October 1, 2001
Financial Law Board

Interim Note on Limited Recourse Clauses

1. Issues

In some cases, a creditor and a debtor enter into an agreement which limits a source for payments of certain monetary claims to certain prescribed assets instead of the whole assets of the debtor. For example, when a single SPC (Special Purpose Company) issues several series of ABSs (asset backed securities), it is common to make an agreement under which each series is to be paid only from certain assets respectively, and hence the assets reserved for one series are not to be used for other series.[1] Another example is that a business company makes a non-recourse loan on certain prescribed assets as security. In this case, the lender and the business company as a borrower enter into an agreement under which no assets other than the prescribed assets would be the source for payment of the loan. A further example is that an agreement is made in connection with trust under which only the trust assets shall be the source for payment for the obligations which the trustee may incur in the course of the operation of the trust.[2]

These agreements are generally referred to as limited recourse clauses, and are recognized as one method for generating a broad variety of cash flow. Given this recognition, these types of agreements should be accepted as lawful as long as the limited recourse clauses clearly set forth the legal relationships between the parties, and hence the economic significance of such agreements themselves can be properly evaluated, and as long as such agreements would not cause any unforeseeable disadvantage to any party other than those who have entered into the agreement, or cause any unnecessary confusion in civil execution or insolvency proceedings.

The Note considers what type of legal relationship which limits a source for

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[1] Kazuhiko Yamamoto, *Saiken Ryudôka No Sukîmu Ni Okeru SPC No Tôsan Tetsuzuki Bôshi Sochi* (Preventing Bankruptcy Proceedings of an SPC under an Asset Securitization Scheme), 17 KIN`YÛ KENKYÛ no. 2 at 124-125 (1998), and Masaru Ono, *Shôkenka, Ryûdôka Ni Okeru Shuyô Na Hôritsujô No Ronten To Kanren Suru Kinji No Rippô* (Main Legal Issues and Recent Legislation Related to Securitization), GEKKAN SHIHON SHIJÔ no. 159 at 41-42 (1998).

[2] Hideto Nakanishi, *Daisansha Ni Taisuru Jutakusha Sekinin No Gentei* (Limitation of the Liability of Trustees to Third Parties), SHINTAKU HÔ KENKYÛ no. 20, at 54 et seq. (1996). See also Institute for Money and Economic Studies of the Bank of Japan, *Kin`yû Torihiki Ni Okeru Juninsha No Gimu To Tôshika No Kenri* (Duties of Fiduciaries and Rights of Investors in Financial Transactions), 17 KIN`YÛ KENKYÛ no. 1, at 73-74 (1998).

payments of certain monetary claims to certain assets instead of whole assets of a debtor would be desirable, and what sort of agreement would enable a creditor and a debtor to achieve this type of legal relationship. The following discussion first examines the relationship between a creditor and a debtor who have executed a limited recourse clause (in **2.**) and then considers legal relationships, including those of other creditors, in the event of bankruptcy of the debtor (in **3.**).

2. Relationship between Creditor and Debtor

(1) Compulsory Execution by a Creditor

When a creditor and a debtor agree that a source for payments of certain prescribed monetary claims (hereinafter "Limited Recourse Claims") shall be limited to certain prescribed assets of a debtor (hereinafter "Limited Recourse Assets"), it is generally intended that a creditor may not carry out compulsory execution against assets of the debtor, except for the Limited Recourse Assets.

It is generally agreed that there is no need to afford protection to creditors contrary to their intentions, and consequently it can be accepted as lawful that an agreement between a creditor and a debtor in connection with pursuing civil execution eliminates execution or limits a legally prescribed extent of execution (an agreement limiting execution) to a creditor's disadvantage. And an agreement which restricts execution only to certain assets or certain types of assets (an agreement limiting liability) is considered to be one type of agreements limiting execution.[3] With respect to execution, if an agreement[4] clearly state itself to be a limited recourse clause, then the agreement should be accepted as legally valid.[5]

Consequently if a creditor with a limited recourse clause sues and demands payments of the claims covered by the clause, and a debtor as a defendant responds by asserting that her/his liability should be limited to Limited Recourse Assets under the clause, then the court should render a judgment[6] which states that "the defendant shall pay ¥xxx to the limit of her/his assets

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[3] TÊICHIRO NAKANO, MINJI SHIKKÔ HÔ (SHINTEI 4 HAN) (Civil Execution Law, New 4th Edition) at 75 (Sêrin Shoin, 2000).

