

Effect of Pledge Established on Beneficial Interest in Trust

Introduction

Most trust products of the past consisted only of properties with high liquidity such as money or marketable securities. In securing the monetary value, pledges established on beneficial interests are thought to be more or less the same as pledges established on general monetary claims or marketable securities. Trusts of this type are likely to be used more frequently in the area of non-recourse finance in light of their convenience as a legal technique for securing the economic value of trust properties whose management strategy involves enjoying the benefits of bankruptcy remoteness (as in the case of trusts used as vehicles to take over properties in asset securitization transactions). Among other things, the beneficial interest is an important security for financial institutions in non-recourse finance that can be used as an asset helpful for controlling properties in trust and securing their economic value.

In particular, in the cases of asset securitization, especially in cases of securitization based on real estate development where a trustee has various rights with respect to real estate or sites thereof in trust during the trust term, the legal relations of the properties subject to the beneficial interest tend to become intricate. Further, the amendment of the Trust Business Law enables trust banks to establish trusts as trustees with respect to various properties. As a consequence, the legal nature of such properties subject to the beneficial interest and the contents of the beneficial interest are expected to increase in variety.

Therefore, when a financial institution is establishing a pledge on a beneficial interest, and is pondering its schemes for various transactions using the trusts, it must consider the effects which may be conferred onto the pledge with respect to the range of powers of the beneficial interests. After making some clarifications on the legal nature of beneficial interests, the following document summarizes our considerations on the effect of pledges established on beneficial interests.

1 Legal Position of Pledge on Beneficial Interest

There is no provision in the Trust Law regarding a pledge established on beneficial interest (“Pledge on Beneficial Interest”). Even in the Loan Trust Law and the Investment Trust and Investment Corporation Act (the “Investment Trust Laws”), two special laws concerning trusts, none of their provisions directly address the subject of Pledge on Beneficial Interest. In fact, the only relevant provision is a provision governing a pledge on certificates of beneficial interests in Special Purpose Trusts under the Law Concerning Liquidation of Assets (the “Asset Liquidation Law”) applied by way of *mutatis mutandis* application of the provision for pledge of shares under the Commercial Code (Article 178, Paragraph 1 of the Asset Liquidation Law, and Articles 207 and 208 of the Commercial Code).

Consequently, we assume, in considering the effect of a Pledge on Beneficial Interest, that

the provisions of the Civil Code as a general law shall apply to such pledge. This gives rise to the question about whether a Pledge on Beneficial Interest should be categorized as a pledge of real estate, a pledge of movables, or a pledge of claims. To answer this question, we need to clarify the legal nature of beneficial interest.

Various theories have been proposed on the legal nature of a trust which forms the basis of a beneficial interest. Foremost examples include the “claim theory”¹ (the traditional and commonly accepted theory which holds that the transfer of a trust property to a trustee is deemed to be the transfer of an ownership right and hence the right of the beneficiary to the trustee shall be deemed a claim to the trustee), the “substantial legal entity theory”² (a minor but predominant theory which holds that a trust property shall have a substantial legal entity and that the beneficiary shall have the ownership right to the trust property as well as the claim to the trustee), and other theories based on claim theory. To date, however, no common consensus has been reached³.

Nevertheless, most of academic views including claim theory acknowledge that a beneficial interest is similar in nature to a claim under the Civil Code, and even the substantial legal entity theory, a theory which acknowledges the existence of ownership rights as the legal nature of beneficial interests, also assumes that the provisions regarding the transfer and pledge of claims under the Civil Code shall apply to the transfer and pledge of a beneficial interest⁴. Therefore, we can basically state that academic views acknowledge that the provisions regarding the pledge of claims under the Civil Code shall apply to the Pledge on Beneficial Interest.

Provided further that, under the Asset Liquidation Law, the provisions on the pledge of shares in the Commercial Code shall apply *mutatis mutandis* to the pledge on certificates of beneficial interest in a Special Purpose Trust, therefore, we consider it reasonable that while the Pledge on Beneficial Interest shall be considered as the pledge of claims, the pledge established on certificates of beneficial interest in a Special Purpose Trust shall be treated as an exception established by legislation. This is because the pledge of shares is originally treated as an exception of the pledge of claims under the Civil Code (Civil Code, Article 364, Paragraph 2).

Based on the understanding that the provisions on the pledge of claims under the Civil Code shall apply to the Pledge on Beneficial Interest under the current law as stated above, the following constitutes our considerations on the requirements for the establishment of the Pledge on Beneficial Interest (i.e. requirement for validity and requirement for perfection against third parties) and the effect of the pledge once established.

2 Requirements for the Establishment of the Pledge on Beneficial Interest

(1) Requirement for validity

➤ Beneficial interest similar in nature to a claim payable to a specific person (*shimei saiken*)

¹ Tetsuji Aoki *Shintaku Hô Ron* (Discussion of Trust Law) at 299-301, and Shintaro Irie *Zentei Shintaku Hô Genron* (Principle of Trust Law, Full-fledged Revision) at 150-154, etc.

² Kazuo Shinomiya *Shintaku Hô (Shin ban)* (Trust Law (New Edition)) at 79 et seq. (Yûhikaku 1989)

³ Various theories on the legal nature of trusts are described in detail in Makoto Arai *Shintaku Hô* (Trust Law) at 29 et seq. (Yûhikaku 2002)

⁴ Kazuo Shinomiya *Shintaku Hô (Shin ban)* (Trust Law (New Edition)) at 326 et seq. (Yûhikaku 1989)

(Basically, a beneficial interest other than the following beneficial interests shall be similar in nature to a claim payable to a specific person (*shimei saiken*.)

-Upon amendment to the Civil Code (enforced on April 1, 2004), a pledge on any beneficial interest comes into effect only by agreement between the parties without requiring the delivery of any instrument.

- Beneficial interest represented in bearer form certificates (Loan Trust Law, Article 8, Investment Trust Law, Article 5 and Article 49-5 and Asset Liquidation Law, Article 173)

-As each of the provisions of the special law requires delivery of the relevant certificate upon transfer, the delivery of the certificate shall be required in order to establish a pledge under Article 363 of the Civil Code.

