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Financial Law Board

Possibility of Avoiding Servicer Risk by Using a Declaration of Trust[1]

I. Overview of Issues

A. Collections by a Servicer and Commingling Risk

In securitization transactions for financial receivables, the special purpose vehicle ("SPV"), such as a trustee in a trust or a special purpose company, who holds such receivables usually delegates the management and collection of those receivables to the original holder thereof (the "originator") or a servicing company (collectively, the "servicer") since the SPV does not have the human or physical resources to handle management and collection of receivables on its own. In practice, the collections that the servicer has received from debtors are delivered to the SPV over a prescribed period in accordance with a servicing agreement (the "servicing agreement") between the SPV and the servicer.

These structures involve a commingling risk in situations, for example, where a petition to commence insolvency proceedings is made against the servicer following receipt of collections from the debtors, but before or immediately after the servicer has delivered the same to the SPV. Another example is where an attachment is made by another creditor of the servicer against the servicer's deposit account in which collections are kept. In these situations, the SPV will not be able to assert priority against the bankruptcy trustee or the attaching creditor in connection with the right to demand delivery of the monetary amount equivalent to the collections. The result is that it would not be possible to receive payment of the entire amount of collections. In addition, this commingling risk cannot be avoided by creating a pledge in, or assigning as security, the servicer's bank account in which the collections are deposited because the right of the SPV as a security holder is subject to corporate reorganization proceedings and may be limited or modified by such proceedings.

B. Enactment of the New Trust Law

The new Trust Law, which came into effect on September 30, 2007 (*Shintaku hô*, Law No. 108 of 2006; the "New Trust Law"), expressly permits another method of entrustment (New Trust Law Article 3(iii)) in which the settlor and the trustee are the same person (a "Declaration of Trust"). Prior to this amendment, it was unclear under the old Trust Law whether it was possible to

[1] Except for citation indicating the source of quotations, the footnotes in the original (Japanese) have been omitted from this translation. If a footnote is indispensable for English readers to understand the context, the translator supplemented the body of this translation with the essence of the footnote. Please see the original for the footnotes.

create such a trust.

Paragraph 2 of the Supplementary Provisions of the New Trust Law stipulate that the above Article 3(iii), which permits a Declaration of Trust, will not apply for a one year period from the commencement date of the New Trust Law. That is, it will only be possible to make such a Declaration of Trust after one year has lapsed since the commencement of the New Trust Law. However, analysis of how this new scheme will be used in practice has already begun widely.

Moreover, the Law Concerning Amendments to Relevant Laws in Association with Enactment of the Trust Law (*Shintaku hô no sekô ni tomonau kankei hôritsu no seibi tô ni kansuru hôritsu*, Law No. 109 of 2006; hereinafter the "Trust Reform Law") has been enacted in association with the commencement of the New Trust Law, in order to, amongst other things, amend the Trust Business Law and other related laws.

C. Possibility of Using a Declaration of Trust as a Means to Eliminate Commingling Risk

One feature of a trust is that compulsory execution cannot be exercised against trust assets (New Trust Law, Article 23(1)), except based on a claim pertaining to the obligation for which the trust assets are recourse assets (New Trust Law, Article 2(9), and Article 21(1)), including a claim that arises in connection with trust assets. Another feature of a trust is that the trust assets will not be included in the bankruptcy estate or the assets of a failed company that would be subject to other insolvency proceedings, even if the trustee of a trust becomes bankrupt (New Trust Law, Article 25(1), (4) and (7)). These features also apply in the case of a Declaration of Trust. This has resulted in considerable interest concerning whether it is possible to eliminate the commingling risk caused by a deterioration in the credit position of a servicer by the servicer's creating a Declaration of Trust regarding the rights to the collections.

II. Analysis

A. Which Rights May Be Entrusted as Trust Assets in a Declaration of Trust?

This section analyses two methods of creating a Declaration of Trust in connection with the rights to collections: (1) entrusting the rights to cash proceeds which are to be collected from the receivables, and (2) entrusting the rights to depository claims to the collection account(s), into which the cash proceeds collected from the receivables are deposited.

1. Entrusting the Rights to Cash Proceeds which are to be Collected from the Receivables

One possible means of entrusting the cash proceeds of the collections (method (1) above) is to entrust the cash proceeds after each collection.

However, this method is problematic for the following reasons (among others): (i) it would appear to be impractical and burdensome from an administrative and cost perspective given that, for example, a Declaration of Trust is required to be made in a written form containing certain prescribed items (New Trust Law, Article 3(iii)) and that a notarial deed must be created or a notice to the beneficiary must be given by means of a document bearing a certified date (New Trust Law, Article 4(3)) for each Declaration of Trust; (ii) commingling risk will still exist during the period between receipt of the collections and the Declaration of Trust; and (iii) in the event that the servicer becomes bankrupt, the Declarations of Trust made immediately prior to bankruptcy may be avoided.