[4] For example, the clause which states that "the creditor shall not carry out civil execution on her/his claims of XXX against the assets of the debtor except for YYY and ZZZ."

[5] See Yamamoto, *supra* note 1, at 125-126.

[6] If Limited Recourse Assets consist of many separate assets, then it is possible that a statement of assets could be attached to the judgment, while the text of the judgment may state "to the limit of the assets stated in the attached statement" instead of "to the limit of defendant's assets AAA and BBB."

AAA and BBB."[7] If the creditor uses a judgment of this type as a writ of execution to carry out civil execution against the assets of the debtor other than Limited Recourse Assets, then the debtor may demand a prohibition against compulsory execution, by asserting third party objections (Civil Execution Law Article 38).[8]

(2) Limited Recourse Assets

A limited recourse clause would determine the range of Limited Recourse Assets within the debtor's assets. If an agreement does not clearly state whether certain assets are included in Limited Recourse Assets, then the answer would depend on an interpretation of the agreement, i.e. an interpretation of the limited recourse clause, and would involve a reasonable interpretation of the intentions of the parties.

One possible issue would be whether proceeds received from disposition of Limited Recourse Assets as well as fruits derived or produced from Limited Recourse Assets fall within Limited Recourse Assets. In many cases, it would economically reasonable to include the proceeds and the fruits into the cash flow which the parties seek to achieve in addition to original Limited Recourse Assets which are disposed of or which derive or produce the fruits. It may be possible to hold that for practical purposes the proceeds

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[7] "(A suit for payments) includes assertions of the enforceability of the claim, the existence of the liability (in the sense that the assets of the defendant are bound by the claim) and the extent thereof (the defendant may assert the defense of limitation of liability). A judgment for payments is suited to being the basis for compulsory execution as it declares both the substance of the claim and the enforceability of the claim or the existence and the extent of the liability, although in most cases the latter is not expressly stated" (NAKANO, *supra* note 3, at 163-164). Besides, the inherited liabilities, where there has been a qualified acceptance (*gentei shônin)*, are limited to certain assets of the debtor, and since in this sense these types of liabilities are similar to Limited Recourse Claims(liabilities). And hence court decisions concerning these types of inherited liabilities are of reference. A judgment by the *Daishin`in*(former Supreme Court of Japan) on June 2, 1932 held that a judgment, which ordered the successor who had effected a qualified acceptance to pay the inherited liabilities, shall include the caveat that payments of the inherited liabilities were limited to the extent of the inherited assets, and stated, "appellant shall pay the amount of ¥4,500 and the amount equivalent to 10 percent per year on said amount from May 25, 1927, limited to the extent of the assets that appellant has inherited from Kamenosuke Matsuda" (Kamenosuke Matsuda was the ancestor of the appellant) (June 2, 1932, 11 TAIHAN MINSHÛ at 1099).

[8] This is the same as the situation in which a qualified acceptance has taken place. In this case, the debtor who effected the qualified acceptance may bring an action of third party objections if there is a dispute as to whether certain assets which have actually been attached are the inherited assets or own assets of the debtor (NAKANO, *supra* note 3, at 270 and 295).

and the fruits are in fact the cash flow that the parties seek to achieve, rather than original Limited Recourse Assets which are disposed of or which derive or produce the fruits. For this reason, in most cases, parties include a provision within a limited recourse clause which states that proceeds and fruits are included in Limited Recourse Assets. Nevertheless a limited recourse clause is an agreement between a creditor and a debtor which states that the creditor may not carry out civil execution against the assets other than Limited Recourse Assets (see **(1)** above), and does not provide to the creditor any interest such as a right *in rem* over Limited Recourse Assets. Also, where there is no statutory provision concerning Limited Recourse Assets as is prescribed under Article 14 of the Trust Law[9], there are no grounds for granting a creditor any interest such as a right *in rem* over proceeds or fruits, regardless of the intentions of the parties. For this reason unless a limited recourse clause clearly states that proceeds from disposition of Limited Recourse Assets and fruits derived or produced from Limited Recourse Assets are included in Limited Recourse Assets, the determination of whether the proceeds and the fruits are included in Limited Recourse Assets would be made on the basis of a reasonable interpretation of the intentions of the parties (one example of a reasonable interpretation of the intentions of the parties would be an SPC that issues more than one series of ABSs, as discussed in **(3)** below).

