

# Loans & Secured Financing

## 2022

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**Michael Chernick**

Shearman & Sterling LLP

Lexology Getting The Deal Through is delighted to publish the seventh edition of *Loans & Secured Financing*, which is available in print and online at [www.lexology.com/gtdt](http://www.lexology.com/gtdt).

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on United States, Mexico, Bahamas and Cyprus.

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Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Michael Chernick of Shearman & Sterling LLP, for his assistance with this volume.

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# Japan

Hiroki Aoyama and Yuki Matsuda

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## GENERAL FRAMEWORK

### Jurisdictional pros and cons

- 1 | What are the primary advantages and disadvantages in your jurisdiction of incurring indebtedness in the form of bank loans versus debt securities?

Japanese financial legislation is premised on the basic assumption that bonds and other debt securities are typically held by a large number of ordinary or sophisticated investors, while licensed banks provide bank loans on a bilateral basis. This leads to the following distinctions from a legal perspective.

- Debt securities are treated as financial instruments subject to regulations under the Financial Instruments and Exchange Act, while bank loans are not in most cases.
- Secured bonds can be issued only pursuant to the restrictions under the Secured Bond Trust Act to ensure orderly collective enforcement of the securities interests. Bank loans are not subject to such regulation.
- To make material amendments to the terms and conditions of bonds, it may be necessary to hold a bondholders' meeting to approve the amendments, which is costly and time-consuming. Bank loans do not require such proceedings.

A banking licence under the Banking Act or a moneylender's licence under the Money Lending Business Act is required to conduct a money-lending business in Japan, subject to certain exemptions. Generally, purchasing bonds does not require such a licence.

### Forms

- 2 | What are the most common forms of bank loan facilities? Discuss any other types of facilities commonly made available to the debtor in addition to, or as part of, the bank loan facilities.

The most common forms of facilities in Japan are revolving credit facilities (commitment lines) and term loan facilities. While commitment lines are suitable to meet variable funding needs (eg, working capital), term loan facilities are good for funding fixed amounts of money. If phased payments are needed, such as in a construction project, committed term loan facilities are relatively common. Letters of credit are sometimes provided in international transactions.

### Investors

- 3 | Describe the types of investors that participate in bank loan financings and the overlap with the investors that participate in debt securities financings.

Banks play a central role in the Japanese loan market. The most sizable among them are three mega banks (Mizuho, MUFG and Sumitomo

Mitsui Banking Corporation), which, together with Resona and Resona Saitama, accounted for 39.7 per cent of the outstanding loan balance as of the end of 2020. Other players include non-bank moneylenders, private investment funds and government-related financial institutions.

Pension funds are not frequently seen in the loan market, although they often become holders of corporate bonds and other debt securities.

- 4 | How are the terms of a bank loan facility affected by the type of investors participating in such facility?

Some types of investors have a tendency towards certain conditions. For example, some insurance companies tend to prefer a fixed interest rate to a floating interest rate. However, since most of the lenders in the bank loan market are traditional banks, the terms of bank loan facilities overall are not so influenced by the type of investors.

### Bridge facilities

- 5 | Are bank loan facilities used as 'bridges' to permanent debt security financings? How do the structure and terms of bridge facilities deviate from those of a typical bank loan facility?

Yes. Sometimes, bank loan facilities are used for bridge financing, some of which are intended to be converted into permanent debt securities. Generally, the term of the loan is shorter and the interest rate is higher compared to those of a permanent loan (the higher interest rate may drive the borrower to procure an early refinancing of the bridge loan).

### Role of agents and trustees

- 6 | What role do agents or trustees play in administering bank loan facilities with multiple investors?

In practice, administrative agents and security agents are commonly appointed in syndicated loan transactions and play the role of the participating lenders' representative. For example, clerical correspondence with the borrower, collection of the principal and interest of the loan and their distribution to the lenders, are generally assigned to the agent. Since the syndicated lenders appoint the agent, it owes a fiduciary duty to the lenders, not the borrower. However, agents' roles are limited to administrative functions and do not cover any discretionary judgements, such as making a determination to declare the loan in default when an event of default occurs. Therefore, the agent is usually exempted from liability to the lenders unless there is wilful misconduct or gross negligence.