- Beneficial interest represented in registered (non-bearer) form certificates

-Certificates of beneficial interest in registered form in any investment trust or loan trust are legally positioned only as evidential instruments, and delivery thereof shall not be required upon transfer (Investment Trust Law, Article 5⁵, and Loan Trust Law, Article 8⁶). Pursuant to Article 363 of the Civil Code, a pledge may be established on such beneficial interest only by agreement between the relevant parties, just as in the case of a pledge on a claim payable to a specific person (*shimei saiken*).

-With respect to a certificate of beneficial interest in registered form under the Asset Liquidation Law, as the delivery of the certificate shall be legally required upon transfer thereof (Asset Liquidation Law, Article 173, Paragraph 2), the delivery thereof shall be required upon establishment of a pledge pursuant to Article 363 of the Civil Code. A certificate of beneficial interest in registered form under the Asset Liquidation Law has the enhanced nature as a marketable security in contrast to a beneficial interest of loan trust⁷, and is positioned as a certificate intermediate between an academically defined “registered certificate” and an academically defined “bearer certificate”.

(2) Requirement for Perfection against Third Parties

- Beneficial interest similar in nature to a claim payable to a specific person (*shimei saiken*)

- A pledge of beneficial interest similar in nature to a claim payable to a specific person

⁵ Isao Sasaki *Tokubetsu Hô Kommentar, Shôken Tôshi Shintaku Hô* (Commentary on Special Law, Securities Investment Trust Law) at 53 (Daiichi Hôki, 1977)

⁶ Takashi Matsumoto *Tokubetsu Hô Kommentar, Shôken Tôshi Shintaku Hô* (Commentary on Special Law, Loan Trust Law) at 76 (Daiichi Hôki, 1977)

⁷ Kôtarô Nagasaki *Chikujô Kaisetsu Shisan Ryûdôka Hô* (Clause-by-clause Review, The Asset Liquidation Law) at 467 (Kinyû Zaisei Jijô Kenkyûkai, 2003)

(*shimei saiken*) is perfected upon notice to or consent by the trustee bearing a fixed date (Civil Code, Article 364).

➤ Beneficial interest represented in bearer form certificates

-A pledge on a certificate of beneficial interest in bearer form in an investment trust or loan trust shall be perfected by delivery and continuous possession of the certificate.

-A pledge on a certificate of beneficial interest in bearer form under the Asset Liquidation Law shall be perfected by delivery and continuous possession of the certificate due to the *mutatis mutandis* application of Article 207 of the Commercial Code pursuant to Article 178 of the Asset Liquidation Law.

➤ Beneficial interest represented in registered form certificates

-The same treatment as a claim payable to a specific person (*shimei saiken*) shall apply to a certificate of beneficial interest in registered form in an investment trust and a loan trust.

-A pledge on a certificate of beneficial interest in registered form under the Asset Liquidation Law shall be perfected by delivery and continuous possession of the certificate due to the *mutatis mutandis* application of Article 207 of the Commercial Code pursuant to Article 178 of the Asset Liquidation Law.

3 Effect of Pledge on Beneficial Interest

As discussed in 1 above, there are no special laws or provisions in the Trust Law on the effect of establishment of a Pledge on Beneficial Interest. The only exception is a provision governing a certificate of beneficial interest in Special Purpose Trusts under the Asset Liquidation Law. Accordingly, the effect of a Pledge on Beneficial Interest shall be subject to the provisions on a pledge of claims under the Civil Code.

(1) Extent of Effect of Pledge

(a) Right to demand payment of principal and profits

First of all, the power of a beneficial interest shall include the right to receive profits earned from operation of the trust property (right to demand profits) and the right to receive delivery of the trust property as the principal (the right to demand payment of principal), and each of these rights shall be deemed as a right to demand proprietary payment and a claim payable to a specific person (*shimei saiken*). Accordingly, the effect of the Pledge on Beneficial Interest shall be deemed to be the same as the effect of a normal pledge of

claims.

The right to demand payment of principal constitutes a main claim of the beneficial interest, and it is justifiably understood that a Pledge on Beneficial Interest shall have an effect on such right.

Secondly, the Pledge on Beneficial Interest is understood to have an effect on the right to demand profits in the same way that it has an effect on interests on general monetary claims⁸ (Civil Code, Article 87, Paragraph 2); provided, however, that the right to demand profits may be regarded as either a basic claim (*kihon saiken*) or a derived claim (*shibun saiken*), and such right which has already arisen prior to establishment of a pledge may be independently disposed as a derived claim. For this reason, the Pledge on Beneficial Interest is understood to have no effect on the right to demand profits as a derived claim.

In connection therewith, the provisions of each agreement determine when the right to demand profits arises. Under normal circumstances, the day for calculating profits earned as a result of operation of a trust property during a certain period shall be the trust calculation date under the relevant trust agreement. As the amount of profits in trust is calculated and fixed on the trust calculation date, the independent right to demand profits is deemed to come into effect on such trust calculation date. Consequently, the Pledge on Beneficial Interest is understood to have no effect on the right to demand any profits whose trust calculation date has already arrived prior to the establishment of Pledge on Beneficial Interest.

With respect to a jointly managed designated (discretionary) money trust (*goudou unnyou sitei kinsen sintaku*) (a “money in trust”) and a loan trust (*kashitsuke shintaku*) which provides for a fixed rate of returns and recovery of losses in principal or interest⁹, such trusts shall be deemed to have the same economic function as deposits, and the right to demand profits shall be deemed to affect the part of the profits calculated on a daily pro rated basis for the relevant period on and after the date of establishment of the Pledge on Beneficial Interest, regardless of whether the trust calculation date has arrived¹⁰.

(2) Binding Effect on a Pledged Beneficial Interest

(a) Interpretative application of binding effect of a pledge of claims under the Civil

⁸ Sakae Wagatsuma *Shintei Tanpo Bukken Hô* (New Edition, Law of Real Right Granted by Way of Security) at 190 (Iwanami, 1968), Kaoru Yunoki and Takio Takagi *Hôritsu Gaku Zenshû No. 19 Tanpo Bukken Hô Dai San Ban* (Complete Edition of Jurisprudence No. 19 Law of Real Right Granted by Way of Security, Third Edition) at 149 (Yûhikaku, 1982)

⁹ With respect to a money trust without specified method of operation, the parties are permitted to enter into a contract for replacement of losses in principal or interest pursuant to Article 9 of the Trust Business Law.

