security interests for the benefit of the bondholders, when bonds are to be secured by a mortgage, a pledge and other security interests, but not including the statutory general security interest. This means that creating a security interest other than the statutory general security interest to secure the specified bonds will involve a trust arrangement to hold the security interest.
Because such trust arrangement is not yet popular in Japan, creating such an arrangement may lead to an unjustifiable level of cost. On the other hand, the statutory general security interest created by operation of law under the Asset Liquidation Law is not subject to the restriction, and does not pose a similar concern in terms of cost.

Growing number of defaults in TMK financing
According to the Financial Services Agency of Japan, the number of TMKs having filed their business commencement notices has been increasing (during the fiscal year ending on March 31, 2007, 799 TMKs; during the fiscal year ending on March 31, 2008, 1,057 TMKs; and during the fiscal year ending on March 31, 2009, 1,061 TMKs). Transparency in the tax treatment with respect to a TMK as mentioned above may have contributed to such increasing number.

On the other hand, according to Moody’s, the number of defaulted loans (including specified bonds issued by TMKs) underlying the commercial mortgage backed securities has increased significantly (as of May 2009, 3.2% of the entire amount of the underlying loans; and as of May 2010, 9.4% of the entire amount of the underlying loans).

From the data described above, it is inferred that there are an increasing number of defaulting specified bonds issued by TMKs. Our introductory outline of selected issues with respect to the statutory general security interest is provided in the context of such increasing number of defaults and the resulting necessity of the specified bondholder to firmly secure its position as a secured creditor and to actually exercise its statutory general security interest on the assets of a TMK.

Effect of statutory general security interest on real estate sold to third party
In the case where real estate is held by TMK
It is an issue whether the statutory general security interest can be enforced against the real estate, even after the real estate is sold by a TMK to a third party in breach of a covenant of the TMK not to dispose of the real estate without the consent of the specified bondholder.

If the statutory general security interest is registered in the real estate registry, the statutory general security interest could be enforced against the real estate held by the purchaser from the TMK. Although this issue has not yet been tested by a Japanese court, and is still open to future discussion, the foregoing interpretation would prevail for the following reason. The Civil Code (minpou) of Japan provides a statutory general lien ippan sakidori tokken, and such statutory general lien can be enforced against the real estate even after the sale, as long as the statutory general lien is registered on the real estate in the real estate registry. Because the Asset Liquidation Law defines the statutory general security interest as a statutory lien sakidori tokken, and such lien is effective on all the assets of a TMK having the substance of a statutory general lien, both the statutory general lien and the statutory general security interest, when registered, would have a similar effect on the real estate sold to a third party.

On the other hand, if the statutory general security interest is not registered in the real estate registry, the statutory general security interest cannot be enforced against the real estate registered under the name of the purchaser from the TMK. Even in such case, the statutory general security interest can be enforced against the claim of the TMK for payment of the purchase price against the purchaser. As long as the money paid as such purchase price remains with the TMK, such money is also subject to the statutory general security interest, because such security interest is effective on all the assets of the TMK.

In the case where trust beneficiary interest is held by TMK
In real estate finance transactions, it is frequently the case that a TMK holds real estate in the form of a trust beneficiary interest in real estate. The issue is whether the statutory general security interest can be registered on the trust beneficiary interest, and such registration can protect the interest of the specified bondholder as mentioned above, if the trust beneficiary interest held by a TMK is sold to a third party in breach of a covenant of the TMK not to dispose of the trust beneficiary interest without the consent of the specified bondholder.

Because the statutory general security interest cannot be registered on the trust beneficiary interest in the real estate registry, the statutory general security interest on the trust beneficiary interest cannot be protected by way of registration.

Even with the risk resulting from such lack of means to register the statutory general security interest on the trust beneficiary interest, the specified bondholder can enter into an agreement with the trustee holding the real estate with respect to the trust beneficiary interest, and can impose on the trustee an obligation not to consent to the transfer of the trust beneficiary interest unless the specified bondholder consents. A transfer of a trust beneficiary interest in real estate without the consent of the trustee is void ab initio under the usual trust agreement containing an anti-assignment clause where the trustee’s consent is required to transfer the trust beneficiary interest.
Priority of statutory general security interest

In the case where real estate is held by TMK

It is also an issue whether the statutory general security interest can be enforced as having priority over a subsequently registered mortgage, if a mortgage is created on the real estate held by a TMK in breach of the covenant of the TMK not to dispose of the real estate without the consent of the specified bondholder.

If the statutory general security interest is registered in the real estate registry, the statutory general security interest could be enforced as having priority over the subsequently registered mortgage. Although this issue has not yet been tested by a Japanese court and is still open to future discussion, the foregoing interpretation would prevail for the following reason. The Civil Code provides a statutory general lien under the Code, the statutory general security interest under the Civil Code, the statutory general security interest could still be categorised as a statutory general lien under a statute other than the Civil Code. If categorised as such, the priority between the statutory general security interest and the registered mortgage would be the same as that between the statutory general lien under the Civil Code and the registered mortgage. As a result, the registered statutory general security interest could be enforced as having priority over the subsequently registered mortgage.

