Enforcement of Security Interests in Real Estate Finance Transactions in Japan

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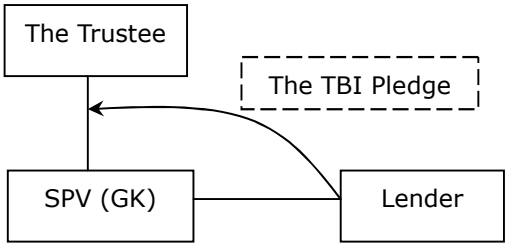
For market participants struggling with liquidity shortfalls and a sluggish real estate market, it is not uncommon for events of default to occur in Japanese real estate finance transactions where the finance is provided typically in the form of non-recourse loans (the "**NRL**") or specified bonds (the "**Specified Bond**") issued pursuant to the Law Concerning Asset Liquidation (Law No. 105 of 1998 as amended from time to time) (the "**Asset Securitisation Law**"). The primary remedies of the finance providers such as lenders of an NRL (the "**Lenders**") and specified bondholders of a Specified Bond (the "**Bondholders**") are certain rights granted under the relevant finance documents. However, the Lenders or the Bondholders ultimately contemplate the enforcement of their security interests.
In this bulletin we consider major legal issues with respect to:

I. the remedies of the Lenders in the case of a pledge (the "**TBI Pledge**") over trust beneficial interests (the "**TBI**") in a trust owning real estate; and

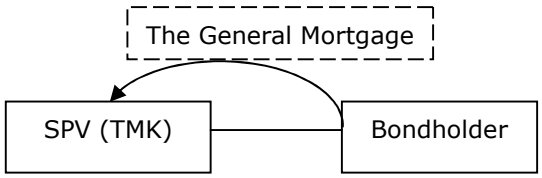
II. the remedies of the Bondholders in the case of a general mortgage (*ippan-tanpo*) (the "**General Mortgage**") that is granted over all of the assets of a specified purpose company (*Tokutei Mokuteki Kaisha*) (the "**TMK**") incorporated under the Asset Securitisation Law in favour of the Bondholders by virtue of Article 128 of the Asset Securitisation Law.

For the purposes of our discussion of these issues, we assume that (a) in the case of an NRL, a limited liability company (*Godo Kaisha*) (the "**GK**"), established under the Companies Act (Law No. 86 of 2005 as amended from time to time), holds the TBI and has created a TBI Pledge in favour of the Lenders as security for the debt under the NRL (the "**NRL Debt**") (refer to Scheme Figure I below) and (b) in the case of a Specified Bond, the TMK has issued the Specified Bond secured only by the General Mortgage (refer to Scheme Figure II below).

Scheme Figure I



Scheme Figure II



I. Enforcement of the TBI Pledge

The Lender may enforce the TBI Pledge by invoking a statutory procedure under the **Civil Execution Act** (Law No. 4 of 1979 as amended from time to time). However, there are concerns that the statutory procedure takes considerable time and cost and produces sales prices that tend

to be low. Therefore, from a practical perspective, the Lender would typically consider taking the non-statutory procedure, that is, a private procedure carried out without need of a court procedure (the "**Non-Statutory Procedure**").
In addition, the Lender, as the pledgee of the TBI Pledge, may directly receive trust dividends from the trustee and apply them towards the satisfaction of the NRL Debt as we will discuss in detail in section 3 below.

1. Remedies under the Non-Statutory Procedure

A Japanese TBI pledge agreement usually sets out the following four elements in relation to a Lender's remedies under the Non-Statutory Procedure:

(i) the Lender is empowered to dispose of (or gain title of) the TBI in such a manner and at such time and price generally considered to be fair and proper;

(ii) the Lender is further empowered to apply the sales price (or, in the case where the Lender gains the title of the TBI, the assessed value of the TBI determined by the Lender) first to related expenses and then towards the satisfaction of the NRL Debt in a manner which the Lender regards as reasonable, regardless of the statutory priority order of the appropriation;

(iii) the Lender is accountable to deliver to the debtor (i.e., GK) any excess of the sales price or assessed value over the NRL Debt; and

(iii) the Lender is entitled to recover any deficiency pertaining to the NRL Debt after the appropriation described in sub-paragraph (ii) above from the debtor.

