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Financial Law Board

Legal Issues on Asset Securitization in Japan

1. Introduction

Japan has recently been witness to various legal reforms aimed at promoting asset securitization. In spite of these reforms, however, the notion of asset securitization has not infiltrated into a wide range of investors. It is possible to assert that customary or cultural factors peculiar to Japan may be the cause. For example, evaluating profits from the perspective of cash flow does not have a strong foundation in Japan with respect to some types of assets that fit securitization. It may also be pointed out that, in comparison to other countries, much greater attention is paid to the privacy in Japan. Besides these factors, however, the retarded proliferation of securitization may also be attributed to certain legal issues on asset securitization.

Accordingly, the Financial Law Board (the "Board") has decided to discuss, in this note, issues in the current legal systems related to asset securitization. Set forth below are general and specific issues identified and recommendations thereof.

This note has been prepared on the basis of the Board's answer to the "Questionnaire on the Promotion of Securitization of Receivables and Real Properties" conducted by the Liberal Democratic Party in April 1999. This note is thus not a comprehensive list of issues inherent in the current legal systems related to asset securitization. The issues discussed here have not been arranged in accordance with any theoretical order or order of importance. The Board presents this note as an aid for future discussion, considering the present situation in Japan where the legal reform on asset securitization is an urgent task.

2. General Issues and Recommendations

- Various laws regarding asset securitization, such as the Law Concerning Securitization of Specified Assets by Special Purpose Companies (the "SPC Law"), the Law Concerning Regulation of Business regarding Specified Claims, etc. (the "Specified Claims Law"), and the Real Estate Specified Joint Venture Enterprise Law, have not been enacted consistently with each other, and lack appropriate mutual coordination.

- In order to regulate securitization activities rationally, the framework of information disclosure should be reinforced and the existing regulations at the product origination stage should be abolished or substantially relaxed so that a wide range of products can be designed. Information disclosure should not only "cover all of the required matters", but should also be "easy to understand" in particular when new types of securitization products are introduced. On the basis of such information disclosure, the number of potential investors should be expanded, for example, by permitting a securitization product in such amount as can be purchased by personal investors.

- The Civil Code, the Commercial Code, the Bankruptcy Law and other relevant laws of general application contain a hundred of ambiguity with respect to securitization, and are in need of legislative reform.

- It would not be advisable if new legislation increases procedural and other relevant costs so that it might be more difficult to carry out related transactions not covered by that law.

- In addition to revision of private laws and business regulations, it is also important to ensure commensurate reform of the relevant taxation.

3. Specific Issues and Recommendations

(1) Article 12 of the Law Concerning Application of Laws in General (the "General Application Law")

As a method of perfection of an assignment of claims, a registration is authorized under the Law Concerning Exceptions, Etc. to the Civil Code, Applicable to Perfection of Assignment of Claims (the "Assignment Exceptions Law"), and a public notice is authorized under the Specified Claims Law. The relevant provisions of these Laws are applicable, however, only if the perfection of an assignment is governed by Japanese law. Under Article 12 of the General Application Law, the perfection of an assignment of claims shall be governed by the laws of the place of the obligor's address. As a result, if the obligor's address is in a foreign country, then the assignment will be governed by the laws of that foreign country and must be perfected in accordance with the requirements thereunder. If certain receivables to be securitized in Japan include those against an obligor whose address is in a foreign country, then the assignment of such receivables cannot be perfected by the registration or public notice in Japan, and must

be perfected in accordance with the requirements of that foreign country. In reality, taking such a perfection step in a foreign country will be impractical from the perspective of cost. Therefore, revision of Article 12 of the General Application Law is required in order to provide a more stable legal infrastructure for the securitization of receivables (including those against non-resident obligors).

(2) Taxation

- Because a special purpose company ("SPC") under the SPC Law is merely an instrument or vehicle for the securitization, the registration tax and other public charges imposed on an asset transfer to an SPC have been reduced. The reduction is not sufficient, however. These charges should be exempted completely.