¹⁰ For an opinion to the same effect regarding the scope of effect of an attached beneficial interest, please see Yoshihiro Kataoka *Kinsen Shintaku Juekiken no Sashiosae ni tsuite* (Attachment of Beneficial Interest in Money Trust) (Kinyû Hômu Jijô No. 1198, at 18)

Code

It is understood that the binding effect of a pledge of claims shall be the same as the effect of an attachment of claim, and further, that the collection, repayment, exemption, offsetting, and novation of a claim or any other actions that cause extinguishments or changes of a pledged claim may not be effective against the pledgee by analogy of Article 481, Paragraph 1 of the Civil Code¹¹. Further, any change unfavorable to the pledgee such as an extension of the due date or reduction in the interest rate may not be effected¹².

Accordingly, it is generally understood that payment of profits in trust and delivery of the principal from the trustee to the beneficiary, being the pledgor, may not be effective against the pledgee as the effect of the binding effect of the Pledge on Beneficial Interest. It shall be noted, however, that an action contrary to such binding effect shall be permitted upon confirmation or consent by the pledgee¹³. In transactions of real estate securitization, for example, a pledge agreement generally provides that a pledgor is permitted to receive profits until the occurrence of any event of default with respect to any loan extended by a financial institution acting as the pledgee to an SPC holding a beneficial interest.

In addition, the release of a beneficial interest by the pledgor constitutes a termination event for the trust which causes the trust property to be returned to the settlor or his heir¹⁴. Accordingly, it should be understood that such release may not be effective against the pledgee in light of the effect of the binding effect mentioned above.

(b) Effect of pledge against right of instruction (binding effect)

(A) Clarification of issues

Some trust agreements provide that a settlor or a beneficiary shall be entitled to give instructions on the management and disposition of trust property to the trustee thereunder (“Right of Instruction”). This Right of Instruction is not directly provided for in the Trust Law, but it can be granted to a settlor or a beneficiary under the trust agreement¹⁵.

¹¹ Sakae Wagatsuma *Shintei Tanpo Bukken Hô* (New Edition, Law of Real Right Granted by Way of Security) at 191 (Iwanami, 1968), Kaoru Yunoki and Takio Takagi *Hôritsu Gaku Zenshû No. 19 Tanpo Bukken Hô Dai San Ban* (Complete Edition of Jurisprudence No. 19 Law of Real Right Granted by Way of Security, Third Edition) at 152

¹² Ryôhei Hayashi *Chûshaku Minpô* (8) (Commentary of Civil Code (8)) at 358 (Yûhikaku, 1965)

¹³ See note 12 above.

¹⁴ Kazuo Shinomiya *Shintaku Hô (Shin ban)* (Trust Law (New Edition)) at 335 (Yûhikaku 1989), Articles 56 and 62 of the Trust Law

¹⁵ Kazuo Shinomiya *Shintaku Hô (Shin ban)* (Trust Law (New Edition)) at 311 and 343 (Yûhikaku 1989)

While this Right of Instruction is granted to a settlor in the case of a non-discretionary money trust (*tokutei kinsen shintaku*) or investment trust (*toushi shintaku*), it is normally granted to a beneficiary in the case of an asset securitization transaction. In most transactions to securitize assets, an originator acting as the settlor creates a trust by entrusting certain assets to the trustee and then transfers the beneficial interest to an SPC. This is because it is necessary to separate the Right of Instruction, which controls the relevant assets, from the originator in order to ensure that the SPC achieves bankruptcy remoteness, after the originator has transferred the assets to the SPC.

Therefore, if the Right of Instruction is granted to the beneficiary under the trust agreement, the issue arises about whether the Pledge on Beneficial Interest can bind the exercise of such Right of Instruction.

(B) Nature of the Right of Instruction

In considering the abovementioned issue, we first need to determine how the Right of Instruction granted under the trust agreement will be positioned in relation to the beneficial interest.

The Trust law has no specific provisions with regard to the Right of Instruction, and this right may be granted to the settlor or beneficiary under the relevant agreement. If this aspect is emphasized, the Right of Instruction is deemed to be a special right granted to the beneficiary by a special agreement and a right unquestionably different from the beneficial interest. From this viewpoint, the Right of Instruction is only granted to the beneficiary by a special agreement, and hence the Pledge on Beneficial Interest does not have any effect on the Right of Instruction¹⁶.

This concept suggests that when the beneficial interest is transferred, the Right of Instruction shall not be transferred together with the beneficial interest as a matter of course. But it is understood that the Right of Instruction shall be transferred, in practical terms, together with the beneficial interest, and in light of the reasonable intention between the parties, the abovementioned concept is not realistic.

The exercise of the Right of Instruction may directly affect the economic value of the trust property underlying the beneficial

¹⁶ For the viewpoint so described, please see Tomoji Akiyama *Shintaku Juekiken ni taisuru Tanpoken no Settei-Fudōsan Ryūdōka Shintaku wo Chūshin to shite-* (Establishment of Security Interest on Beneficial Interest in Trust-Focus on Trust of Securitization of Real Estate) at 20 (Shintaku Hō Kenkyū, No. 27)

interest. Hence, the Right of Instruction, which constitutes the economic value of the beneficial interest, shall be positioned as a right incidental to the beneficial interest, and it should be deemed to be subject to the disposition of the beneficial interest by way of establishment of the Pledge on Beneficial Interest (Civil Code, Article 87).

(C) Consideration of the binding effect on the Right of Instruction

Secondly, even if the Right of Instruction is subject to establishment of the Pledge on Beneficial Interest as a right incidental to the beneficial interest, we cannot conclude, solely on the basis of this premise, that the exercise of the Right of Instruction is bound as a matter of course. In general discussion on the binding effect of pledges of claims, a pledgor may exercise any rights necessary to preserve a pledged claim¹⁷. For this reason, we need to further consider whether the exercise of the Right of Instruction shall be bound even before the enforcement of the pledge if the Pledge on Beneficial Interest is to have an effect on the Right of Instruction.