The term Non-Statutory Procedure used in this bulletin includes the appropriation of the TBI by the Lender at a price evaluated by the Lender itself,[1] as well as the sale of the TBI to a third party under the initiative of the Lender.

In the absence of any express provision that the disposition (or appropriation) of the TBI should take place "in a manner and at such time and price generally considered to be fair and proper" as described in sub-paragraph (i) above, one might query the permissibility of the Lender's disposition (or appropriation) in the manner and at the price that the Lender arbitrarily determines. However, the relevant terms of the TBI pledge agreement should be interpreted to the effect that the disposition (or appropriation) of the TBI must be done in such a manner and at such a price that are fair and proper in light of the prevailing transaction practice despite the absence of provisions described in sub-paragraph (i) above. Please note that the law and judicial precedents do not provide specific criteria to determine what price would be accepted as a fair value disposition. In practice, Lenders make the effort to ensure the fairness of a disposition of a TBI, for example, by determining the sales price using the best price by tender or on the basis of the appraised value offered by real estate appraisers.[2] It is important to sell (or gain title) at a price that can be reasonably shown as equivalent or close to the market value taking into account specific circumstances in individual cases. The above mentioned examples would help account for the fairness of a disposition.

From the viewpoint of the Financial Instruments and Exchange Law (Law No. 25 of 1948 as amended from time to time) (the "**FIEL**"), it would not be too bold to say that a Lender's disposition of the TBI under the Non-Statutory Procedure (or the instructions provided by the Lender regarding disposition of the TBI in the course of the Arbitrary Disposition (as discussed below)) would not, in principle, constitute an Investment Management Business (*toushi unyou*

[1] Article 515 of the Commercial Code (Law No. 48 of 1899 as amended from time to time) allows the Lender to realise the TBI Pledge in the manner described in this paragraph as an exception to the general prohibition under Article 349 of the Civil Code.

[2] As a matter of course, a value that is less than the appraised value would not always be regarded as an unfair value.

gyo),[3] because that kind of a disposition is merely an enforcement of the TBI Pledge by the Lender or an action by the Lender to protect its claim under NRL. In this regard, the Financial Services Agency (the "**FSA**") stated, in a response to public comments, that "it is thought highly likely that the lender's instruction to an SPC to dispose of Securities[4] over which certain security interests had been created in favour of the lender to secure the lender's claim would not constitute a business concerning the Discretionary Investment Contract (*toushi ich-nin keiyaku*)[5] subject to substantial determination in each individual case to the extent the application of the FIEL is concerned."[6]

As discussed above, the TBI pledge agreement usually provides that the Lender may dispose of the TBI in accordance with its provisions. In practice, however, a disposition under the Non-Statutory Procedure is likely to be difficult to implement as it is made without the cooperation of the debtor. For example, (i) if the potential buyers are not familiar with sales under the Non-Statutory Procedure, the transaction may not progress smoothly, and (ii) it is not entirely clear how the Legal Affairs Bureau will deal with the application for real estate registration to reflect the change of TBI beneficiary if the TBI sales agreement is made by the Lender (as pledgee) and not by the borrower as the holder of the TBI. Hence, one can conclude that there are many cases where the Lender has no choice but to dispose of the TBI through what is referred to as Arbitrary Disposition done in cooperation with the debtor.