## Role of lenders

- 7 | Describe the primary roles and typical fees of the financial institutions that arrange and syndicate bank loan facilities.

A financial institution becomes an arranger of a syndicated loan when it receives a mandate from a potential borrower. Upon accepting that mandate, the arranger owes a fiduciary duty to the borrower. At this stage, the primary role of the arranger is to solicit syndicated lenders and manage the preparation of the documentation. Fees are determined based on the complexity of the deal and other factors, but, generally, the fees are calculated as a certain percentage of the arranged loan amount.

## Governing law

- 8 | In cross-border transactions or secured transactions involving guarantees or collateral from entities organised in multiple jurisdictions, which jurisdiction's laws govern the bank loan documentation?

The governing law of a loan agreement may be designated by the parties. Most Japanese borrowers prefer to have the laws of Japan as the governing law of their loan agreements, while some cross-border loan documents are governed by other laws, such as English law or New York law. Security interests over tangible assets are governed by the law of the assets' locations, while security interests over shares are governed by the law of incorporation of the issuer. Thus, the parties typically provide for those laws to govern the security documents.

## REGULATION

### Capital and liquidity requirements

- 9 | Describe how capital and liquidity requirements impact the structure of bank loan facilities, including the availability of related facilities.

Japanese banks and other financial institutions have started to prepare for the implementation of Basel III. For example, banks are looking to liquidate their long-standing loan receivables, such as project finance loans, to decrease their risk assets. Banks may become less aggressive in making long-term loans compared to several years ago.

### Disclosure requirements

- 10 | For public company debtors, are there disclosure requirements applicable to bank loan facilities?

Public company debtors are not generally required to disclose entering into loan agreements or disbursement of loans.

### Use of loan proceeds

- 11 | How is the use of bank loan proceeds by the debtor regulated? What liability could investors be exposed to if the debtor uses the proceeds contrary to regulations? Can investors mitigate their liability?

There are no general regulations that restrict the use of loan proceeds. However, financial institutions are regulated under the Criminal Proceeds Transfer Prevention Act, which aims to prevent money laundering and financial support for terrorist activities.

- To that end, the Act requires financial institutions to:
- undertake know your customer procedures before entering into a loan transaction with a borrower;
  - create and maintain transaction records; and
  - report to the relevant authority if they find suspicious transactions.

Under the amendment to the Act made in recent years, if the borrower is a corporation, the financial institution must identify the individuals holding substantial control over the borrower.

If the loan proceeds are used for money laundering, terrorism or other antisocial activities, it may expose lenders to reputational risks at the very least. To mitigate these risks, the use of proceeds of a bank loan is usually specified in the loan agreement, and misuse thereof would be an event of default. Under standard syndicated loan documentation, the unanimous vote of the lenders is required for the borrower to change the use of proceeds.

### Cross-border lending

- 12 | Are there regulations that limit an investor's ability to extend credit to debtors organised or operating in particular jurisdictions? What liability are investors exposed to if they lend to such debtors? Can the investors mitigate their liability?

In most cases, lenders are only required to report a transaction to the authority after lending money to a foreign entity under the Foreign Exchange and Foreign Trade Act. However, far stricter regulations are applicable if the borrower is involved in the production of weapons in North Korea, Taliban activities or nuclear activities in Iran, or is another designated person. If a loan is granted to these persons without the prior approval of the relevant authority, the lender may be subject to administrative or criminal sanctions, or both.

### Debtor's leverage profile

- 13 | Are there limitations on an investor's ability to extend credit to a debtor based on the debtor's leverage profile?

When a non-bank moneylender lends money to individuals, the loan amount plus other borrowings should not exceed one-third of the individual's annual income. In other cases, however, there are no specific regulations limiting lending ability based on the borrower's financial condition.

### Interest rates

- 14 | Do regulations limit the rate of interest that can be charged on bank loans?