- The reasonableness of the current requirements under the SPC Law for the posting of dividends/distributions paid by an SPC as a loss is questionable. It appears to be explained generally that these requirements have originally been established in contemplation of REIT's (real estate investment trusts), but the current SPC Law does not contemplate this type of transaction. In addition, the requirements for posting dividends/ distributions paid as a loss are unclear. For example, the following points are unclear:
  (i) When an SPC issues several types of bonds, will the requirements be met if only one of those several types is publicly offered in an amount of one hundred million yen or more? On the contrary, will the requirements be met if those several types are publicly offered in the aggregate total of one hundred million yen or more?
  (ii) Will the requirements be met if eligible institutional investors initially subscribe for bonds and/or senior investment securities and then immediately sell them to those who are not eligible institutional investors?

- In the context of a real estate trust, the handling of the senior-junior structure of beneficial interests under the tax laws must be clarified in connection with the so-called real estate trust notification (the National Tax Administration Agency Notification "Re: Handling of Income Tax, Corporation Tax, Consumption Tax, Inheritance Tax and Donation Tax with respect to a Real Estate Trust with Divided Beneficial Interests").

(3) SPC Law

- Many of the measures that are explained as investor protection measures under the SPC Law are generally understandable, to some extent, in the context of asset securitization of real estate (presumably, involving the issuance of senior investment securities in many cases). In the context of securitization of pecuniary receivables (in most cases only bonds will be issued), however, these measures have given rise to results that are not always reasonable. This difference should be somehow reflected in the regulations under the Law.

- Given an issuance of asset-backed securities in a multi-seller form, it is possible for an asset securitization plan to only state an outline of the schedule for the second and subsequent issues, leaving subsequent adjustments to a finalization procedure. In the case of an application certificate form for a senior investment or bond, if a series of issuance iscontemplated under the plan, it is required that each application certificate form necessarily state certain information (in the case of the issuance of bonds, for example, the aggregate issue amount, the amount, interest rate, manner of redemption of each issue, etc.) regarding all of the other series. As a result, even though some flexibility is given for the operation of an asset securitization plan [at the plan formation stage], it is required, at the application certificate preparation stage, that the above information be definite also for future issue. This will render it practically impossible to issue several series at separate future instances. It would be preferable to leave scope for freedom to issue subsequent series on condition that the benefits of the investors of the asset-backed securities then existing will not be harmed (through a limited-recourse mechanism, etc.). This will be effective and meaningful in order to provide substantial protection to investors and facilitate efficient fund raising activities.

- The significance of an asset securitization plan is sometimes explained from the perspective of information disclosure to investors. However, it overlaps the disclosure regulations under the Securities and Exchange Law, and the substance of such an asset securitization plan is insufficient. It would, therefore, be difficult to explain the significance of an asset securitization plan from the disclosure perspective. It would rather be better to clearly characterize an asset securitization plan as merely a mechanism for confirming that such plan satisfies the minimum requirements for being eligible for exceptional treatment under the Commercial Code and the relevant tax laws. Therefore, the regulations of an asset securitization plan should be substantially relaxed.

- The minimum capital requirement of an SPC is three million yen under the SPC Law. An SPC is merely a vehicle for securitization, and its capital is not considered to have significance as its credit base. Therefore, the minimum capital requirement should be substantially reduced. The requirement that an SPC be audited by an independent auditor is also a factor resulting in increased costs.

- The significance and substance of senior investment securities appear to be often explained as being analogous to preferred stocks under the Commercial Code. There remains a doubt as to whether the framework under the Commercial Code can provide investors with such substantial rights as are generally required by them with respect to the equity portion of the securitization of real estate (for example, is it possible to stipulate a priority clause under which substantially all of the distributable profits or residual assets shall be delivered to the holders of senior investment interests?)