In the case where trust beneficiary interest is held by TMK

If a TMK holds a trust beneficiary interest in real estate, the form of the security interest which may be subsequently created on the trust beneficiary interest will be a pledge. If a pledge is subsequently created on the trust beneficiary interest in breach of a covenant of the TMK not to dispose of the trust beneficiary interest without the consent of the specified bondholder, because the statutory general security interest cannot be registered on the trust beneficiary interest, the statutory general security interest cannot be protected by way of registration.

Even with the risk resulting from such lack of means to register the statutory general security interest on the trust beneficiary interest, the specified bondholder can enter into an agreement with the trustee holding the real estate with respect to the trust beneficiary interest, and can impose on the trustee an obligation not to consent to the creation of pledge unless the specified bondholder consents. Creation of a pledge on a trust beneficiary interest could neither be effective nor perfected without the consent of the trustee under the usual trust agreement containing an anti-assignment clause where the trustee’s consent is required to create a pledge on the trust beneficiary interest. As a result, imposing the foregoing obligation on the trustee will help protect the interest of the specified bondholder.

Structural consideration

Although the interpretations described above would effectively protect the statutory general security interest, a statutory general security interest still has some uncertainty considering that the issues described above have not yet been tested by a Japanese court and are still open to future discussion. As a result, the financiers to TMKs sometimes try to overcome such uncertainty by selecting a debt financing package comprised of both the specified bonds and the loan. The loan can be secured by a mortgage and a pledge without being restricted by the Secured Bond Trust Law. Such mortgage or pledge on the real estate or trust beneficiary interest held by a TMK is generally speaking, well established, with much less uncertainty than the statutory general security interest.

Exercise of statutory general security interest

General

If a TMK defaults on its payment on the specified bonds, the specified bondholder will have to consider collecting from the assets of the TMK. The specified bondholder’s preference would usually be for disposition of the real estate or trust beneficiary interest through a private/voluntary sale. A private/voluntary sale would usually result in a higher sale price than in a court held auction sale. The time necessary for the private/voluntary sale would be shorter than that of the court held auction sale.

However, if the director or the asset manager of a TMK refuses to cooperate, or if there is any other reason why the specified bondholder no longer pursues disposition through a private/voluntary sale, the statutory general security interest would have to be exercised through a court held auction sale or other court processes applied for by the specified bondholder as the holder of the statutory general security interest.

There may also be the case where the specified bondholder would like to collect from the cash remaining in the bank account of the defaulting TMK which is the subject of the statutory general security interest. Such collection can also be made through a court process applied for by the specified bondholder.
Although various issues with respect to the statutory general security interest, including those discussed above, have yet to be resolved, the statutory general security interest can be an effective security for the financier to a TMK as discussed above. Cumulative court cases and arguments in the industry will resolve the issues and will lead to more reliance on the TMK financing structure. We hope that this article helps enhance arguments on various issues with respect to the statutory general security interest under the Asset Liquidation Law.

Notes:
1 Toshihiko Tsuchiya, Legal Practice of TMK (TMK no houritsu jitsumu) Chuo-Keizaisha, Inc., page 225 (2009)
2 Hiroo Atsumi,Toyoki Emoto and Hidefumi Takagi, Theory and Practice of TMK (TMK no riron to jitsumu) Kinzai Institute For Financial Affairs, INC., page 384 (2009) and Toshihiko Tsuchiya, Legal Practice of TMK (TMK no houritsu jitsumu) page 227 (2009)

Exercise of statutory general security interest on real estate
If the specified bondholder is to exercise its statutory general security interest on real estate held by a TMK through a court process, the bondholder’s main scenario would usually be to make an application for a court held auction sale of the real estate.

When such application is made, the specified bondholder needs to submit either of the following to prove its statutory general security interest. The recent accumulation of actual court cases has enabled us to provide rather detailed examples of the documents in the following items.

Documents to be submitted:
(i) if the statutory general security interest is registered, a copy of the real estate registry; or
(ii) if the statutory general security interest is not registered or registered provisionally, other documents which prove the existence of the statutory general security interest (such as the asset liquidation plan of the TMK, a subscription agreement regarding the specified bonds, and a certification by the relevant participating institution of a book entry transfer system certifying that the specified bonds are entered into the system).

Trust beneficiary interest deposit
A trust beneficiary interest is categorised as “Any Other Property Right” provided in the Civil Execution Law (minji shikkou hou) of Japan, and the deposit being a monetary claim is categorised as “Claim” provided in the Law. The statutory general security interest on those assets can be exercised by first making an application for a seizure.

When such application is made, the specified bondholder needs to submit certain documents described above. The recent accumulation of actual court cases is contributing to more clarity in the court process with respect to the exercise of the statutory general security interest on the trust beneficiary interest and the deposit of the TMK.

Conclusion
We have provided above an introductory outline of the selected issues with respect to the statutory general security interest under the Asset Liquidation Law.