There are usury laws in Japan. Although multiple acts address this issue in a complex manner, the most notable law is that the maximum interest rate for loan transactions is 15 per cent, where the amount loaned is ¥1 million or more.

Usury laws provide that fees or other monies paid to a lender in respect of a loan are deemed to be interest for the purposes of usury regulations. In this regard, the scope of 'deemed interest' is often a practical issue. First, under the Commitment Line Act, for certain borrowers, such as a stock corporation with a share capital of at least ¥300 million, commitment fees are statutorily exempted from the scope of 'deemed interest'. Second, the categorisation of other fees as deemed interest, such as arrangement and agent fees, has at times been a critical issue. From a practitioners' perspective, if independent and substantial services (such as arrangement services) are provided, and the amount of the fees is reasonable, the approach has been not to deem these fees as interest.

### Currency restrictions

- 15 | What limitations are there on investors funding bank loans in a currency other than the local currency?

Funding in a foreign currency is possible in Japan. In some cross-border banking transactions, the borrower is entitled to choose, among several

options, which currency to borrow in every interest period (multi-currency clause).

### Other regulations

- 16 | Describe any other regulatory requirements that have an impact on the structuring or the availability of bank loan facilities.

As a general rule, a banking licence under the Banking Act or a money-lender's licence under the Money Lending Business Act is required to conduct a moneylending business in Japan. The 'place of business' is a broad concept that may encompass cross-border lending to a Japanese borrower by a foreign financial institution.

In this regard, if a foreign bank has a Japanese branch licensed under the Banking Act, the bank may lend to a Japanese borrower through the branch. In addition, if the branch is licensed as a 'foreign bank agent' under the Act, and it acts as an agent or intermediary of the foreign bank in connection with the negotiation and preparation of the loan documents, then the foreign bank may lend to a Japanese borrower from its headquarters or a branch outside Japan.

## SECURITY INTERESTS AND GUARANTEES

### Collateral and guarantee support

- 17 | Which entities in the organisational structure typically provide collateral and guarantee support for bank loan financings? Are there limitations on which entities in the organisational structure are permitted to provide such support?

The borrower, its parent company and its subsidiaries commonly provide assets as collateral. Parent guarantees for subsidiaries (downstream) and subsidiary guarantees for parent companies (upstream) are also commonly used.

There are no specific statutory limitations or restrictions on such securities or guarantees. However, there is an issue with upstream guarantees owing to the general fiduciary duty owed by the guarantor's directors. If a subsidiary provides an upstream guarantee solely for the benefit of a majority shareholder (owning less than 100 per cent of the shares in the guarantor), and there is no corporate benefit to the subsidiary in providing such guarantee, then the directors of the subsidiary may be accused of breaching their fiduciary duties. To avoid this risk, subsidiaries usually refrain from providing upstream guarantees unless the consent of the minority shareholders has been obtained. The same applies to upstream security, whereby a subsidiary provides security to its parent company's lenders.

- 18 | What types of obligations typically share with the bank loan obligations in the collateral and guarantee support? If so, are all such obligations equally and ratably covered by the collateral and guarantee support?

Secured obligations are sometimes designated as a certain group of unspecified obligations (blanket security), such as 'obligations arising from banking transactions with the secured party'. In those cases, all the secured party's banking claims are equally secured.

### Commonly pledged assets

- 19 | Which categories of assets are commonly pledged to secure bank loan financings? Describe any limitations on the pledge of assets.

There are three major types of security in Japan: pledges, mortgages and security assignments. A pledge is often created over shares and

receivables, a mortgage is used for real estate, and a security assignment is often used for movable properties.

### Creating a security interest

- 20 | Describe the method of creating or attaching a security interest on the main categories of assets.

The concept of a 'universal' security interest for loans (whereby a security interest over all the debtor's properties, whether present or future-acquired, is granted to the lender) does not exist under Japanese law. Thus, the assets provided as security must be specified in the security documents, and different procedures and requirements for the creation and perfection of security interests apply to different categories of assets (such as real estate, movables and receivables).