In this respect, a similar issue exists concerning whether a pledge of shares can bind the exercise of voting rights by a shareholder acting as a pledgor. A commonly accepted academic view on this issue is that the establishment of a pledge does not affect the exercise of the voting right¹⁸. While this view is founded on the premise that parties only use the pledge to secure the economic value of collateral¹⁹, we have to decide whether the Pledge on Beneficial Interest has a similar effect on the Right of Instruction relating to the beneficial interest.

In contrast to the voting right of shares, the Right of Instruction for beneficial interest directly designates the manner of management and disposition of trust property. Further, it directly causes fluctuation in the value of the trust property underlying the economic value of the beneficial interest.

This, in turn, gives rise to the problem that the exercise of the Right of Instruction must be bound at a certain level by the Pledge on Beneficial Interest which pledge secures the exchange value of the beneficial interest, being the collateral.

¹⁷ Ryôhei Hayashi *Chûshaku Minpô (8)* (Commentary of Civil Code (8)) at 359 (Yûhikaku, 1965)

¹⁸ Sakae Wagatsuma *Shintei Tanpo Bukken Hô* (New Edition, Law of Real Right Granted by Way of Security) at 202 (Iwanami, 1968), Katsurô Ueyanagi, Tsuneo Ôtori, Akio Takeuchi *Shinban Chûshaku Kaisha Hô (3)* (Commentary of Corporation Law (3), New Edition) at 223 (Y ûhikaku, 1997)

¹⁹ Katsurô Ueyanagi, Tsuneo Ôtori, Akio Takeuchi *Shinban Chûshaku Kaisha Hô (3)* (Commentary of Corporation Law (3), New Edition) at 224 (Y ûhikaku, 1997)

Next, we present a judgment delivered by the second petty bench of the Supreme Court on April 16, 1999²⁰, which comments on the issues mentioned above.

This decision was handed down in a case where a pledgor of a pledge of claims filed a petition for bankruptcy against the debtor of the pledged claim. The Supreme Court decided that a pledgor cannot file petitions for bankruptcy unless they have a particular reason, such as the consent of the pledgee. The decision was based on the following reasons: the premise of collection right provided for in Article 367 of the Civil Code, “the bankruptcy of the debtor of the relevant claim has material effects on the exercise of the collection right of the pledgee; for example the bankruptcy restricts the pledgee from collecting the claim only if bankruptcy proceedings begin (please refer to Article 16 of the Bankruptcy Law); and where the debtor of a claim is a stock corporation, as in the case at hand, a corporate dissolution takes place (please refer to Article 404, item 1 of the Commercial Code), leading to a situation wherein the pledgee may not normally demand performance of the balance of the claim which remains outstanding in whole or in part after a dividend payment under the bankruptcy procedure.”

The right to file a petition for bankruptcy is the right to decide the manner of collection of a claim, in the sense that the filing party chooses to collect the claim through the bankruptcy procedure as a collective collection procedure. Therefore the abovementioned decision by the Supreme Court can be said to follow the general view about the binding effect of pledges on pledged claims.

On the contrary, the Right of Instruction of the pledgor, being a beneficiary, is the right granted under the relevant agreement and does not directly relate to the exercise of the right to demand profits or the right to demand payment of principal based on the beneficial interest. Thus, the above-mentioned decision by the Supreme Court may not be directly applicable to the Right of Instruction.

Provided, however, that in considering whether, as the Supreme Court in its decision asked, “there are material effects on the exercise of the collection right of the pledgee”, it seems that the exercise of the Right of Instruction may have material effects on the trust property because such trust property constitutes the economic value of the beneficial interest (such as instruction to sell the trust property) and therefore any exercise of the Right of Instruction may

²⁰ 53 *Minshu* 4 at 740, *Hanrei Jihô* No. 1680 at 84

impair the collection right of pledgee of the beneficial interest.

The details of such Right of Instruction vary according to the relevant agreement, and this prevents us from being able to present a uniform discussion on the issue. Nonetheless, according to the decision by the Supreme Court, we can consider that the Right of Instruction may be exercised, even if the binding effect of the Pledge on Beneficial Interest in principle affects the exercise of the Right of Instruction, if there is any “particular reason” such as the consent of the pledgee. Hence if the Right of Instruction is exercised in order to secure the value of the trust property, a “particular reason” may allow the exercise of the Right of Instruction by the pledgor²¹.

(D) Practical handling of the Right of Instruction

In relation to the above discussion, in a transaction of asset securitization, under a trust agreement an asset manager is designated as an instruction agent for the beneficiary, and under a project agreement all related parties, excluding an originator, agree on steps setting up certain rules with respect to the person who may exercise the Right of Instruction. In these rules, the financial institution acting as the pledgee, the beneficiary acting as the pledgor, the trustee, and the asset manager shall agree on such matters as the designation of the instruction agent, and the manner of termination of such agent in the case where both an event of default occurs with respect to a loan secured by the Pledge on Beneficial Interest and after which the pledgee exercises the Right of Instruction. Hence the binding effect of the Pledge on Beneficial Interest over the Right of Instruction is not necessarily considered a practical problem²².

In a transaction of asset securitization the parties having a contractual relationship with a beneficiary are limited. If all of such parties have agreed on designation of an instruction agent under the relevant agreement, there will be few cases giving rise to the problem

²¹ When there are several beneficial interests in a single trust, there are cases where matters are determined by a majority vote of the beneficiaries under the trust agreement. In these cases, we should understand that the binding effect of the Pledge on Beneficial Interest affects the exercise of the voting rights for the pledged beneficial interest with respect to the matters to be resolved that may have material effects on the exercise of the collection right by the pledgee; provided, however, that such beneficial interest shall be conditioned to be subject to a resolution by majority vote. If any resolution is adopted by a majority vote by other beneficiaries, the pledgee of the beneficial interest is deemed to follow such resolution.