For the purposes of this bulletin, "**Arbitrary Disposition**" means the disposition of the collateral with the cooperation of the debtor, which is distinct from the enforcement of the security interest under the Non-Statutory Procedure. In practice, the term "**Arbitrary Disposition**" often refers to cases where the debtor/pledgor will dispose of the collateral in accordance with the conditions permitted by the Lender/pledgee followed by a payment on the secured claim from the disposition proceeds of the collateral. It may seem that an Arbitrary Disposition resembles enforcement under the Non-Statutory Procedure in that the Arbitrary Disposition effectively compels the debtor/pledgor to dispose of the collateral subject to a security interest. However, in the strict or legal sense, an Arbitrary Disposition differs from the enforcement of a security interest because in an Arbitrary Disposition the disposition of the collateral is carried out as a voluntary act of the debtor/pledgor and the collateral is not disposed of by the Lender mandatorily regardless of the intention of the debtor/pledgor.

2. Remedies under the Civil Execution Act

The enforcement procedure of a claim under the Civil Execution Act, as it is reasonably construed, would be applicable *mutatis mutandis* to the enforcement of the TBI Pledge under the Civil Execution Act given that the TBI would fall within the ambit of "any other property right (*sonota no zaisan ken*) " as set out in Paragraph 1 of Article 193 of the Civil Execution Act.

Based on the above premise, a petition for a seizure order (*sashiosae meirei*) (the "**Seizure Order Petition**") must be filed in court to commence the enforcement procedure of the TBI Pledge. The filing of the Seizure Order Petition should be supported by a document evidencing the existence of the TBI Pledge pursuant to Paragraph 1 of Article 193 of the Civil Execution Act. This supporting document does not require any formality, and a private

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[3] Sub-paragraph 1, Paragraph 4 of Article 28 of the FIEL and Item "*ro*" of Sub-paragraph 12, Paragraph 8 of Article 2 of the FIEL.

[4] As defined in Paragraph 1 of Article 2 of the FIEL.

[5] As defined in Item "*ro*" of Sub-paragraph 12, Paragraph 8 of Article 2 of the FIEL.

[6] Please see FSA, "Regarding the outcome etc. of public comments on draft Cabinet Order and Cabinet Office Ordinance regarding the system of financial instruments and exchange law" dated 31 July 2007, No. 200 on page 82. It is also noteworthy that in the past no concerns were raised as to whether the Lender's disposition of securities through the Non-Statutory Procedure allowed under a security agreement (or its right to instruct the borrower to dispose of the securities under an Arbitrary Disposition) constituted Investment Advisory Business under the Law Concerning the Regulation, etc. of an Investment Advisory Business Relating to Securities (Law No. 74 of 1986), one of the predecessors of the FIEL.

document (i.e., a document produced by a private person) is eligible to the extent that it is made by, or with the involvement of, the debtor such as a written contract.[7] The supporting documents would principally consist of the TBI Pledge Agreement and/or the trustee's written consent to the creation of the TBI Pledge coupled with the debtor's written request for such consent.

A Lender who has seized the TBI (the "**Seizure Lender**") may directly collect a monetary claim under the TBI, such as a trust dividend, and apply it towards the satisfaction of the NRL Debt in accordance with Article 155 of the Civil Execution Act, although the Lender may do the same without having to invoke the Civil Execution Act as we will discuss in section 3 below. In practice, however, the Lenders are unlikely to obtain full satisfaction of the outstanding NRL Debt immediately through the enforcement of the Direct Collection Right (as defined in section 3 below). The Seizure Lender would therefore contemplate the filing of a further petition for either mandatory appropriation or sales by way of (i) an order to transfer the TBI to the Seizure Lender at the price determined by the court in lieu of payment (the "**Transfer Order**"); (ii) an order to sell the TBI in the manner determined by the court (the "**Sale Order**"); or (iii) an order to realise the value of the TBI in a manner determined by the court to be suitable under Paragraph 1 of Article 161 of the Civil Execution Act. However, we have a paucity of precedents to examine this issue further and it would be prudent to wait for more precedents before proceeding with any further discussion regarding these procedures in detail. For example, it is not certain how a provision that requires the consent of the trustee for the assignment of the TBI under the trust agreement (the "**Non-assignment Clause**"), which is prevalent in practice, will be treated in the enforcement procedures under the Civil Execution Act. One debatable issue is whether the above mentioned remedies in the case of a TBI Pledge will prevail against the Non-assignment Clause in view of the judgement dated 10 April 1970 ruled by the Supreme Court of Japan, in which it was held that a monetary claim, the transfer of which required the debtor's consent, was transferrable in accordance with a court order (*tenpu meirei*) without the debtor's consent and regardless of the transferee's knowledge of such transfer restriction. It is not certain whether the nature of the TBI as opposed to a pure monetary claim is a factor in settling this issue.