### Real estate

A mortgage is typically used for real estate. The secured obligations can be specified (fixed mortgage) or designated as a certain group of unspecified obligations (blanket mortgage).

A mortgage is perfected by registration at the legal affairs bureau with jurisdiction over the location of the property. The registration fee is 0.4 per cent of the amount of the secured obligation. To reduce the up-front cost, some lenders permit the security provider to make a provisional registration only, on day one, which costs ¥1,000 per property. Once the mortgage is provisionally registered, the priority is reserved for that mortgage over subsequent competing parties, such as other mortgagees. However, provisional registration is of little use unless formal registration is completed.

To upgrade from a provisional to a formal registration, documents (some of which must be provided by the security provider) must be submitted, and registration fees (which are typically borne by the security provider or the borrower) must be paid. Therefore, a lender must consider how to secure the necessary documents and costs until the mortgage is formally registered. Typically, a security provider must submit and update the necessary documents in the lenders' custody and upgrade to a formal registration before or upon the occurrence of certain trigger events (eg, breach of any financial covenants or the occurrence of an event of default).

### Movable assets

Pledges and security assignments (also known as 'security by way of assignment' or 'assignment for the purpose of security') can be used to constitute a security over movable properties. Since actual delivery of the property is required to effectuate a pledge over movable property, security assignment is more often used since it does not require actual delivery. The secured obligations can be specified obligations or designated as a certain group of unspecified obligations.

To perfect a security assignment of movable property, actual or constructive delivery of the subject property (such as an occupant's manifestation of its intent to occupy the subject assets on behalf of the secured parties) is required. Alternatively, registration of the transfer will also perfect the security assignment.

Aside from the above, special requirements apply to certain categories of movable properties, such as aircraft and automobiles.

### Receivables

Pledge and security assignment are the most typical forms of security for receivables. The secured obligations can be specified obligations or designated as a certain group of unspecified obligations.

Lenders can perfect the pledge or security assignment by giving notice to, or obtaining consent from, the obligor in written form with a notarised date certificate. Alternatively, registration of the pledge or transfer will also perfect the pledge or security assignment.

Receivables may be collateralised without having to obtain the obligor's consent even if the underlying contract has a transfer restriction clause. However, if receivables are collateralised in breach of a contractual restriction, the obligor may refuse to pay the secured party upon the enforcement of the security if the secured party was aware, or owing to gross negligence unaware, of the restriction at the time of collateralisation. Although the usefulness of this type of security is somehow limited in this regard, some practitioners see new possibilities for secured transactions that utilise receivables with restrictions as collateral. One exception to the foregoing general rule relates to bank deposits, which cannot be collateralised without the bank's consent. Banks are generally reluctant to give consent unless they are a secured party.

## **Shares**

A pledge is the most typical form of security for shares. The secured obligations can be specified obligations or designated as a certain group of unspecified obligations.

The method for perfection depends on the type of shares. If the shares are dematerialised, the pledge is perfected by means of electronic book entry. If not, the share pledge is perfected by the delivery of the share certificate representing the pledged shares. If the shares are not dematerialised and share certificates are not issued pursuant to the articles of association of the issuing company, then the share pledge is perfected by recording the pledge in the shareholder ledger.

## **Intellectual property**

Pledge and security assignment are available forms of security for intellectual property, such as patents, trademarks, design rights and copyrights. In most cases, a security assignment can be perfected via registration at a lower cost than a pledge. One disadvantage of constituting a security assignment is that it exposes the secured party to a lawsuit for infringement because the secured party becomes the legal titleholder to the intellectual property.

## **Others**

The creation and perfection of security interests over other types of assets (such as factory foundations, debt securities and trust beneficial interests) are covered by the rules applicable to each type of asset.

## **Perfecting a security interest**

21 | What steps are necessary to perfect a security interest on the main categories of assets? What are the consequences of failing to perfect a security interest?