²² In transactions of asset securitization, the effect of the Right of Instruction on the Pledge on Beneficial Interest is not necessarily clarified in all cases. In cases where this issue is left unclear, the determination of the person exercising the Right of Instruction by agreement among the parties to the related agreements shall be deemed to be a tentative solution. This is because only limited parties have related claims and obligations where an SPC holds a beneficial interest in an asset securitization contract, and practical problems are recognized as unlikely to arise if the parties agree on such matter.

of binding effect of the Pledge on Beneficial Interest over the Right of Instruction; provided that the designation of an instruction agent by the beneficiary is deemed to be a delegation, the beneficiary, being the delegator, may freely terminate such delegation under Article 651 of the Civil Code. While it is provided that the designation of the instruction agent by way of such delegation may not be terminated under the relevant agreement in many cases, a major theory holds that any agreement on the impossibility of terminating a designation shall be deemed invalid under Article 651 of the Civil Code²³. Therefore, even if an instruction agent is designated, we must theoretically pay attention to the binding effect of the Pledge on Beneficial Interest over the Right of Instruction.

(E) Issue relating to the effect of the binding effect on the Right of Instruction

In the case that the Pledge on Beneficial Interest is deemed to have binding effect over the Right of Instruction, and if any transaction relating to the trust property has been conducted between the trustee and a third party upon any instruction by the pledgor to the trustee (for example, the sale of any real estate, as the trust property, to a third party), the issue arises about how to consider the effect of such transaction.

In this regard, Article 31 of the Trust Law grants a beneficiary the right to cancel the disposition of the trust property performed by the trustee if said disposition does not comply with the purpose of the trust. If the Pledge on Beneficial Interest shall have binding effect over the Right of Instruction as described above, the pledgee should, based on the subrogation right of an obligee (Civil Code, Article 423), subrogate the exercise of the right held by the beneficiary pursuant to Article 31 of the Trust Law, in order to cancel the instruction contravening such binding effect given by the pledgor, because such instruction runs against the purpose of the trust.

(c) Binding effect over other rights held by the beneficiary

Various rights other than the Right of Instruction discussed in (b)

²³ On the issue of whether Article 651 of the Civil Code is a mandatory provision, one theory (major theory) holds that the waiver of termination right shall, as a general rule, be invalid except where a special contract exists permitting the waiver of any termination right exercised for the benefit of the delegatee. The other theory holds that any waiver of a termination right provided in a special contract shall, as a general rule, be valid under the principal of the freedom of contract, because said provision shall not be deemed to be a mandatory provision (Ikushiro, Hironaka *Shinban Chûshaku Minpô* (16) (New Edition, Commentary of Civil Code (16)) at 282).

above are granted to the beneficiary under the Trust Law. These include the right to demand inspection and explanation of the books and the list of properties relating to the trust business (Trust Law, Article 40, Paragraph 2), the right to demand a change in the manner of management of the trust property (Trust Law, Article 23), and the right to demand removal of the trustee (Trust Law, Article 47), etc.

Here we should consider whether the Pledge on Beneficial Interest has binding effect over these rights, just as in the discussion on the Right of Instruction. For example, the right to demand inspection of books is not thought to have a material effect on the collection right of the pledgee. Thus, the beneficiary shall not be bound, just as shareholder's rights such as the voting right are not bound, by the binding effect of the pledge of shares.

On the contrary, it is deemed desirable to consider that the Pledge on Beneficial Interest has binding effect over the right to demand a change in the manner of management of the trust property, because such right directly affects economic value of the trust property (provided, however, that if requirements under Article 23 of the Trust Law are satisfied, the beneficiary may exercise such right as an action to secure the value of the trust property). With respect to the right to demand removal of the trustee, while a change in the manager of a trust property has a material effect on the trust property, such right to demand removal of the trustee shall be exercised when the trustee breaches any of his obligations. Accordingly, such right may be considered a right to secure the value of the trust property, and concrete judgments are necessary for individual cases.

As discussed above, it is appropriate in practical terms to clarify the individual rights granted to the beneficiary under the Trust Law, and the relevant agreement should include provisions that specifically prohibit or restrict the exercise of such rights.

(d) Binding effect on the rights held by the settlor

In relation to the binding effect on rights held by a beneficiary as described above, we need to consider rights held by a settlor as a specific issue under the Trust Law. The Trust Law grants similar rights to both the settlor and the beneficiary as related parties of the trust. Concretely, the right to demand inspection and explanation of the books and the list of properties relating to the trust business (Trust Law, Article 40, Paragraph 2), the right to demand compensation for loss due to a breach of trust (Trust Law, Article 27), the right to demand a change in the manner of management of the trust property (Trust Law, Article 23), the right to demand removal of the trustee (Trust Law, Article 47), etc. are also granted to the settlor. In some cases, the Right of Instruction is granted to the settlor under relevant trust agreements or by legislation (in the

case of an investment trust (*toushi shintaku*), etc.).

If the positions of the settlor and beneficiary do not belong to the same person (in the case of an investment trust (*toushi shintaku*), etc.), then the beneficial interest shall be subject to the various rights inherent in the trust including the Right of Instruction held by the settlor, being a third party, and the pledgee shall secure the economic value of the beneficial interest as restricted by such rights of the settlor by the Pledge on Beneficial Interest. Therefore, it seems reasonable in this case to consider that such rights of the settlor shall not be bound by the Pledge on Beneficial Interest.

On the contrary, if the positions of the settlor and beneficiary belong to the same person (including cases where the position of settlor is transferred concurrently with the transfer of beneficial interest by the initial settlor), and it is difficult to deem that the rights based on the position of settlor naturally constitute a part of the beneficial interest, then it should not be considered necessary to give independent interest to the rights of the settlor in many cases, even though the position of the settlor is clearly legally distinguished from that of the beneficiary. Accordingly, we can conclude that the Pledge on Beneficial Interest binds such rights of the settlor in the same way²⁴. Provided, however, that if the Right of Instruction held by a settlor in a non-discretionary money trust (*tokutei kinsen shintaku*) is entrusted to an investment adviser, the condition of the interests of related parties in such case is most similar to the situation where the positions of the settlor and beneficiary do not belong to the same person. This, in turn, could give rise to doubt as to whether the Pledge on Beneficial Interest can be reasonably considered to bind the Right of Instruction held as a settlor as a matter of course. Accordingly, in this case, it would be necessary for the parties, including the investment adviser, to agree on the handling of the Right of Instruction.