(3) Disposition of Limited Recourse Assets

A limited recourse clause may permit or prohibit disposition of Limited Recourse Assets. This causes the issue of whether disposition of Limited Recourse Assets would be valid if a debtor disposes of Limited Recourse Assets without obtaining a creditor's consent regardless of the agreement which states that the debtor must not dispose of these assets without the creditor's consent. It is generally agreed that even if a holder of interests disposes of the interests and thereby violates the agreement with a third party under which the holder may not dispose of the interests, the disposition is valid regardless of the subjective status of the parties to whom the interests are disposed of. This interpretation would also apply to a limited recourse clause. Consequently if a debtor disposes of Limited Recourse Assets without a creditor's consent despite the stipulation that the debtor may not dispose of Limited Recourse Assets without the creditor's consent, then the parties to whom Limited Recourse Assets are disposed of will acquire them regardless of their subjective status.[10]

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[9] KAZUO SHINOMIYA, SHINTAKU HÔ (SHIN BAN) (Trust Law, New Edition) at 61 (Yûhikaku, 1989) states that Article 14 of the Trust Law grants subrogation of trust assets, and hence it grants beneficiary's interests an effect similar to rights *in rem*.

[10] The interests of the creditor who has executed the limited recourse clause are different from the rights *in rem* type of interests of the person who has acquired ownership of real property which has not been perfected, as in the case of the first assignee in a double assignment of real property. Consequently it is not appropriate to

If, however, a debtor disposes of Limited Recourse Assets without a creditor's consent, and violates an agreement not to dispose of them without a creditor's consent, then the debtor will violate the provision of the limited recourse clause, and consequently will probably incur a liability for damages (Civil Code Article 415). If a debtor disposes of Limited Recourse Assets and thereby reduces the amount of assets reserved to pay the liability, and consequently a creditor receives less payment on the liability than she/he would otherwise receive, then the difference would constitute damages for which the creditor is entitled to compensate. If the provisions of the limited recourse clause state that the claims for damages also constitute Limited Recourse Claims, then this event would be governed by these provisions, but otherwise the claims for damages should be paid from whole assets of a debtor, since if a source for payments of the claims were to be limited to Limited Recourse Assets, the monetary amount that the creditor could receive from the debtor would be the same as if the claim were to be denied, and consequently there would be no meaning in finding the violation which caused the claims for damages.

Consideration from another perspective, however, is required in the case of the limited recourse clause of an SPC which issues more than one series of ABSs, since in this case the limited recourse clause protects the interests of the holders of other series of ABSs. The reasonable approach in this case is to understand that if the debtor disposes of Limited Recourse Assets without the creditor's consent, then the claims for damages incurred by the violation of the clause would be Limited Recourse Claims, and that a source for payments should be limited to Limited Recourse Assets in order to protect the interests of the holders of other series of ABSs, since if the claims for damages were to be paid from all assets of the debtor without limitation to Limited Recourse Assets, then the assets reserved for other series of ABSs would also be included in the assets encumbered by the claim, which would therefore damage the interests of the holders of other series of ABSs.

Nevertheless, even if the claims for damages incurred by the violation of the agreement, which prohibits disposition of Limited Recourse Assets without a creditor's consent, are Limited Recourse Claims, and a source for payments is limited to Limited Recourse Assets, then there is still the issue of how to handle the proceeds received from disposition of Limited Recourse Assets, unless this is so prescribed in the agreement (see **(2)** above). If this issue is resolved by stating that the proceeds do not constitute Limited Recourse Assets on the grounds that the agreement does not state so, then this would only result in disposition of Limited Recourse Assets in order to avoid having them encumbered by the ABSs. This is not a

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consider the rules concerning a party of bad faith with malice which apply to a double assignment of real property as being of reference to a case of disposition of assets in the violation of the limited recourse clause.

reasonable resolution in view of the meaning of the limited recourse clause, and consequently the proceeds should be considered to be Limited Recourse Assets through a reasonable interpretation of the intentions of the parties (see **(2)** above).