3. Exercising the Direct Collection Right

The pledgee may directly collect the pledged claim pursuant to Paragraph 1 of Article 366 of the Civil Code (Law No. 89 of 1896 as amended from time to time) (the "**Civil Code**").[8] Therefore, the Lender may directly receive the money distributed by the trustee as a trust dividend and apply it towards payment of the pledged claim that has become due. This right (the "**Direct Collection Right**") offers the Lender a convenient means for debt collection since it is exercised simply by providing a notice to the trustee of the change of the account into which the trustee shall pay the trust dividend (the "**Receiving Account**"). However, it is prevalent in Japanese real estate finance transactions that the Receiving Account is opened at the Lender, if the Lender is a bank (and therefore, the Lender may set off the sum liable under the deposit against the NRL Debt), or in the name of a Lender, if the Lender is not a bank (in other words, the Lender is able to directly collect the claim from the outset without having to depend on the Direct Collection Right). It is, therefore, less likely that the occurrence of an event of default necessitates the exercise of the Direct Collection Right.

II. Exercise of the General Mortgage

When using the TMK as a vehicle for holding assets in real estate finance transactions, it is often the

[7] In the case of security interest over properties the transfer of which requires registration other than general lien (*ippan no sakidoritokken*), only prescribed public documents qualify as supporting documents for the Seizure Order Petition (Paragraph 1 of Article 193 of the Civil Execution Act). However, the TBI Pledge does not fall under such security interest.

[8] In the case of the TBI of a trust established under new Trust Act (Law No. 108 of 2006 as amended from time to time), Paragraph 1 of Article 98 of the Trust Act applies to the effect that the pledgee has a right to receive trust dividends and appropriate them towards its claim.

case that the Bondholders do not have any security interest over a specific asset such as the TBI, but instead, have a General Mortgage. The legal nature of the General Mortgage is a general lien (*ippan no sakidoritokken*) provided for in the Asset Securitisation Act. As such, the Bondholders (i) may enforce the General Mortgage under the Civil Execution Act without a title of obligation (*saimu meigi*) and (ii) rank prior to the unsecured creditors without having to register the General Mortgage. In the following sections, this bulletin will briefly discuss (i) the documentary requirement for the commencement of the enforcement procedure of the General Mortgage and (ii) the ranking of the Bondholder against tax authority as a preferential creditor.

1. The Document Evidencing the Existence of the General Mortgage

In order to commence the enforcement procedure of the General Mortgage under the Civil Execution Act, a document evidencing the existence of the General Mortgage must be submitted to support the filing of the required petition under the Civil Execution Act[9] as is the case with the enforcement of the TBI Pledge.

