November 25, 1998
Financial Law Board

Issues on Commitment Fees

The Financial Law Board ("Board") has discussed issues on commitment fees so as to clarify whether and to what extent commitment fees constitute "deemed interests" under the Interest Rate Restriction Law (*Risoku Seigen Ho*) or the Law Concerning the Regulation of Receiving of Capital Subscription, Deposits and Interest on Deposits (*Shusshi Ho*) (the "Capital Subscription Law"). If it is interpreted that commitment fees constitute "deemed interest", commitment fees are subject to these laws and possibly illegal under certain circumstances. In this article, three views, which demonstrate that commitment fees do not necessarily violate these laws, are explained (Sections 2-4). However, it is difficult, if not impossible, to assert that there are no grounds in the counterargument that commitment fees possibly violate these laws, and therefore, the Board proposes to seek legislative action which would enhance the legal certainty and transparency regarding the issue on commitment fees (Section 5).
The Board will remain vigilant on this issue and will further discuss it when necessary.

1. Issues

(1) Commitment Line Agreement

A commitment line agreement is an agreement under which a lender establishes and maintains a certain commitment line for a certain period of time and undertakes to make loans to a borrower upon its request within the limit of such credit. In consideration for entering into such commitment line agreement, a commitment fee will be paid by the borrower to the lender during the contract term. Note that since the agreement continues to be in effect for a certain period of time, certain conditions such as the non-existence of a material adverse change with respect to the financial conditions of the borrower are usually set.

Although a commitment line agreement is similar to an agreement on overdraft in a current account provided by a bank, the agreement on overdraft in a current account often contains a provision similar to the following which gives a bank broad discretion over whether, or not, to provide overdraft facility:
"If there has been a change in the general financial condition, it becomes necessary for the Bank to preserve the Bank's rights or there exists any other reasonable cause, the Bank may at any time reduce the maximum amount of overdraft, suspend the overdraft facility or terminate

this Agreement."

In addition, there is no fee paid in consideration for the agreement on overdraft in a current account.

For the purpose of this article , the term "commitment line agreement" will not include such agreements under which lenders have such broad discretion. Instead, the following discussion refers only to those agreements under which there are objective, clear and reasonable standards for lenders to reject loans.

(2) Legal Issue Concerning Commitment Line Agreement

The legal issue concerning the commitment line agreement is whether a commitment fee would constitute a "deemed interest" under Article 3 of the Interest Rate Restriction Law or under Article 5, paragraph 6 of the Capital Subscription Law and if it does, whether such a commitment fee would exceed the limit of interest rates provided for in such laws. These issues are illustrated in the <<Example>> below.

<<Reference>>
Article 3 of the Interest Rate Restriction Law:
"For the purpose of application of the provisions of the preceding two Articles, moneys other than the principal which a creditor receives in connection with the pecuniary loan for consumption shall be deemed to be interests, regardless of whether they are received as fees, discount charges, commissions, investigation charges or otherwise under whatever name they may be charged; provided, however, that this shall not apply to the expenses of the execution of the contract or of performing obligations."

Article 5, paragraph 6 of the Capital Subscription Law:
"Moneys which are received by a person lending money in relation to the said loan shall be deemed to be interests, regardless of whether they are received as fees, discount charges, commissions, investigation charges or otherwise under whatever name they may be charged, and the provisions of paragraphs 1 and 2 shall apply thereto."

<<Example>>
Customer X and Bank Y enter into an agreement with the contract term being one year, the commitment line being one hundred million yen (¥100 million) and the commitment fee being at a rate of 0.3% per annum on the commitment line (¥300,000 per year).

Case 1: Customer X never utilizes the credit facility for the whole year:
(Interest: ¥300,000) / (Capital: ¥0) / (Loan period: 0 year) = infinite %

Case 2: Customer X draws down ¥1 million under the commitment line of ¥100 million at a rate of 4% per annum and repays the same after three (3) months:
(Interest: ¥310,000) / (Capital: ¥1 million) / (0.25 year) = 124%

In the above instances, a literal interpretation of the expression stipulated under the Interest Rate Restriction Law and the Capital Subscription Law, i.e., "or otherwise under whatever name they may be charged", might lead to an argument that a commitment fee constitutes a "deemed interest" exceeding the limit on interest rates defined under these laws. Does such an argument sound persuasive?