During the course of the public debate surrounding the use of this new type of trust, a structure in which an umbrella assignment of future collections (cash) is made at the time of the commencement of securitization, as a type of entrustment of cash, as described in (1) above, has been discussed. Nevertheless this approach must be carefully examined as there has not been sufficient discussion focusing on cash proceeds, while there has been discussion with regard to matters such as the legality and requirements for disposition (e.g. creation of security interest or assignment as security) of future receivables and personal properties in bulk which a debtor has not acquired at the time of contract for such disposition.

2. Entrusting the Depository Claims to the Collection Accounts

The next issue for analysis is the method of entrusting the claims to deposits in connection with a collection account (i.e., (2) above). This method matches well with the fact that, in practice, the collection of the receivables and the delivery of the cash collected for the SPV are made through the deposit account held by the servicer (which in practice involves a credit or remittance of moneys by the debtors into the deposit account of the servicer, and a debit from this account or a transfer from this account into the account in the name of the SPV). Moreover, if a Declaration of Trust that would cover claims to deposits corresponding to future collections can be created at the time of commencing the securitization transactions, this method will not face the same difficulties associated with entrustment of cash at each collection described in 1 above. From a theoretical perspective, in some ways it is also easier to pursue analysis of this type of entrustment on the basis of academic discussions concerning collateralization of deposits in a bank account.

We have therefore conducted an analysis, set out below, of the various issues surrounding the Declaration of Trust over depository claims to a collection account (i.e., (2) above).

B. Issues under the New Trust Law and the Civil Code (issues concerning the Creditors' Right to Rescind a Fraudulent Transaction, the Right of Avoidance,

as well as Public Order and Good Morals are discussed later)

1. Validity of a Declaration of Trust (Validity of a Declaration of Trust over Future Depository Claims)

(a) Validity of a Declaration of Trust over Depository Claims to an Ordinary Deposit Account as a Collection Account

We shall first examine whether it is possible to make claims against deposits in an "ordinary deposit account" (*futsû yokin kôza*), which allows a depositor to deposit or withdraw money at any time, as a collection account the subject of a trust. In this respect, the discussions on collateralization of deposits in ordinary deposit accounts provide a useful reference because such collateralization is also a disposition of claims against deposits in an ordinary deposit account.

In the discussions on collateralizing deposits in ordinary deposit accounts, there are two views, one of which is, as described in (i) below, based on the traditional understanding regarding the legal nature of deposits in ordinary deposit accounts, as presented in an article by Professor Hiroto Dôgauchi, published in 2000,[2] and the other is, as described in (ii) below, based on a subsequent article by Professor Hiroki Morita, published in 2003[3]:

(i) That in the case of deposits in ordinary deposit accounts, "any amount newly deposited will at all times be added to the then existing balances to constitute a single claim,"[4] so that "the claim that existed from the beginning continues to maintain the same nature, only the amount changes"[5] (this is hereinafter referred to as "Model A"); and

(ii) That in the case of deposits in ordinary deposit accounts, "when a new credit or debit is recorded against the deposit, the cause of formation of a claim is renewed, thus a new claim, for an amount equal to the amount of the deposit following the increase or decrease, will replace the old one." [6] (this is hereinafter referred to as "Model B").

In the discussions on creating a security interest in deposits in

[2] Hiroto Dôgauchi, *Collateralizing Deposits in savings accounts, in* Financial Transactions and Civil Code Legal Doctrine, 58 (Hiroyasu Nakata and Hiroto Dôgauchi eds., Yûhikaku 2000).
[3] Hiroki Morita, *Collateralizing Deposits in savings accounts: a Restatement, in* Trust Transactions and Civil Code Legal Doctrine, 305 (Hiroto Dôgauchi, Takashi Ômura and Masahiko Takizawa eds., Yûhikaku 2003).
[4] Sakae Wagatsuma, 2-II *Special Provisions of Obligations: Lectures on Civil Law V3* 742 (Iwanami Shoten 1962).
[5] Dôgauchi, *supra* note 2, at 58.
[6] Morita, *supra* note 3, at 305.

ordinary deposit accounts, it has also been pointed out that, as requirements for the validity of creating a security interest over claims against deposits in ordinary deposit accounts, the objects must be *independent*, or *identifiable*. (Note that Morita states that what is referred to as "*independent*" in Dôgauchi's article is almost the same concept as "*identifiable*" in Morita's.[7]) In this regard, both of these professors found that it was possible to identify the ordinary deposit accounts by means such as their account numbers, so that these requirements can be duly satisfied. Moreover the aforementioned article by Dôgauchi also discussed whether the subject assets are sufficiently identifiable as assets under the exclusive control of the secured party, which is a requirement for the validity of any attempt to create proprietary rights in such assets, and concluded that deposits in ordinary deposit accounts in connection with a collection account of a servicer would satisfy this requirement.