- The effective date of the issuance of senior investment securities of an SPC is different from that of new shares of a corporation (*kabushiki kaisha*), and is the same as the date of registration of such issuance, as in the case of the initial issuance of shares upon incorporation of a corporation. Under the practice for the initial issuance of shares upon incorporation of a corporation, a financial institution handling subscription payments will ordinarily deliver the paid-in capital to the company against delivery of a certified copy of its registration. Such a copy will not be issued until approximately 10 days after the application for registration. As a result, an originator under a scheme using an SPC will not be able to receive the invested funds during such period. In the case of the issuance of new shares under the Commercial Code, on the contrary, a financial institution handling subscription payments will ordinarily honor a payment request of the issuing company even before the registration of such capital modification. In light of this practice, the provisions governing the effective date of the issuance of senior investment securities should be modified, at least in a manner similar to those governing the effective date of the issuance of new shares of a corporation, or, preferably, to allow senior investment securities to be issued at the same time as the payment of investments to the financial institution handling such payments. SPC's should thus be enabled to receive invested funds as soon as possible.

- It is necessary to infuse more flexibility into the provisions governing dividends with respect to senior investment securities, in order to enable the use of dividends in line with the relevant securitization scheme.

- Each holder of a senior investment interest (a "Senior Investment Member") in an SPC reserves the right to remove a director and the right to elect a replacement director, and these rights cannot be excluded even by the articles of incorporation of the SPC. Thus, from the perspective of bankruptcy remoteness, it is difficult for the originator to hold senior investment securities. This point should be reformed. In actuality, the fact that each Senior Investment Member has the right to elect and remove directors under certain circumstances often gives rise to difficult questions. It is suggested that there be freedom to characterize the position of a Senior Investment Member as a passive investor (for example, by allowing the articles of incorporation to provide whether the Senior Investment Members shall have the voting right, and to define the scope of such right).

- Senior investment securities can be redeemed only at the final stage, and any other alternative redemption method cannot be used, such as gradual redemption during the duration of the securitization plan. The provision of flexibility with respect to the timing of redemption of senior investment securities is necessary.

- If a financial institution acquires more than 10% (or 5%) of senior investment securities of an SPC, an approval of the Fair Trade Commission is required under the Anti-Monopoly Law. There is no good reason to impose this Anti-Monopoly Law restriction on the acquisition of equity securities for investment purposes in a securitization transaction. This is also inconsistent with the present situation under which life insurance companies and other similar institutions are expected to be dominant investors in the equity portion of SPC's.

- The scope of loans that an SPC under the SPC Law can borrow is too limited. The restrictions on the borrowing of loans should be relaxed.

- It should be explicitly provided that the parties may agree to limit the scope of the preferential right for the bondholders and to insert a limited recourse commitment.

- It is unclear whether the holders of bonds issued by an SPC under the SPC Law can apply for the enforcement of their preferential right against the assets of such SPC, or whether they can only participate in the process of a general creditor's execution

or enforcement of security interests, or receive a preferred distribution in bankruptcy proceedings of such SPC.

- According to paragraph 6 of Article 111 of the SPC Law, a trustee of bonds may examine the status of the business and assets of the SPC issuing such bonds if the trustee determines it necessary in order to perform the functions listed in paragraph 1 or 4 of the said Article. It is unclear whether it is expected (under the SPC Law) that a trustee of bonds will diligently monitor the status of management, investment and disposition of the assets of the SPC, or how the interpretation of this point will affect the scope of responsibility of a trustee of bonds.

- In many cases of securitization of real estate in foreign countries, the conditions of bonds provide that a refinance, sale or other disposition of the securitized assets during a tail period (which refers to a period between each expected redemption date and the final redemption date, and during which a refinance, sale or other disposition of the securitized assets is expected for the purpose of raising funds for redemption of the principal of the bonds at the final redemption date) shall require a decision of the meeting of bondholders in order that the bondholders shall have the initiative for the disposition of the securitized assets. It is unclear, in Japan, whether such a situation is considered to be "any matter that will materially affect the benefit of the bond holders" (*see* Article 113 of the SPC Law and Article 319 of the Commercial Code), and whether it is, therefore, possible to actually convene a general meeting of bondholders.

- In the context of general meetings of bondholders, one imaginable reform is to uphold, by legislation, the validity of such clause of the conditions of bond that when several classes of ABS have been issued, if one of the classes becomes subject to the acceleration clause, then the interest rates for all of the series shall be uniformly modified to the rate for the most subordinate series and one general meeting of all of the bondholders shall be held.