The Ministry of Justice stated in the "Interim Announcement on the Situation of Review and Examination of the Deregulation Promotion Plan" (announced in January, 1997) in an answer to the argument concerning the legality of a commitment fee that "if it is excluded from the definition of deemed interests, it is highly probable to encourage the evasion of laws by those who try to collect fees that are substantially equivalent to high interest charges so that such exclusion could practically cause intensive harm."

Then in the new "3-year Plan on Deregulation Promotion" announced on March 31, 1998, it is stated that treatment of commitment line agreements for the purpose of Capital Subscription Law and Interest Rate Restriction Law will be determined by the end of 1998 and that any legal action necessary therefor will be taken during the fiscal year 1999.

At present, there appear to be two methods of charging commitment fees. One is to calculate them by multiplying the relevant commitment line by a certain rate regardless of whether the commitment line is used ("Method A"), and the other is to calculate them by multiplying the unused portion of the commitment line by a certain rate (a commitment fee will not be collected with respect to the used portion of the commitment line;"Method B"). (Cf. "Legal Nature of Commitment Line and Validity Thereof" by Masaharu Sugawara, 1522 *Kinyu Homu Jijo*, at 87-88)

> Note: Mr. Sugawara argues in his article with respect to the legal nature and validity of commitment line agreement as follows:

1) Commitment fees are considered as funding reserve costs for the lender. In Method B, a commitment fee as a whole may be considered as a funding reserve cost, but in Method A, as interests are originally considered to contain costs required for funding, double collection of funding reserve costs takes place in relation to the outstanding drawn down portion of the commitment line and the relevant commitment fee can be substantially recognized as interest in relation to the outstanding drawn down amount of the commitment line.

2) "To begin with, a commitment fee is thought to be a cost necessary for securing funds before making a loan rather than a money required to perform a loan contract and it is intrinsically different from a money relating to a loan. Also under the Japanese Civil Code, a financing constitutes a monetary loan for consumption and is deemed to be concluded upon delivery of a relevant money so that it appears appropriate to consider a commitment line agreement having a commitment fee for its consideration as a different agreement from a financing agreement. Accordingly, a commitment fee will not constitute a "deemed interest" for the purpose of the Interest Rate Restriction Law or the Capital Subscription Law and therefore a commitment line agreement should not be illegal."

Provided, however, that with respect to a commitment fee relating to the outstanding drawn down amount of the commitment line in Method A, "it seems inevitable for such a commitment fee to be regarded as a "deemed interest" since it is substantially identified as an interest."

3) In addition, even if it is assumed that the entire amount of commitment fees is determined to constitute "deemed interest", "judgment on whether it is substantially illegal or not" under the Capital Subscription Law "shall be based on the consideration of the balancing of the demerits caused by and the merits obtained from concluding such agreements." The demerit of the commitment line agreement is that a borrower may be forced to pay a commitment fee at a high rate and the merit thereof is that a borrower will become able to obtain a loan facility expeditiously. "The merit in this situation prevails over the demerit and there seems to be no substantial illegality." "Accordingly, even if a commitment fee is determined to constitute a "deemed interest", there is a lack of substantial illegality and therefore it should be assumed that a commitment fee does not constitute a crime of violation of the Capital Subscription Law."

The Board also does not necessarily believe that a commitment fee should constitute an interest in relation to the outstanding drawn down amount of a commitment line. Therefore,

the Board hereby presents views different from those of Mr. Sugawara.

In the following sections 2. through 4., three different views with respect to the commitment fee are explained. In section 5., it is suggested that legislative action is necessary for the corroborative purposes.

2. A View that a Commitment Fee does not Constitute a Deemed Interest

This is a view to construe that a commitment fee does not constitute a "deemed interest" within the scope of the Interest Rate Restriction Law and the Capital Subscription Law, taking into consideration the legislative purpose of the "deemed interest" provisions, the purpose and aim of a commitment fee, and the intentions of the parties, etc.