If the lenders fail to perfect a security interest over an asset, they do not have any priority over the subject asset against a third party. Thus, if the borrower creates a perfected security interest in favour of other lenders, perfects the transfer of the asset to a purchaser, goes bankrupt, or if a borrower's creditor seizes the asset before the perfection of the security interests, then the lenders with unperfected security interests cannot assert any preferred position against those other lenders, the purchaser, the bankruptcy trustee or creditors.

Also, in Japanese insolvency proceedings, claims with unperfected security interests are usually treated as general claims and are subordinated by law to senior claims.

## **Future-acquired assets**

22 | Can security interests extend to future-acquired assets? Can security interests secure future-incurred obligations?

Lenders can capture future-acquired movable properties by designating the collateral as a pool of properties under the security documents. The

pool must be sufficiently identified by specifying the type of asset, location and other necessary criteria. Also, future receivables can be subject to a pledge or security assignment, provided that the target receivables are sufficiently identified. On the other hand, if new real estate is acquired or new shares are issued, additional security interests must be established by the security provider.

## **Maintenance**

23 | Describe any maintenance requirements to avoid the automatic termination or expiration of security interests.

There is no specific law that automatically terminates security interests. That said, the period for registration of movable properties and receivables may expire after 10 years or 50 years, depending on the case, and subject to exceptions. Thus, even if the lender perfects its security interests over movable properties and receivables by registration to secure long-term loans, it must renew the registration before the expiration of the relevant period.

## **Release**

24 | Are security interests on an asset automatically released following its sale by the debtor? If so, are the releases mandated by law or contract?

Security interests are not automatically released, even if the borrower sells the subject asset out of court. However, in the case of a security assignment of a pool of movable properties, if part of the pool is sold and delivered from the specified location, the properties sold will be automatically released from the security interest. In the case of mandatory sales of real estate in the course of judicial foreclosure, security interests are automatically released following the sale, subject to limited exceptions.

## **Non-fulfilment of guarantee obligations**

25 | What defences does a guarantor have against claims for non-fulfilment of guarantee obligations? Can such defences be waived?

If the obligation of a guarantor is not joint and several, it has a 'defence of notice to the borrower', under which the lender must request that the borrower perform its payment obligation before making a claim against the guarantor. Also, the guarantor is entitled to assert a 'defence of collecting from the borrower', under which the lender must try to seize the debtor's assets before going to the guarantor, if the guarantor proves that the borrower can afford to repay the obligation and that enforcement on the borrower's assets can be easily achieved. Such a guarantee is not common in business transactions and joint-and-several guarantees are usually required since those defences are not available to a joint-and-several guarantor.

## **Parallel debt requirements**

26 | Describe any parallel debt or similar requirements applicable in a secured bank loan financing where an agent acts for multiple investors.

Traditionally, as a generally accepted principle of Japanese law, the holders of secured obligations must hold the security interests. Therefore, all lenders (rather than a single security agent or security trustee) are secured parties in most syndicated loan transactions, even where a security agent is appointed, and a security agent's role is only administrative. This sometimes leads to burdensome procedures when there is a transfer of loans or collective enforcement of security interests.

The security trust structure is an alternative to the traditional approach. After the amended Trust Act introduced the concept of a security trust in 2007, it became clear that a security trust could be utilised under Japanese law. In practice, however, security trusts have not been very frequently used, partly owing to the increase in transaction costs on account of fees payable to the licensed security trustee and complex documentation.

Another alternative is the use of a parallel debt structure, where a security agent holds security interests to secure parallel debts owed to it by the borrower, rather than to secure loan obligations owed to each lender. Although the concept of parallel debt is novel to the Japanese legal community and there are no widely reported domestic transactions using a parallel debt structure governed by Japanese law, it should be theoretically feasible to create a parallel debt structure under Japanese law.

## Enforcement

- 27 | What are the most common methods of enforcing security interests? What are the limitations on enforcement?**

There are two types of enforcement of a security interest created in a commercial transaction: a judicial (in-court) procedure and a private (out-of-court) process.

In the case of a real-estate mortgage, the lender may choose judicial enforcement, under which the real estate will be sold to a third party through a judicial auction process, and the sale proceeds will be applied to the repayment of the secured obligation.