(4) Obligations of Debtor

A debtor with the limited recourse clause would have an obligation not to dispose of Limited Recourse Assets unless the limited recourse clause permits to do so, even if there is no provision which prohibits disposition of Limited Recourse Assets without a creditor's consent, as discussed in **(3)** above. A debtor's obligation not to dispose of Limited Recourse Assets should be especially emphasized if there is no provision which states that proceeds received from disposition of Limited Recourse Assets also constitute Limited Recourse Assets, since disposition of Limited Recourse Assets and reduction of the assets reserved for the claim could reduce the amount of payments that could be received by the creditor. This type of obligation is naturally what the debtor may incur as a result of the limited recourse clause.

In the same manner, a debtor also has an obligation not to destroy or reduce Limited Recourse Assets. As with **(3)** above, the claims for damages would arise if the debtor violates this obligation and the claims for damages would be paid from whole assets of the debtor and not only from Limited Recourse Assets, unless the limited recourse clause states that the claims for damages is paid only from Limited Recourse Assets. As also discussed in **(3)** above, however, since the limited recourse clause of an SPC which issues more than one series of ABSs also protects the interests of the holders of other series of ABSs, it is reasonable that the claims for damages should be paid only from Limited Recourse Assets through making the specific agreement.

If the limited recourse clause states that a debtor has discretion which includes the management and disposition of Limited Recourse Assets, then the debtor would naturally be permitted to manage and dispose of these assets pursuant to the discretion that she/he has been granted, and consequently granting of discretion to the debtor will not cast any doubt on the validity of the limited recourse clause itself.

(5) Assignment of Limited Recourse Claims

When Limited Recourse Claims are assigned, there is no need for the assignee to acquire interests in excess of those held by the assignor, and when Limited Recourse Claims are attached, there is no reason for the person with the right of attachment to exercise rights or acquire interests in excess of those held by the debtor. Thus these events should be interpreted as causing no change to the effect of the limited recourse clause in connection with Limited Recourse Assets, and even if the creditor falls into

bankruptcy there would also be no change to the effect of the limited recourse clause.

3. The case of Debtor's Bankruptcy

(1) Concept of Insolvency

"Insolvency" as a cause for bankruptcy of a legal person as debtor (Bankruptcy Law Article 127(1)) generally means that the total valuation amount of liabilities exceeds that of assets.[11]

Since Limited Recourse Claims are paid from the assets of the debtor limited to the maximum of Limited Recourse Assets, if a bankrupted parties owes liabilities with the limited recourse clause, the amount added to their liabilities in determination of insolvency would be reduced to the valuation amount of the relevant Limited Recourse Assets as long as the amount of Limited Recourse Claims exceeds the valuation amount of Limited Recourse Assets.

(2) Distribution under Bankruptcy Proceedings

The basic idea in considering the method of distribution under bankruptcy proceedings is that if there is the limited recourse clause, creditors who entered into the limited recourse clause (hereinafter "Limited Recourse Creditors") and other creditors (hereinafter "General Creditors," and the claims held by the General Creditors hereinafter are referred to as "General Claims") are treated in the same manner as if there were no limited recourse clause, and General Creditors enjoy indirect benefit by the existence of the limited recourse clause.

The following two methods can be thought as practical methods of distribution to implement this idea. Under the first method, Limited Recourse Creditors would not receive any distribution in excess of the valuation amount of Limited Recourse Assets, while under the second method, Limited Recourse Assets would be distinguished from the assets other than Limited Recourse Assets (hereinafter "Other Assets"), and Limited Recourse Assets would be distributed to Limited Recourse Creditors and General Creditors *pari passu*, while Other Assets would be distributed to Limited Recourse Creditors being subordinate to General Creditors.[12] Either of these methods of distribution is consistent with the

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[11] See KATSUMI YAMAKIDO, HASAN HÔ (Bankruptcy Law) at 48 (Sêrin Shoin Shinsha, 1974). See also MAKOTO ITO, HASAN HÔ (ZENTEI DAI 3 PAN HOTEI BAN) (Bankruptcy Law (Completely Revised 3rd Edition, Supplemented Edition) at 69 (Yûhikaku, 2001).

[12] The actual amount of distributions under the second method will differ depending on whether the amount of General Creditors' claims, which is counted as the basis for proportional distributions of Limited Recourse Assets at the same priority, is (i) the

purpose of the limited recourse clause which limits a source for payments of certain monetary claims to certain prescribed assets of the debtor (see **1.** above), and is also consistent with the provisions (see **2. (1)** above) under the limited recourse clause which state that the civil execution only be made against certain assets or certain types of assets in execution.