Firstly, with regard to the Interest Rate Restriction Law, an "interest" regulated by the Law has originally been interpreted as any money or its alternative which is paid in consideration for the use of principal money in proportion to the amount and outstanding period thereof. Article 3 of the Interest Rate Restriction Law which deals with"deemed interests" was incorporated, considering the fact that various moneys having the substance of interests had been collected under various names other than interests.*[1] Therefore, the Interest Rate Restriction Law is not intended to regulate moneys paid which have no substance of interests, and the scope of "moneys other than the principal which the creditor receives" under Article 3 of the Interest Rate Restriction Law should be narrowly interpreted to the payment of moneys having substance of interests, based on the social understanding of such a term. A commitment fee, however, is a money collected from a borrower in consideration for the commitment of a lender to grant loans to the borrower within a certain limit regardless of the actual drawdown (i.e. the use of principal) or the amount thereof. That means that conditional linkage between the commitment fee and the actual lending (i.e. a relation that "if the relevant lending were not made, the relevant consideration would not have been paid") cannot be recognized and therefore it should not be deemed to have the substance of an interest paid in consideration of the use of principal. Accordingly, we believe that commitment fees do not constitute "moneys other than the principal which the creditor receives in connection with the pecuniary loan for consumption " as mentioned in Article 3 of the Interest Rate Restriction Law, and that it is not subject to restriction by such Law.

Secondly, with regard to Article 5, paragraph 6 of the Capital Subscription Law, "moneys which are received by a person lending money in relation to such lending" should be interpreted to mean moneys paid on the premise that actual lending takes place, because the

Capital Subscription Law should be strictly interpreted since it aims to regulate money lenders with criminal sanctions in order to prohibit high interest lending. Although the aforementioned "moneys received in relation to such lending" are not limited to interests paid in consideration of the use of principal, such moneys should be limited to the payment of moneys having at least conditional linkage with the relevant actual lending.*[2] In this context, a commitment fee does not have any such conditional linkage with the actual lending since it has to be paid even if an actual lending does not take place (see Case 1 of <<Example>>). Therefore, a commitment fee is not a "money received in relation to a lending" and accordingly, the said paragraph of the Capital Subscription Law should not apply to a commitment fee.

Let us look at the above interpretation with reference to the legislative intent. If the purpose of the Interest Rate Restriction Law and the Capital Subscription Law is to restrict usury and protect borrowers (who are often vulnerable) in light of the circumstance that powers of the lender and the borrower are not equal, the intervention by such Laws should not be necessary in case of a commitment line arrangement between a bank and a company above a certain scale, both having at least the same level of bargaining power.

If we take the view that a commitment fee does not constitute a "deemed interest" as discussed above, neither Method A nor B would violate the Interest Rate Restriction Law or the Capital Subscription Law.

However, if any transaction which is substantially usurious is carried out under the disguise of a commitment line agreement, the Interest Rate Restriction Law and the Capital Subscription Law should be applied.

Specifically, application of Article 3 of the Interest Rate Restriction Law and Article 5, paragraph 6 of the Capital Subscription Law shall be determined by judging the economic rationality of the transaction after considering comprehensively such factors as the need for prohibition of excess lending, the borrower's intention, the lender's intention to circumvent the Laws, its actual intention to lend money within a certain limit, and its lending ability therefor. For example, consider a case where a borrower applies for a loan of ¥100,000 for a period of six months but the lender suggests establishing a credit line of ¥500,000 for a contract term of one year and proposes to lend ¥100,000 for a period of six months as applied with an interest at 15% per annum on the amount of loan (¥100,000) and a commitment fee at 3% on the amount of credit line (¥500,000). In such a case, it is necessary to evaluate whether the borrower has the financial rationality to establish a credit line of ¥500,000. In

other words, the total amount of the commitment fee might be deemed as an interest and such an agreement may be held to be a violation of the Interest Rate Restriction Law and the Capital Subscription Law, if the powers of the lender and the borrower are not equal, even in the case where a commitment fee would be legal had it been arranged between a bank and a company above a certain scale both of whom have an equal level of bargaining power.

*1 Article 4 of the old Interest Rate Restriction Law (enacted on September 11, 1877) provided that "any moneys under the name of fee, exorbitant interest or otherwise shall be judicially null and void" and accordingly, delivery of moneys under the name of remuneration or commission was held as equivalent and determined to be null and void in judicial precedents.