One problem with this procedure is that the sale proceeds are likely to be substantially lower than what would be realised through a voluntary sale. Therefore, in most cases, lenders prefer an out-of-court process.

Enforcement of security interests is in some way affected under insolvency proceedings. There are three major statutory insolvency proceedings: bankruptcy, civil rehabilitation and corporate reorganisation. Under bankruptcy proceedings and civil rehabilitation proceedings, security interests are treated as 'out-of-procedure rights', and their enforcement is, in principle, not affected by the proceedings.

In a civil rehabilitation procedure, however, there are two notable exceptions. First, the court may issue an injunction to stop the enforcement of a security interest by a creditor, if the injunctive relief would be in the general interest of the creditors, and the relevant secured creditor would not suffer unjustifiable damage as a result. Second, the security interests may be extinguished with the approval of the court in exchange of the debtor's payment of the fair value of the asset if the collateral is essential for the continuance of the debtor's business.

Under corporate reorganisation proceedings, secured creditors are prohibited from enforcing their security interests outside the process, and secured creditors can receive repayment only in accordance with the reorganisation plan approved in the reorganisation proceedings, both in terms of timing and the amount of recovery.

## Fraudulent conveyance and similar doctrines

- 28 | Describe the impact of fraudulent conveyance, financial assistance, thin capitalisation, corporate benefit and similar doctrines on the structure of bank loan financings.**

A debtor's fraudulent conveyance may be invalidated by the insolvency trustee or the debtor-in-possession, or be subject to rescission by a creditor who might otherwise be impaired by such conveyance.

Japan has no specific regulation on 'financial assistance' and has not explicitly adopted the 'corporate benefit' doctrine. However, directors of a target company may be accused of breaching their fiduciary duties if the company provides a guarantee or collateral to the purchaser of the company, if the target company still has minority shareholders.

Under the thin capitalisation rule, a part of the interest paid to a non-Japanese lender with a close relationship to the borrower may not be deductible if debt is considered to have been provided instead of a capital contribution.

## INTERCREDITOR MATTERS

### Payment and lien subordination arrangements

- 29 | What types of payment or lien subordination arrangements, or both, are common where the debtor has obligations owing to more than one class of creditors?**

Several methods of subordination are used in the Japanese loan market. Aside from structural subordination (which involves borrowing entities at different levels, where the subsidiary borrows senior debt and the parent borrows subordinated debt), there are two types of contractual subordination structures: absolute subordination and relative subordination.

Under an absolute subordination arrangement, if the borrower becomes insolvent, the payment of subordinated debt is contractually made conditional upon the full payment of the senior debt. Thus, senior lenders ensure that the subordinated lender does not receive payment in priority to, or at the same ranking with, the senior lender.

The essence of a relative subordination arrangement is an intercreditor agreement between the senior and subordinated lenders. Typically, the subordinated lenders agree to turn over any payment they receive from the borrower to the senior lenders until the senior debt is paid in full, with certain exceptions of permitted payment. This type of arrangement is not intended to bind the insolvency trustee in the event of the borrower's insolvency. If the borrower is insolvent, the insolvency trustee may disregard the intercreditor agreement and make distributions proportionate to the loan amounts held by the senior and subordinated lenders. Senior lenders then have to rely on the subordinated lenders to turn over the distributions to the senior lenders to uphold the priority of the senior debt.

Despite this disadvantage, senior lenders, as well as subordinated lenders, sometimes prefer relative subordination rather than absolute subordination. This is because a relative subordination arrangement could lead to greater distribution to senior lenders if the distributions are turned over by the subordinated lenders. Under absolute subordination, by reason of the condition attached to the subordinated debt, subordinated lenders may not participate in any distribution from the insolvency estate until the unsecured portion of the senior debt, if any, is paid in full. This means that the subordinated lenders are subordinated not only to the senior lenders, but also to the general unsecured creditors, such as trade creditors, whose claims rank pari passu with the unsecured portion of the senior debt.