- It is provided that an SPC under the SPC Law may issue senior investment securities or bonds in several classes or in several series to be issued at different times. Pursuant to this provision, in an increasing number of cases, several classes of specified bonds under the senior-junior structure are issued. In such a case, however, it is unclear what clause within the conditions of bond should be relied upon to ensure the senior-junior structure.

- Issuance by the program method is restricted for ABS other than ABCP. Is this restriction meaningful? Concerns about the validity of a limited recourse commitment does not seem to be a good reason for prohibiting the program method (even if any doubt remains with respect to the validity of this commitment, it is possible to design a product, without impairing the protection of investors, by appropriately formulating the scheme, for example, by making it a condition for the rating of the bonds to maintain a certain uniform quality of the assets transferred to the SPC under the SPC Law for the issuance of each series of bonds).

- Under the SPC Law, various measures are provided to prohibit or restrict certain acts that may possibly trigger bankruptcy of an SPC, such as prohibition of concurrent engagement in other businesses, restriction of borrowing activities, restriction of disposition of the assets, and restriction of investment of surplus funds. On the contrary, no particular arrangement (*e.g.*, restriction of filing for legal actions) is employed to ensure that an SPC will meet a certain threshold that is ordinarily required for a rating agency to recognize the bankruptcy remoteness of such SPC. This point appears to be left to the contrivance of market participants. In practice, however, there is no option but to rely on Cayman SPC's (to function as the holding company of a domestic SPC under the SPC Law). Therefore, a Japanese version of charitable trust or special purpose trust should be introduced.

(4) Real Estate Joint Venture Enterprise Law

- Many of the provisions of the Law are unnecessary for institutional investors though they may be necessary for general personal investors. It is difficult for an investor to incorporate an SPC under the SPC Law and make it the proprietor of the business of an anonymous partnership (*tokumei kumiai*). As each set of standard terms and conditions used for each contract requires authorization, it is impossible to execute a flexible contract promptly.

- A legal system enabling REIT should be established.

(5) Civil Code; Assignment Exceptions Law

- It should be highly valued that the Assignment Exceptions Law affords an assignee the power to give assignment notice to the obligor. It is provided that the perfection requirement shall be met by delivering a certificate of registered matters (a "Registration Certificate") to the obligor. Once it becomes necessary to perfect the

assignment against the obligor, to seek the issuance of a Registration Certificate and deliver it to the obligor will be a greater burden than notice under paragraph 1 of Article 467 of the Civil Code. Moreover, there is a possibility that this notice system will not function very well in practice (it being a concern that content-certified mail cannot be used). Can this system of perfection notice to the obligor be simplified, for example, by allowing the giving of the registration number or other appropriate reference instead of delivery of a Registration Certificate? Even though a Registration Certificate is required, it is suggested that the Law explicitly provide the interpretation that when a Registration Certificate is not immediately available for delivery, it shall be allowed to send a written notice indicating certain matters (an outline of the registration, an explanation that a Registration Certificate will be sent as soon as it is available, etc.), and that the assignment shall be perfected against the obligor as of the date of the registration if a Registration Certificate is sent subsequently within a reasonable period.

- Severance of an assignment of receivables from the defenses against the assignor is one of the most important issues in the securitization of loan receivables owned by financial institutions. Because of this issue, these receivables are not adequately securitized. Even despite limited application to securitization, legislation is nevertheless required to appropriately harmonize the benefit of the obligor and the benefit of the assignee.

(6) Bankruptcy Law; Corporate Reorganization Law

- The requirements for an act subject to the avoidance power of a trustee should be clarified. For this purpose, possible reforms will be to clarify the requirements for a purchase transaction that cannot be avoided, by introducing the concept of "ordinary course of business", and to clarify the requirements for an act "creating a security interest" that is subject to the avoidance. Under existing case law, even the sale of a real property at a fair price may possibly be subject to the avoidance. Insofar as a price of a purchase transaction is fair, however, such transaction will not decrease the value of the assets of the obligor, and, ultimately, to the benefits of general creditors. It should be understood that such a transaction cannot be avoided as a general rule. This understanding should be explicitly provided in the Laws.