Based upon the above considerations, we have not found any reason to treat the issue of whether a Declaration of Trust may be established over deposits in ordinary deposit accounts differently from the discussions as to the creation of a security interest in such deposits. Therefore, we are of the view that such Declaration of Trust can also be effectively made.

(b) Issues and Possible Solutions in the Event that the Collection Account is a General Account

From the discussions regarding (a) above, it would appear that if a bank account is opened solely for the purpose of depositing collections in connection with receivables in a securitization transaction (such an account being referred to as a "special account"), there would be no objection to recognizing the validity of the Declaration of Trust over depository claims to such special account (in its entirety).

In practice, however, it is usually difficult to change existing collection accounts when implementing a securitization transaction. As a result, there is usually no option other than to use the existing collection accounts for such transactions. This means that collections of the financial receivables that are the subject of the securitization transaction will be commingled with collections of financial receivables belonging to the originator/servicer that have not been securitized, or those that are the subject of other securitization transactions, as all of these collections are deposited into the same existing collection accounts (an account of this nature is hereinafter referred to as a "general account"). In many cases, and particularly

[7] *See* Dôgauchi, *supra* note 2, at 47-51, and Morita, *supra* note 3, at 307-308.

when the originator also serves as the servicer, the general accounts which the originator/servicer uses in the course of normal business would also be used as the collection account for the securitized receivables which the servicer is engaged to collect.

One possible solution for a servicer using a general account as the collection account would be to create a Declaration of Trust in connection with a portion of the depository claim corresponding to the collections for the "securitized" financial receivables. If this method is possible, after the Declaration of Trust, a sort of "quasi-coownership" would arise between the servicer's personal/proprietary accounts and the trust assets in connection with a single claim against the general account. That said, given the requirement that the subject of a trust should be identifiable as set out above, there may be divided opinions as to whether such requirement could be satisfied by identifying "the portion of the claim against the general account that correspond to collections of the securitized receivables" on the basis that the exact figure of such portion cannot be foreseen at the outset and will only be able to be specified after collections are actually made[, which means, among other things, that the bank where the general account is opened will not be able to identify which specific portion of the money in the account is subject to the trust unless the servicer informs the bank of the actual amount of the collections of the securitized receivables at each collection. On the other hand, some of the Board members who participated in this debate suggest that it is possible to argue that identifiability is established at the time of entrustment on the ground that the formula to determine whether each collection constitutes a trust asset or the servicer's personal property is well-defined, provided that each collection is traceable to the relevant receivable].

One possible alternative would be to create a Declaration of Trust over the claim against the general account in its entirety, rather than a portion thereof. More specifically, the claim to the general account would be entrusted in its entirety, with the SPV being designated as the beneficiary in connection with the collections related to the securitized receivables, while the servicer, acting in its proprietary/personal capacity, would be designated as the beneficiary of the other collections. In sum, the beneficial interests are divided or classified based upon the source of the payments. After the details of the collections are confirmed, each of the respective collection amounts will be distributed to the SPV and the servicer, as the case may be, as payments in respect of each such beneficial interest. By entrusting the entire claim against the general account in this way, we could avoid the issue discussed above regarding a trust which is established only in respect of a portion of the claim against the bank account corresponding to the collections of the "securitized" financial receivables, thus, it would be possible to use a Declaration of Trust

over the claim against such general account as a means to avoid commingling risk even if the general account is used as the collection account. Set out below is a discussion regarding this alternative method:

(i) Does This Method Circumvent the Requirement of the Trust Assets Being Identifiable, i.e., the Necessity of "Recognizability" or the Trust Assets Being Distinguishable from Other Assets?

Since a Declaration of Trust created by this method will enable us to avoid the issue of whether the trust assets are sufficiently identifiable associated with a trust over a portion of the general account, we examine below whether any criticism may be made about whether this type of entrustment circumvents the requirement that the trust assets must be sufficiently identifiable, i.e., the necessity of "recognizability," or the trust assets being distinguishable from other assets[, as the Civil Law of Japan provides that the disposition of certain kinds of assets should be perfected by certain prescribed methods that are recognizable to third parties].

We understand that the requirements of being *independent* and *identifiable* as set forth above are adopted to protect a third party who enters into a transaction in connection with this entrusted property from unexpected losses by clarifying the legal status of the entrusted property.