### Creditor groups

- 30 | What creditor groups are typically included as parties to the intercreditor agreement? Are all creditor groups treated the same under the intercreditor agreement?**

Senior, mezzanine, subordinated lenders and any other relevant creditor groups involved in the loan transaction often become parties to intercreditor agreements. Such intercreditor agreements include subordination arrangements and treat each lender group differently, depending on what was agreed in each transaction.

## Rights of junior creditors

31 | Are junior creditors typically stayed from enforcing remedies until senior creditors have been repaid? What enforcement rights do junior creditors have prior to the repayment of senior debt?

Normally, junior creditors are prohibited from enforcing remedies unless senior creditors have been repaid in full, or are enforcing the same remedies together with the junior creditors. It is relatively rare in domestic transactions to see an arrangement where junior creditors can exercise enforcement rights after the expiration of a standstill period.

32 | What rights do junior creditors have during a bankruptcy or insolvency proceeding involving the debtor?

The essence of a relative subordination arrangement is an intercreditor agreement between the senior and subordinated lenders. Typically, the subordinated lenders agree to turn over any payment they receive from the borrower to the senior lenders until the senior debt is paid in full, with certain exceptions of permitted payment. This type of arrangement is not intended to bind the insolvency trustee in the event of the borrower's insolvency. If the borrower is insolvent, the insolvency trustee may disregard the intercreditor agreement and make distributions proportionate to the loan amounts held by the senior and subordinated lenders. Senior lenders then have to rely on the subordinated lenders to turn over the distributions to the senior lenders to uphold the priority of the senior debt.

## Pari passu creditors

33 | How do the terms of the intercreditor arrangement change if creditor groups will be secured on a pari passu basis?

If all creditors have the same ranking, intercreditor agreements mainly focus on the lenders' voting process and decision-making requirements. In some cases, these provisions are in the loan agreement rather than executed in a separate intercreditor agreement.

## LOAN DOCUMENT TERMS

### Standard forms and documentation

34 | What forms or standardised terms are commonly used to prepare the bank loan documentation?

The model syndicated loan agreement published by the Japan Syndication and Loan-trading Association is generally used as the basis of the documentation for syndicated loans. The Loan Marketing Association, the Loan Syndications and Trading Association, the Asia Pacific Loan Market Association and other international standardised forms are used mainly in cross-border transactions.

### Pricing and interest rate structures

35 | What are the customary pricing or interest rate structures for bank loans? Do the pricing or interest rate structures change if the bank loan is denominated in a currency other than the domestic currency?

Both fixed and floating interest rates are widely used. In domestic corporate banking transactions, the 'TIBOR (Tokyo Interbank Offered Rate) plus spread' structure is relatively common. When floating rate bank loans are denominated in foreign currency, the benchmark to determine the base rate is usually selected among the popular rates for that currency.

36 | Have any procedures been adopted in bank loan documentation in your jurisdiction to replace LIBOR as a benchmark interest rate for loans?

On 5 March 2021, ICE Benchmark Administration, the authorised and regulated administrator of LIBOR, finally announced their plans to cease publication of JPY LIBOR immediately after the end of 2021. In response to the announcement, the Bank of Japan and the Financial Services Agency of Japan together issued a statement that emphasises the importance of smooth transition to a replacement benchmark in accordance with the transition plan announced by the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks (the secretariat of which is staffed by the Bank of Japan). Financial institutions are increasing the pace of preparations for the scheduled permanent cessation of LIBOR.

## Other loan yield determinants

37 | What other bank loan yield determinants are commonly used?

In some transactions, the applicable margin is determined on the basis of the borrower's leverage ratio (pricing grid). Another example of interest determinants is the passage of time. For example, while the applicable interest rate is relatively low in the first years after the draw-down, the rate goes up periodically (step-up clause).

In response to the recent trend of low interest rates in Japan, zero floor provisions have been widely used in Japanese loan documentation, where the base rate (or, occasionally, the applicable rate) will be deemed zero if the rates become negative in the absence of such provision.

## Yield protection provisions

38 | Describe any yield protection provisions typically included in the bank loan documentation.