(3) Subrogation Right Based on Security Rights (*butsujo dai-i-ken*)

Any subrogated property that arises with respect to the trust property shall continue to be subject to the beneficial interest; hence the Pledge on Beneficial Interest has an effect on such subrogated property as a matter of course. Further, a beneficial interest on subrogated property itself is inconceivable, if it does not at the same time exist on the trust property. Therefore, discussion of the subrogation right based on security rights (*butsujo dai-i-ken*) does not seem expressly necessary.

²⁴ With respect to the issue as to whether an attachment on a beneficial interest in a non-discretionary money trust (*tokutei kinsen shintaku*) has an effect on the settlor's Right of Instruction, commentary exists that deems it appropriate to consider that the settlor's Right of Instruction ceases due to the attachment of the beneficial interest, because the exercise of the Right of Instruction may materially violate the value of the beneficial interest due to the significant alteration of the substance of the trust property as a result of such exercise (The Chuo Trust and Banking Company, Limited, Trust Study Group *Shintaku Juekiken to Kyôsei Shikkô (Ge)* (Beneficial Interest and Compulsory Execution (Second Volume)) at 25 (Kinyû Hômu Jijô No. 1257)

Provided that the trust itself is left unchanged and only the beneficial interest is divided (it is understood that a beneficial interest can be quantitatively divided²⁵), we can consider that a pledge may have an effect on a beneficial interest divided in such a manner as a matter of course. On the contrary, if we consider the case where a single trust is divided into two or if two trusts are consolidated into one, the requirements and effects of such division or consolidation of trust itself are unclear. However, if such division or consolidation is considered a novation of the relevant trust agreement, it may be questionable whether the Pledge on Beneficial Interest continues to exist after such division or consolidation, which issue must be further investigated.

(4) Possessory Lien (*ryuchi ken*)

If an instrument is delivered in establishing a pledge, the pledgor would be given possessory right²⁶. Further consideration about possessory liens (*ryuchi ken*) seems unnecessary from a practical point of view, however.

(5) Effect of a Pledge on Beneficial Interest on a Certificate of Beneficial Interest under the Asset Liquidation Law

We have to be mindful that the effect granted to a pledge established on beneficial interest in a Special Purpose Trust under the Asset Liquidation Law is not the same as that based on the application of the Civil Code as described above. Rather, its effect is similar to the effect of a pledge of shares.

More specifically, different effects are assigned to an informal pledge (*ryakushiki jichi*) and a registered pledge (*touroku jichi*). In the case of an informal pledge, we can only secure the value arising from the disposition of the certificate of beneficial interest itself, which is similar to the case of the pledge of shares, and a preferential right with respect to the repayment of the principal and distribution of interests, etc. is not granted (Asset Liquidation Law, Article 178 and Commercial Code, Article 209). On the contrary, in the case of a registered pledge, such pledge shall be understood to have an effect on the money or beneficial interest received by the holder of the certificate of beneficial interest by way of repayment of principal, distribution of dividends, and cancellation, consolidation, division or repurchase of beneficial interest (Asset Liquidation Law, Article 178 and Commercial Code, Article 208).

While the debate remains open about whether the real subrogation right (*butsujo dai-i-ken*) based on an informal pledge may be exercised on repayment of principal or distribution of dividends, as well as on the manner of such exercise, the pledge on a certificate of beneficial interest seems to be considered in the same way as the pledge of shares. This is because the provisions for pledge of shares in the Commercial Code apply

²⁵ Kazuo Shinomiya *Shintaku Hô (Shin ban)* (Trust Law (New Edition)) at 322 (Yûhikaku 1989)

²⁶ Sakae Wagatsuma *Shintei Tanpo Bukken Hô* (New Edition, Law of Ownership Right Granted by Way of Security) at 192 (Iwanami, 1968)

mutatis mutandis to the pledge on beneficial interest under the Asset Liquidation Law²⁷.

4 Execution of Pledge on Beneficial Interest, Preferred Reimbursement Right

(1) Direct Collection

(a) Exercise of right to demand principal and profits

A pledge of claims under the Civil Code has the effect of permitting a pledgee to directly collect its claim subject to the pledge (Civil Code, Article 367, Paragraph 1). As a general manner of direct collection, the pledgee may exercise the right to demand profit or the right to demand payment of principal which is already due. In exercising the right to demand profit which is a monetary claim in many cases, the pledgee directly receives profit from the trustee and applies it to the pledged claim already due.

On the other hand, we must further consider direct collection based on a pledge in relation to the right to demand payment of the principal. As with trusts whose principal was delivered in cash form like many traditional trust products, the pledgees may directly collect principal and apply it to the pledged claim already due in the same manner as a collection of profits, and the method of collection does not specifically differ from that used for a pledge concerning other monetary claims. However, if a trust is used to take over various properties for management in various transactions such as securitization (amendments to the Trust Business Law are expected to promote diversification of trust properties hereafter) and such trust properties, which are properties other than money, are delivered in kind to the beneficiary upon termination of trust (the trustee is not likely to always remain under obligations to convert the trust properties into cash and repay the principal), we must consider the issue as to how the pledge affects the trust properties delivered to the beneficiary.

For example, in a transaction to securitize real estate where real estate is the trust property, the pledgee may deliver the relevant real estate to itself, namely demand the pledgor transfer title of the real estate and register such transfer. In this case the pledge shall remain in full force on the real estate²⁸. Therefore, any real estate constituting the trust property is delivered to the beneficiary upon termination of the trust, etc., and the pledgee shall hold the pledge of real estate on such real estate.

While the effect of the pledge under substantive law is maintained as

²⁷ For the effect and manner of exercise of real subrogation right (*butsujo dai-i-ken*) based on pledge of shares, please refer to Kazuteru Kami *Kabushiki no Tanpokenja no Kenri* (Rights of Secured Party of Pledge of Shares) at 98 (Jurist extra number, *Shôhō no Sôten I Sôsoku Kaisha* (Points of Issue of Commercial Code I, General: Company) (Yûhikaku)), etc.