A judgment of the Great Court of Judicature dated October 23, 1936 (15 *minshu* 21 at 1843) held in a case in which a money was deducted under the name of a fee that:

"..... In other words, the only ground on which the original judgment acknowledged legality of the relevant loan for consumption was the consent by the appellant, etc. to the deduction of the fee, and no judgment was given on the actual substance of such a fee. Any fee or extension fee deducted by the lender with an approval of the borrower other than the regular interest upon conclusion of a loan for consumption shall, in the first place, be legally effective if there is a fact that, upon making a loan, the lender has spent time and energy for research of financial or other conditions of the borrower or for the conclusion of the relevant contract and the amount of such a fee is not unusually high as a compensation therefor under the concept of such a transaction. Therefore, if such a fee or extension fee does not have an actual substance thereof and the lender is only trying to exploit pecuniary profit other than the regular interest using the name of a fee or extension fee, it shall be regarded as equal to a fee, exorbitant interest, etc. other than the interest provided for in Article 4 of the Interest Rate Restriction Law and it shall be judicially null and void and naturally such a loan for consumption is not legally effective within such scope. Accordingly, there is no way to verify which of the above categories the fee or the extension fee under the original judgment falls under so that the original judgment should be determined illegal for insufficient trials if not for lack of grounds."

The new Law (enacted on May 15, 1954) tries to prevent the avoidance of laws by further clarifying legal interpretation of a fee, discount fee, etc. by deeming them as interests.

"The expenses of concluding the contract" provided for in the proviso of Article 3 of the Interest Rate Restriction Law are interpreted to be the expenses directly and actually required for conclusion of a contract. With respect thereto, a judicial precedent (the Supreme Court judgment dated June 10, 1971 (638 *hanrei-jiho* at 70)) held that even if the expenses of concluding the contract or of performing obligations were delivered under such names, if the creditor did not actually spend them for such purposes, they should be deemed to be interests unless the creditor alleged and proved the facts that the creditor needed such moneys as expenses.

*2 Judicial precedents appear to give attentions to the linkage of such moneys with the actual loan. For example, the Supreme Court judgment dated December 21, 1982 held that "moneys other than the principal should be limited to those found to have relation with the relevant loan" and the Sapporo High Court judgment dated March 22, 1972 held that such moneys should be "moneys received by the lender in relation to the relevant loan activities" (moneys which were held to be interests in the cases were moneys having conditional linkage with loans actually made such as expenses for repayment of obligations, stamp duties, preparation fees of notarial deeds and registration charges of mortgages.).

3. A View that Only the Portion of a Commitment Fee Corresponding to the Actual Amount Lent Constitutes a "Deemed Interest"

This is a view that "moneys which the creditor receives in connection with the loan for consumption having money for its subject" under Article 3 of the Interest Rate Restriction Law and "moneys which are received by a person lending money in relation to the said loan" under Article 5, paragraph 6 of the Capital Subscription Law should include only the costs incurred by the drawdown of actual lendings.

When commitment fees are charged based on Method A, a commitment fee under a commitment line agreement is calculated based upon the amount of the commitment line, the contractual period, and the commission rate.The amount of actual lending is not considered for the calculation of the commitment fee. Under a commitment line agreement, as far as the aggregate amount of the actual lending is below the commitment line, the borrower can determine the amount of the loan, i.e., he can draw down, repay, and redraw down within the contractual period, if necessary.

In terms of the amount and period drawn down, it is possible to divide the entire commitment fee into two parts: the portion corresponding to the loans which have already been drawn down and that corresponding to the line which has yet to be drawn down. In <<Example>> Case 2 (see Section 1.(2)), the commitment fee is ¥300,000 which corresponds to the contract term of one year and the commitment line of ¥100 million, among which ¥750 (¥1 million x 0.003 x 3/12) corresponding to the loan period of three months and loan amount of ¥1 million corresponds to the actual loan drawn down. The balance of ¥299,250 does not correspond to the loan and such an amount can be deemed to be a consideration for retaining a right to borrow ¥99 million for a period of one year and another ¥1 million for a period of 9 months.

Therefore, the portion of a commitment fee corresponding to a loan actually drawn down in respect of the amount and the period can be characterized as a consideration not for the use of principal but for retaining the right to borrow. However, the loan is granted because of the payment of such an amount. Accordingly, such a portion of the commitment fee, incurred by the drawdown of actual lending may constitute a “deemed interest”.