To ensure the payment of the amount expected from the debtor in the event of an increase in the cost of the loan, loan agreements in Japan often state that the borrower must choose to either assume the increased cost or repay the relevant outstanding loans. Also, if the borrower intends to make prepayments, the borrower must pay break funding costs corresponding to the prospective interest amount to be accrued for the remaining interest period. Prepayment premiums are sometimes required. In cross-border loan agreements, foreign lenders sometimes require tax gross-up provisions.

## Accordion provisions and side-car financings

39 | Do bank loan agreements typically allow additional debt that is secured on a pari passu basis with the senior secured bank loans?

In domestic corporate banking transactions, accordion provisions are not very common, and the borrower does not usually have the right to borrow an additional secured loan.

## Financial maintenance covenants

40 | What types of financial maintenance covenants are commonly included in bank loan documentation, and how are such covenants calculated?

Typically, under financial covenant clauses, the borrower is required to maintain one or more of the following:

- a leverage ratio (outstanding loan amount divided by EBITDA);
- a debt service coverage ratio (cash flow available for debt service divided by debt service amount);

- a minimum net worth; or
- a minimum profit.

Negotiations are often focused on the level and calculation method of those covenants, based on the borrower's financial projection. When those financial covenants are breached, it usually constitutes an event of default. An equity cure is sometimes allowed, especially in the context of acquisition financing.

#### **Other covenants**

- 41 | Describe any other covenants restricting the operation of the debtor's business commonly included in the bank loan documentation.

The borrower is usually prohibited from taking significant corporate actions without the lender's prior consent. For example, the restricted actions typically include disposing of material assets, incurring additional financial indebtedness and approving mergers, corporate splits or business transfers. In addition, sometimes, a change of control of the borrower is an event of default. The level of the covenants imposed depends on the nature of the loan, the track record of the borrower, the financials of the borrower and many other factors.

#### **Mandatory prepayment**

- 42 | What types of events typically trigger mandatory prepayment requirements? May the debtor reinvest asset sale or casualty event proceeds in its business in lieu of prepaying the bank loans? Describe other common exceptions to the mandatory prepayment requirements.

In acquisition finance transactions, the following are usually subject to mandatory prepayment:

- a certain percentage of the borrower's excess cash flow (the percentage may decrease as the borrower's credit improves);
- the proceeds of any asset sale other than sales in the ordinary course of the borrower's business;
- insurance proceeds and indemnity payments except if these will be used for repair; and
- funds procured by additional debt or equity. Reinvestment is sometimes allowed for a specified period.

#### **Debtor's indemnification and expense reimbursement**

- 43 | Describe generally the debtor's indemnification and expense reimbursement obligations, referencing any common exceptions to these obligations.

Typically, all expenses (including stamp duty and attorney's fees) incurred in connection with the preparation and any revision or amendment of any bank loan documents, together with the creation, maintenance and enforcement of the lender's rights, are borne by the borrower to the extent those costs are reasonable. One exception is the cost of transfers of loan receivables, which is borne by the transferor or transferee of the receivables.

#### **UPDATE AND TRENDS**

##### **Key developments**

- 44 | Are there any current developments or emerging trends that should be noted?

A study group supported by the Ministry of Justice released a report about a proposed framework of new legislation for security over movable properties and receivables, and another study group organised

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by the Financial Services Agency is discussing an introduction of a new legal system for a blanket collateral. These developments may promote lending practices that do not rely on real estate collateral or individual guarantees provided by management members.

##### **Coronavirus**

- 45 | What emergency legislation, relief programmes and other initiatives specific to your practice area has your state implemented to address the pandemic? Have any existing government programmes, laws or regulations been amended to address these concerns? What best practices are advisable for clients?

In April 2021, as we are writing this article, the biggest common concern of Japanese loan market participants is the covid-19 pandemic. In response to a request of the Japanese Financial Services Agency, banks are striving to provide liquidity to support borrowers to ensure the survival of their business. Some banks are extending commitment lines to various sectors including airlines, while others are responding flexibly to requests for amendments of existing loan terms (including extension of loan repayments).

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