²⁸ Sakae Wagatsuma *Shintei Tanpo Bukken Hô* (New Edition, Law of Ownership Right Granted by Way of Security) at 193 (Iwanami, 1968)

described above, the pledge of real estate is perfected by registration of establishment of the pledge (Civil Code, Article 177), and the registration procedure for the pledge of real estate shall be separately taken in order to perfect the pledge on the real estate, which pledge shall be effective against any third party. The assistance of the pledgor is required in order to carry out the procedures for registration of the pledge on such real estate. Even though the rights of a pledgee, where the pledgee received a consent from the trustee bearing a fixed date, have a priority status with respect to the Pledge on Beneficial Interest, there is some doubt as to whether said priority can be maintained under the procedure if the beneficiary receives delivery of the real estate constituting the trust property.

Further, we need to clarify when the pledge held on the delivered real estate comes into effect, based on the effect provided in Article 367, Paragraph 4 of the Civil Code, in relation to denial under the bankruptcy procedure in the case of suspension of payment or insolvency of the pledgor at the time of delivery.

With respect to a denial of conduct made in insolvency, etc. (*kiki hinin*) (Bankruptcy Law, Article 72, Item 2 (Amended Bankruptcy Law²⁹, Article 162, Paragraph 1, Item 1)), we may consider either of two things: that we associate the time of establishment of pledge of real estate with the time of establishment of Pledge on Beneficial Interest, or that the pledgor, being a bankrupt, takes no action for the establishment of pledge on the real estate. Further, in relation to denial of perfection (Bankruptcy Law, Article 74 (Amended Bankruptcy Law, Article 164)), associating the time of establishment of pledge of real estate with the time of establishment of Pledge on Beneficial Interest is likely to cause problems with regard to the scheduling of the reckoning starting point on the 15th day. In this case, however, we may construe that the perfection shall not be subject to the denial by *mutatis mutandis* application of the proviso to Article 74 of the Bankruptcy Law (the proviso to Article 164, Amended Bankruptcy Law).

In connection with the issues described above, the parties to a transaction to liquidate (or securitize) real estate enter into a mortgage agreement with conditions precedent, under which the parties shall agree that the trustee shall establish and register a mortgage before delivering the trust property to the beneficiary either on the day the trustee gives the termination notice, if any termination event occurs under the trust agreement, or the day before the expiration of the trust term. When real estate constituting the trust property is delivered to the beneficiary, and a silent partnership (*Tokumei Kumiai*) investment is made into the SPC (which SPC is the beneficiary of the trust), a conflict may arise with the Real Estate Specific Joint Enterprise Law.

²⁹ Law No.75 of 2004. It will be enforced on January 1, 2005.

Accordingly, if any termination event of the trust occurs, the parties take practical steps to transfer the trust itself to a third party and terminate the transaction by selling the beneficial interest to said third party and changing the trustee to another trust bank.

The issues mentioned above are also applicable when the trust property is a claim or any other property. In the case of a trust property which is a monetary claim, for example, if the trust is terminated for any reason before the due date of the claim secured by the Pledge on Beneficial Interest has arrived and the monetary claim is delivered to the beneficiary, the pledgee shall have the pledge of claims on the monetary claim. As such pledge of claims is not perfected, the pledgee will not be protected if the pledgor disposes of such monetary claim to a third party and the disposition is perfected before the perfection of the pledge of claim of the pledgee.

To respond to this situation, we may assume that the parties agree, under the relevant agreement, that (i) the trustee shall, upon occurrence of any termination event of the trust, immediately notify the pledgee of such termination, and (ii) the pledgor shall, at the time of delivering to the beneficiary the monetary claim constituting the trust property, grant the right to perfect the establishment of pledge of claim by giving notice to the beneficiary bearing a fixed date for perfecting the transfer of the monetary claim and make such perfection an obligation of the trustee.

In considering this issue, if the beneficiary is an SPC, who is not likely to go bankrupt, and the parties in a contractual relationship with the beneficiary are limited beforehand, this will not necessarily appear to be a serious issue. On the other hand, the issue mentioned above becomes important for transactions wherein several specific properties held by a normal business corporation (for example, intellectual property rights) are collectively entrusted to and managed by the trustee. Given that amendments to the Trust Business Law are expected to cause the utilization of trust for various purposes with respect to various properties, it seems necessary to clarify this issue as a premise for the establishment of schemes. For the present, we can conceive of directly establishing a security on the trust property, but in securing a single trust property such establishment would have to incur transactions costs twice³⁰.

(b) Exercise of other rights

The right of direct collection shall enable the exercise of judicial or extra-judicial actions necessary to realize the power of pledged claims, and such

³⁰ Here we need to clarify whether the action of creating a security interest on a trust property apparently in the name of a trust bank may be practically accepted by the trust bank. For example, we need to consider whether the creation of a security interest on the property in the name of the trust bank conflicts with any negative pledge clause or cross default clause (if such a security interest is enforced) included in another agreement to which the

actions as lawsuits for payment, formal demands and receipt of payment, etc. may be undertaken as exercises of the direct collection right. It shall be understood, however, that as an effect of direct collection, the pledged claim may not be disposed of³¹. The acquisition or disposition of such claim, however, will become possible by special agreement on forfeiture in cases of commercial transactions, as described below.

Further, if the object of the pledged claim is the delivery of something other than a movable (in the case of claim for commission or omission), the pledgee may directly demand to realize the substance of the right³². Given the widely accepted theory which holds that it is permissible to exercise formative rights (*keisei-ken*) held by an execution debtor, such as rights of choice, termination, or cancellation, as a substance of the collection right granted to the execution creditor of a monetary claim under the Civil Execution Law (Civil Execution Law, Article 155)³³, the same condition is reasonably deemed to apply to the substance of the collection right of the pledge of claims.

(A) Right to terminate a trust agreement

If the beneficiary has a right to terminate a trust agreement under the trust agreement as the substance of a direct collection and any termination event has occurred, it seems possible for the beneficiary to exercise such termination right. In this case, as the pledge has an effect on the right to demand the principal of the trust property due to termination, the pledge shall remain in force over the trust property once delivery of the trust property is demanded, provided that the trust property is not money.