- With respect to Article 63 of the Bankruptcy Law and Article 106 of the Corporate Reorganization Law, one possible reform is to insert an express clause providing an exception to the effect that these Articles shall not be applied to finance lease

contracts (including, for example, auto-lease contracts under which the residual value is fixed relatively high).

- With respect to the validity of a contract provision that makes cancellation of an agency agreement impossible or that terminates an agency agreement on the grounds of a filing for a corporate reorganization procedure, etc., clarification by legislation is necessary, particularly in respect to the latter.

- When several classes of securities are issued, unwanted effects on one class caused by another should be avoided. For this purpose, it is necessary to clarify the validity of a limited recourse clause.

- A possible reform is to create a system under which investors in loan participation transactions will be protected by providing exceptional treatment in the case of bankruptcy of a bank or other financial institutions, as is the case in the United States.

(7) Secured Bond Trust Law

- When an SPC intends to issue bonds, the existing Secured Bond Trust Law has some shortcomings when attempting to collateralize the assets backing such bonds. For example, the Law limits the types of collateralizable assets (that is, as collateralization of a receivable, only a pledge of a receivable by way of a deed is permissible). The Law must be revised in this respect. There may be a scheme for ABS under which the SPC will receive all or part of the payments with respect to the collateralized assets, first apply the receipt to the payment of the necessary expenses (prior to the payment of the bonds [ABS]), and then deliver the remainder of the receipt to the trustee, unless a default event occurs, during the duration of the ABS. If such a scheme is considered to be “to alter the collateral assets” (Article 75 of the Law), and, therefore, requires a decision of the general meeting of bondholders, then it will be extremely difficult, in practice, to issue ABS under the Law. If such an appropriation of receipts is explicitly authorized in the trust deed, however, can it be understood that the substance of the security interest is initially agreed upon as such and, therefore, that a subsequent appropriation of cash flow with respect to the collateral assets will not constitute an act “to alter the collateral assets”? If it can, then a decision of the general meeting of bondholders will not be required. It is suggested to explicitly support this interpretation. A similar problem exists with respect to disposal of collateral.

- The scope of application of the Law is unclear. More specifically, while it is a generally accepted interpretation that in the case of bonds that are governed by a foreign law and have been issued in a foreign country, if the issuer is a foreign corporation, the Law will not be applicable even though the collateral exists in Japan (in spite of the fact that the security interest will be governed by Japanese law), it is unclear, from the face of the Law, whether the same interpretation will apply, for example, if the issuer is a Japanese corporation. It is desirable for this point to be clarified. (In this regard, it is understood that such a legal relationship cannot be clarified by excluding the application of the Law by agreement between the parties. It is also necessary to consider whether this understanding should be maintained in the future.)

(8) Trust Law

- It is desirable to reform the Securities and Exchange Law to include trust certificates in the definition of "securities" thereunder, as part of the efforts to build up the infrastructure for securitization activities utilizing a trust.

- In the case of cash included in trust assets, the separation of the trust funds is ordinarily made only on the account book as required under Article 28. Therefore, there is a doubt whether the trust assets will be protected in the case of bankruptcy of the trustee. Reform is required.

- It is necessary for the Law to include exceptional provisions to Article 36 to clarify the limited liability of beneficiaries (investors) and ensure that the liability of the trustee will be limited to the trust assets.

(9) Law Concerning Special Measures for Servicing Business ("Servicer Law")

- Consumer loans and unsecured commercial loans made by nonbanks should be included within the scope of eligible claims.

- It should be clearly provided that an originator can perform servicing functions without giving rise to any problems under the Practicing Attorneys Law even if such originator does not have a servicer license.

- It should also be clearly provided that anyone who does not have a servicer license can perform servicing functions, as a profit-making business, with respect to claims that may be subject to a legal contest, without giving rise to any problems under the Practicing Attorneys Law, by appointing another entity holding a servicer license. Without reform in this respect, installation of backup servicers would be costly, and, therefore, it is feared that utilization of the securitization mechanism will be inhibited.