This causes the issue of what type of agreements shall be made as limited recourse clauses which govern distribution in bankruptcy proceedings in order to achieve one of these methods of distribution, and whether these agreements would be accepted as valid in bankruptcy proceedings.

One possible agreement for the first method of distribution might be "if bankruptcy proceedings have been commenced on the debtor, and if the amount of distributions in connection with Limited Recourse Claims exceeds the valuation amount of Limited Recourse Assets, the Limited Recourse Creditor will waive her/his right to receive distributions for the portion to be distributed which exceeds the valuation amount of Limited Recourse Assets." Under substantive laws, this type of agreement can be explained by a legal structure under which creditors waive (some of) their right to receive distributions subject to conditions precedent, and consequently this type of agreement should be accepted as valid in bankruptcy proceedings. In this case, the filing of claims would state the entire amount of Limited Recourse Claims, and at the time when the provisional amount of distributions is calculated according to the filing and if the provisional amount of distributions exceeds the valuation amount of Limited Recourse Assets, then Limited Recourse Creditors would waive their rights to receive distributions of said excess portion. Consequently General Creditors would receive distributions consisting of the portion waived by Limited Recourse Creditors and the provisional amount of distributions made to General Creditors.[13]

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entire amount, or (ii) the amount prorated to Limited Recourse Assets by the ratio of the valuation amount of Limited Recourse Assets and that of Other Assets (Yamamoto, *supra* note 1, at 126, footnote 71, states that either of two approaches above is possible, and that (ii) is one of them). Of these approaches to implement the second method, (i) would be the appropriate since it is consistent with the premise that General Creditors are to be treated in the same manner as if there were no limited recourse clause, and consequently the following discussion assumes that the second method would be implemented according to (i).

[13] Consider for example the following situation. Limited Recourse Claims amount to 600 and General Claims amount to 200 (total liabilities of 800). Limited Recourse Assets amount to 100 and Other Assets amount to 100 (total assets of 200). The distribution ratio under the provisional calculation would be 200/800, and the provisional amount of distributions to Limited Recourse Claims would be 150 (=600*200/800). Limited Recourse Creditors would waive their rights to receive distributions in connection with the portion (50) which exceeds the valuation amount of Limited Recourse Assets (100). The provisional amount of distributions to General

On the other hand, a possible agreement for the second method of distribution might be "distributions to Limited Recourse Claims from the portion corresponding to the valuation amount of the Other Assets shall be made on the basis that the full amount shall be paid for General Claims." This method adopts the idea that distributions from the portion corresponding to the valuation amount of Other Assets are to be distinguished from those from Limited Recourse Assets, and Limited Recourse Claims over Other Assets shall be subordinate to General Claims, pursuant to the agreement between Limited Recourse Creditors and the debtor. For this reason, full payments of General Claims constitute a condition precedent to making any distribution to Limited Recourse Claims from Other Assets.[14] Nevertheless it is easy to see that the actual procedures would be quite complicated if distributions are attempted as set forth in such agreement, and consequently this Note has reserved making any conclusion concerning the validity of the second method, and has merely stated it as a possible method.

Creditors would be 50 (=200*200/800). To this would be added the portion (50) waived by Limited Recourse Creditors, so that 100 would be distributed to General Creditors. As a result of this calculation, the amount of distributions to Limited Recourse Claims would be 100 and that to General Claims would be 100.

[14] For the purpose of comparison, the following uses the same figures as in note 13 (Limited Recourse Claims of 600, General Claims of 200, total liabilities of 800, and Limited Recourse Assets of 100, Other Assets of 100, total assets of 200). First calculation is made of Limited Recourse Assets, resulting in the amount of distributions of 75 to Limited Recourse Claims (=600*100/800), while the amount of distributions to General Claims would be 25 (=200*100/800). Even if the entire valuation amount of Other Assets (100) is distributed to General Claims (total amount of distributions of 125), this would still not result in full payments of General Claims (200). Consequently no distribution would be made from the valuation amount of Other Assets to Limited Recourse Claims, and thus the amount of distributions to Limited Recourse Claims would be 75, and that to General Claims would be 125.