As a related issue in addition to the exercise of a termination right as mentioned above, when the trust does not become due in the case of a pledge established on a beneficial interest in a money trust, repayment may not be immediately applied by collection. As a result, there arises the issue of whether the pledgee may propose termination to the trustee. There has been some discussion as to whether such proposal of termination of a beneficial interest may be made by an execution creditor. If an execution creditor proposes termination to the trustee and the trustee accepts the proposal, some argue that the trustee may receive delivery of the trust property in money after termination³⁴. If we follow this discussion, we can consider the

trust bank is a party.

³¹ Ryôhei Hayashi *Chûshaku Minpô* (8) (Commentary of Civil Code (8)) at 363 (Yûhikaku, 1965)

³² Ryôhei Hayashi *Chûshaku Minpô* (8) (Commentary of Civil Code (8)) at 364 (Yûhikaku, 1965)

³³ Yukihiro Miyawaki *Kyôsei Shikkô Hô [Kakuron]* (Compulsory Execution Law [Item-by-item discussion]) at 146 (Yûhikaku, 1978)

³⁴ Yoshihiro Kataoka and others *Kinsen Shintaku Juekiken no Sashiosae ni Tsuite* (Attachment of Beneficial Interest

pledge in the same way.

In addition, with respect to the beneficial interest in a loan trust, the purchase of the beneficial interest by the trustee is permitted pursuant to Article 11 of the Loan Trust Law (but the trustee is not obligated to purchase the beneficial interest). As a converse, however, there is no concept of early termination, and this gives rise to the issue of whether the pledgee may exercise the right to demand such purchase itself. While an execution creditor of the beneficial interest is not permitted to dispose of the pledged claim as its collection right, some argue that the pledgee should be given the right to demand such purchase itself in parallel with the discussion related to the pledgee's right to terminate the trust³⁵. Based on this argument, the same right shall be permitted for the pledgee of the beneficial interest.

(B) Right of Instruction and Other Rights

Another issue is whether the Right of Instruction held by the beneficiary can be exercised within the extent of the direct collection right of the pledgee. This issue should be considered in the light of extent of the binding force of the pledge, as described above. If the pledgor is basically prohibited from exercising the Right of Instruction as an effect of the pledge, it seems possible on the other side to permit the pledgee to exercise the Right of Instruction as an effect of direct collection.

(2) **Voluntary Disposition**

In most cases, a secured claim subject to the Pledge on Beneficial Interest is a commercial claim (*shouji saiken*). When this is so, the pledgee may acquire or dispose of the beneficial interest and make settlements incidental thereto by making special agreement on forfeiture in the pledge agreement.

In transactions of asset securitization, the pledgee generally seeks investors to invest in the trust property by way of new asset securitization transactions, wherein the beneficial interest will be transferred to another SPC established for such new transaction through voluntary disposition by executing a Pledge on Beneficial Interest³⁶, after which the pledgee applies the proceeds of such transfers to the secured claim as the money is collected.

in Money Trust) at 18 (Kinyū Hōmu Jijō No. 1198)

³⁵ Yoshihiro Kataoka and others *Kinsen Shintaku Juekiken no Sashiosae ni Tsuite* (Attachment of Beneficial Interest in Money Trust) at 19 (Kinyū Hōmu Jijō No. 1198)

³⁶ In this case, the parties shall not take steps to re-entrust any trust that is terminated and whose trust property is delivered upon termination. Rather, they shall take essentially the same steps taken in establishing a new trust by transfer of beneficial interest and replacement of the trustee.

If these steps are taken, most issues regarding the effects of the direct collection right on the termination right and the Right of Instruction shall be resolved; provided, however, that the issue regarding the effects of direct collection mentioned above shall remain until the voluntary disposition.

(3) **Compulsory Execution**

As judicial precedents and reference documents concerning the manner of compulsory execution of beneficial interest are limited, we need to collect cases on practical handling of compulsory execution hereafter. However, if a pledge is established on a beneficial interest, a voluntary disposition will generally be made by way of special agreement on forfeiture. Hence in actual financial transactions, the procedure of compulsory execution is seldom taken.

The procedure of compulsory execution shall be implemented in the manner of a claim execution as stipulated in Article 193 of the Civil Execution Law, because the Pledge on Beneficial Interest is positioned as the pledge of claims. (As an argument for compulsory execution of beneficial interests, some argue that some beneficial interests cannot be included among the “claims” provided for in the Civil Execution Law, and therefore beneficial interests should be regarded as “other property rights” in the execution procedure (Civil Execution Law, Article 167)³⁷. Under this scenario, however, the actual manner of execution would not be different as it should eventually follow the manner of execution of “claims”).

Provided, however, that even though the method of execution of claims takes place, the method of execution will differ in accordance with the kind of trust property subject to the beneficial interest (money or any other property) and whether the delivery of principal is made in money or otherwise. Thus, we need to determine the execution method according to the nature of the individual beneficial interest. Specifically, the Pledge on Beneficial Interest shall be executed by way of order of assignment (Civil Execution Law, Article 159), order of transfer, or order of sale (Civil Execution Law, Article 161), etc.³⁸, according to the nature of the trust property and the manner in which the principal is delivered. With respect to the beneficial interest represented in bearer form certificates, it should be noted that the pledge may permissibly be executed by way of the simple method for execution of pledge (Civil Code, Article 354) as well as by way of auction of movables (Civil Execution Law, Article 190).

³⁷ The Chuo Trust and Banking Company, Limited, Trust Study Group *Shintaku Juekiken to Kyôsei Shikkô (Ge)* (Beneficial Interest and Compulsory Execution (Second Volume)) at 28 (Kinyû Hômu Jijô No. 1257)

³⁸ For details on the method of compulsory execution, please refer to The Chuo Trust and Banking Company, Limited, Trust Study Group *Shintaku Juekiken to Kyôsei Shikkô (Jô) (Ge)* (Beneficial Interest and Compulsory Execution (Second Volume)) (Kinyû Hômu Jijô No. 1256 at 6 et seq. and No. 1257 at 23 et seq.)