However, the portion of a commitment fee not corresponding to the actual loan is not a cost incurred by the drawdown of the actual loan so that it cannot be said to be a money received “in connection with the loan for consumption” or “in relation to the said loan” under the above provisions. Therefore, such a portion of a commitment fee should not be deemed to constitute an interest in the application of the Interest Rate Restriction Law and the Capital Subscription Law.

Applying this point further to <<Example>> Case 2 in Section 1.(2), ¥750 (commission) + ¥10,000 (interest) = ¥10,750 is an “interest” including a “deemed interest” which indicates the interest rate of 4.3% per annum for a loan with the principal amount of ¥1 million and a period of three months. In this case, there will be no violation of either the Interest Rate Restriction Law or the Capital Subscription Law. In this manner, if we regard only the portion of the commitment fee corresponding to the amount and period of the loan actually drawn down as an interest, the annual rate of the lending is 0.3% + 4% = 4.3% regardless of the amount of the loan actually made. Should no loan be made, the whole amount of the commitment fee does not constitute a deemed interest as there is no lending.

In the meantime, when commitment fees are charged based on Method B, a commitment fee is calculated by multiplying the unused portion of the commitment line by a certain rate so that there is no commitment fee corresponding to the actually drawn down loan. Therefore there is no “deemed interest”.

The arguments in the last two paragraphs of Section 2. concerning transactions carried out with substantially high interest shall also apply to this section 3, *mutatis mutandis*.

4. A View that a Commitment Fee Constitutes a "Deemed Interest" but its Illegality is Eliminated by a Legitimate Business Action Excuse

As for the Capital Subscription Law, there is another view that apart from those of sections 2. and 3. above, collection of a commitment fee should be regarded as a legitimate business action (Article 35 of the Criminal Code) and its illegality is eliminated under certain circumstances not impairing the purpose of the Law (such as a bank requesting payment of a reasonable range of a fee when a company is its counterparty) .

In case of a commercial paper (CP) backup line agreement, for example, which involves the same issues as with commitment line agreements, the existence of such backup line agreement has been a prerequisite under the Notifications of the Ministry of Finance (Securities Bureau No. 437 dated March 24, 1993 and Banking Bureau No. 610 dated April 1, 1993. These Notifications were abolished in June 1998 and the Guidelines for Financial Supervision prepared in place thereof do not contain any reference to CP backup lines.) and the Notification of the Ministry of International Trade and Industry (Industrial Policy Bureau No. 126 dated April 1, 1996 which requires liquidity supplementation for the asset back CP by setting up backup lines (1-3-(5) of the said Notification)). Although the existence of such Notifications does not necessarily eliminate illegality, the fact that backup line agreements have been used based on these Notifications ensures that backup line agreements are deemed to be rational both financially and socially. The same reasoning would apply to commitment line agreements as well.

5. Necessity of Legislation

As examined above, there are a few interpretations regarding the legality of a commitment fee under the current Interest Rate Restriction Law and the Capital Subscription Law. It should be noted, however, that the very fact that interpretations are varied suggests legal uncertainty for parties to the relevant transactions under the existing laws of Japan. If we look at the situation in other countries, it is clear that a commitment line agreement can be a rational transaction for both parties to the agreement. Therefore, it is desirable to ensure the legality of the commitment fee transactions through either (i) amending the Interest Rate Restriction Law and the Capital Subscription Law or (ii) enacting a special law (such as the Law

concerning Close-out Netting of Specified Financial Transactions entered into by Financial Institutions, etc., which was enacted as a special law to the bankruptcy regime).

In either cases, the following should be considered:

(i) to limit the scope of the lender in such a way that only those who are less likely to circumvent laws would be lenders (for example, a bank, non-bank or consumer credit company), to require the lender to have the capability and intention to perform obligations under a commitment line agreement;

(ii) to limit the scope of the borrower in such a way that only those who are in need of a commitment line, are sufficiently capable of dealing in transactions where substantially high interest rates are applied would be borrowers; and

(iii) to set up limitation on fees separate from those provided for in the Interest Rate Restriction Law and the Capital Subscription Law in cases where credit lines of which functions are similar to a commitment line are established for consumers.