The certificate of the Specified Bond coupled with the purchase agreement including the terms and conditions of the Specified Bond would typically comprise the supporting documents. However, under the current market practice in Japan, the Specified Bond is usually issued in the form of a book-entry specified bond (*furikae tokutei shasai*) (the "**Book-Entry Specified Bond** ") and therefore a certificate is not issued pursuant to Act on Transfer of Bonds, Shares, etc. (Law No. 75 of 2001 as amended from time to time) (the "**Transfer Act**").[10] If the Specified Bond is in dematerialised form, an alternative document to evidence the existence of the General Mortgage is necessary. In this regard, the Transfer Act[11] provides that the Bondholder of the Book-Entry Specified Bond may request its immediate intermediary, with whom the Bondholder has its own account, to deliver a document certifying the prescribed particulars recorded in the account (the "**Account Certificate**"). In the case of the Book-Entry Specified Bond, therefore, the Account Certificate together with the purchase agreement of the Specified Bond including its terms and conditions may be submitted as the requisite supporting documents.

2. The ranking of the Bondholder against tax authority

Creditors with a General Mortgage, as is the case with a general lien, rank prior to the unsecured creditors as an essential effect of the security interest. Therefore, the Bondholder who is granted the General Mortgage is entitled to receive the distribution of the sales proceeds in the enforcement procedure under the Civil Execution Act.[12]

The ranking amongst the preferential creditors is determined by comprehensively considering both the Civil Code in relation to other security interests, and tax legislation (i.e., National Tax Collection Act (Law No. 147 of 1959 as amended from time to time) and Local Tax Act (Law No. 226 of 1950 as amended from time to time)) in relation to tax authority. By way of an example where the underlying asset of the General Mortgage is a real estate, the statutory ranking of the General Mortgage against tax authority and a mortgage (*teitoken*) (the "**Mortgage**") is in the following order:

(i) the Mortgage and the General Mortgage registered before the statutory due date of tax payment (the rank between the Mortgage and the General Mortgage is determined by

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[9] Paragraph 1 of Article 193, in the case where the underlying asset of the General Security is the TBI, and Sub-paragraph 4 of Paragraph 1 of Article 181, in the case where the underlying asset of the General Security is real estate.

[10] Paragraph 1 of Article 67.

[11] Article 118 and Paragraph 3 of Article 86.

[12] Sub-paragraph 1 Paragraph 1 of Article 87 in the case where the Bondholder commences the enforcement procedure, or Sub-paragraph 2 Paragraph 1 of the same Article in the case where the Bondholder files a demand for the distribution (*haito yokyu*) in the enforcement procedure commenced by the other creditor.

the order of the registration);

(ii) tax payment;

(iii) the Mortgage and the General Mortgage registered after the statutory due date of tax payment has lapsed; and

(iv) the Mortgage and the General Mortgage which has not been registered.

As a consequence of the above order of priority, in the case where the General Mortgage includes real estate and therefore is registrable, it is possible for the Bondholder to obtain priority over a tax authority if it completes the registration of the General Mortgage before the statutory date of the tax payments. In practice, however, the finance documents typically permit tax payments to be made prior to the payment of the NRL Debt or the debt under the Specified Bond. Therefore, to the extent that the finance parties accept the same priority with respect to the distribution under the statutory procedure, the Bondholder does not have to bother registering the General Mortgage in the real estate registration. On the other hand, in the case where the only asset is a TBI, it is not necessarily certain whether and how the General Mortgage can achieve the same priority as the Mortgage that is registered before the statutory due date of tax payment because of the lack of registration system for the TBI as a means of perfection for its transfer.

III. Conclusion

This bulletin has considered major legal issues with respect to the remedies available for the Lenders and the Bondholders in real estate finance transactions. Due to the paucity of precedents, however, there are some issues that cannot be fully addressed now but will evolve with the future development of practice. In any case, when the financiers seek to exercise their rights under the finance documents upon the occurrence of an event of default, an accurate understanding of the above issues would help guide them to achieve a better enforcement plan.

News

Office Relocation

Mori Hamada & Matsumoto relocated its Tokyo office to:
Marunouchi Park Building
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Telephone and fax numbers remain the same.

New Special Counsel

Hiroshi Takahashi, a former Executive Vice President and a Professor Emeritus of the University of Tokyo, joined Mori Hamada & Matsumoto as a special counsel.

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