(10) Law Concerning Agreements Granting Specified Credit Lines

- It is necessary to include SPC's under the SPC Law within the scope of eligible parties.

(11) Other Legal Systems Relating to Securitization of Real Estate or Loan Receivables Secured by Real Estate

- Difficulty to Anticipate Modification of Terms or Renewal or Non-Renewal of a Building Lease Agreement

  Article 32 of the Land and Building Lease Law provides that either party to a lease may at any time request an increase or decrease of the rent and invalidates a covenant that the parties will not request such decrease. Article 28 of the Law provides that a renewal of a lease may not be denied unless there is a good reason to deny. The scope of good reasons is limited, and it is difficult to anticipate under what circumstances such a reason will be recognized. It is expected that these problems will be remedied by introducing the system of a fixed-period lease. Under the presently proposed system of a fixed-period lease, however, it is planned that the system will not apply to the existing leases. The reform will thus not be sufficient from the perspective of promotion of asset securitization. It is necessary for the Law to more clearly define the good reasons. With respect to cases seeking an increase or decrease of the rent, there also are some problems: *e.g.*, an agreement that the parties will comply with a decision of the mediator(s) shall be effective only if it is made after one party files mediation. It is necessary to establish a system under which rent disputes can be resolved earlier.

- Transaction Cost

  Although the registration and license tax rate has been reduced, it remains on a higher level. The registration and license tax should be assessed on a fee basis. In other words, the registration and license tax rate should be such that they

sufficiently cover the costs of the service of real estate registration affairs by the regional Judicial Affairs Bureaus. The necessity of the real property acquisition tax should also be reconsidered.

- Stiffness of Land Readjustment

  In areas of dispersed land use, quality of space should be improved through concentration of usage by land readjustment. Under the existing land readjustment administration, the interpretation of Article 89 of the Land Readjustment Law has been stiffened. The principle that a land lot should be re-plotted in the original position is so predominant that no flexible readjustment is possible.

- Stiffness of Land Leases

  It is provided that the duration of a fixed-period land lease shall be 50 years or longer in the case of an ordinary land lease and within the range of 10 to 20 years in the case of a land lease for commercial use. It is impossible to create a fixed-period land lease for a period ranging from 21 years to 49 years. It is also provided that a fixed-period land lease may not be renewed, but that a new lease may be created on the same lot. These provisions are inappropriate.

- Buried Cultural Artifacts

  Because of the existence of an administrative guidance stating that the costs of survey and unearthing of buried cultural artifacts should be borne and paid by the developer of the land, the risk to be assumed by the developer when buried cultural artifacts are discovered is extremely great. It is necessary to work out a mechanism to share such risk.

- Relation between the Housing Land and Buildings Transaction Broker Law and SPC's

  When an SPC for the securitization of real estate engages in sales transactions of the underlying real properties, is it necessary for the SPC to obtain a license of housing land and building broker? It is provided that an SPC under the SPC Law will not need this license. How about other SPC's? Also, how about a scheme for repackaging trust beneficiary interests (under which the underlying real properties will be transferred in trust to a trust bank and the SPC will hold the trust beneficial interest in the trust)? At least in this case, is there any room to allow the interpretation that an SPC will not require a housing land and buildings broker's license?

(12) Others

- It is necessary to simplify, and increase the transparency of, the procedure to enforce a security interest in order to improve the infrastructure to allow the general public to purchase properties in such procedure.

- With respect to the real property registration system, a filing system should be introduced under which the registration books will be maintained in electronic/magnetic form, applications for registration will be processed online so that the creation of a mortgage and the payment of the purchase price can be made simultaneously between parties in distant places.

- The Banking Law and other relevant rules should be amended to allow banks to engage in backup servicing business and management of SPC operation, by including such functions in the list of incidental functions under the Banking Law. It is also desirable to design systems under which banks, securities and trust business subsidiaries can cooperate as closely as possible in the product development and marketing stages (because of characters of securitization transactions, e.g., a trust may be used in the middle of the entire process, or the exit end of the process may take the form of securities).