In this regard, (i) the servicer acquires the beneficial interest (in its own proprietary/personal account) that corresponds to the collections on the claims that belong to its own proprietary/personal assets, and (ii) the trustee of a Declaration of Trust has a duty of care and a duty of fairness to the beneficiaries in connection with the overall claims against the deposits, therefore the trustee should record the collections in written accounts, identifying which category of receivables each collection relates to, and make appropriate distributions to the relevant beneficiaries in accordance with the terms of the trust agreement.

In light of the above, we are of the view that the use of the above method would not impair the rights and interests of a creditor or other third parties in connection with the proprietary/personal assets of the servicer and therefore, would not constitute an attempt to evade the law.

(ii) Is it Permissible to Create the Divided or Layered Beneficial Interests Discussed Above?

Is it permissible to create divided or layered beneficial interests in a trust, in which the trust assets consist of claims against the general accounts, by reference to the category of receivables the relevant collections relate to?

Professor Kazuo Shinomiya explained that "while it is possible to make a quantitative division regarding the beneficial interests and assign some of them, it would not be permissible to make an assignment that separates the portion similar to a right *in rem* from the portion similar to a right *in personam*."[8] However, it is possible to make a division between, for example, the beneficial interests to the principal portion of the trust assets and the beneficial interests to the profit portion thereof. We therefore believe that it would also be possible to divide the beneficial interests so that each of the beneficial interests would correspond to each of the portions of the trust assets as set forth above.

In practice, it is quite common to use a scheme in which the pool of claims held by the settlor (the originator) are placed in trust, and the beneficial interests are divided or classified into multiple layers (for example senior and subordinate beneficial interests (or beneficial rights to the seller's interests), with the cash flow in connection with the same trust assets being distributed to each of the beneficial interests in accordance with the trust agreement), and in which the settlor continues to hold a portion thereof, so that this scheme can also be considered to be an adaptation of this structure.

Consequently it would appear that creating the divided or layered beneficial interests would be permitted.

2. Duty to Keep Trust Assets Separate

A trustee has a duty to keep trust assets separate. Article 34(1)(ii)(b) of the New Trust Law prescribes that, in terms of claims, a trustee must keep trust assets separate from its own property and property that belongs to other trusts by keeping clear accounts of such claims.

The duty to keep trust assets separate requires that the trust assets and the trustee's proprietary assets or the assets of other trusts be kept separate. No particular difficulty arises from this perspective when a special account is used because all of the rights in connection with such special account will

[8] Kazuo Shinomiya, *Trust Law* 322 (Yûhikaku, New ed. 1989).

constitute the assets of a single trust.

In the case of a general account in which only a portion of the claims to the deposits in the general account is placed in a Declaration of Trust, an issue arises in respect of how the trustee keeps the portion of the claims against the deposits that are included in the trust assets, and the portion that belongs to the proprietary assets of the servicer separate. Nevertheless so long as the respective portions belonging to the trust assets and those belonging to the proprietary assets are clearly differentiated in the accounts, we believe that there is no violation of the duty to keep the property separate. In contrast, where all of the claims to the deposits in the general account are placed in a Declaration of Trust as with the case of a special account, we understand that no particular problem would arise in connection with the duty to keep trust assets separate.

3. Recognizability and Perfection of Trust

The creation of a trust by a settlor and a separate trustee (ie. not the settler) by entering into a trust agreement and transfers the assets that are the subject of the trust to the trustee (as prescribed in Article 3(1) of the Trust Law) presents both the issue of (1) perfecting the transfer to the trustee of ownership over the trust assets, and (2) securing recognizability of the fact that the assets are trust assets (i.e., that it is not the personal property of the trustee but constitutes property that is bound by, amongst other things, the objects of the trust). Prior to the enforcement of the New Trust Law, i.e., when the concept of a Declaration of Trust was not formally recognized, issue (1) above was understood to be an issue of recognizability of the transfer of the assets, which is subject to the rules of "perfection" prescribed in Article 177 of the Civil Code with respect to real estate and Article 467 of the Civil Code with respect to claims, while issue (2) above was understood to be an issue of the "recognizability of trust" as set forth in Article 3 of the former Trust Law.

Article 14 of the New Trust Law maintains the same concepts in respect of issue (2) as Article 3 of the former Trust Law, and there is no particular difference between the creation of a trust by means of a trust agreement with a trustee who is not a settlor and the creation of a Declaration of Trust. [Article 14 of the New Trust Law provides that with regard to assets for which acquisition, loss or change of a right cannot be perfected or asserted against a third party unless they are registered or recorded, the fact that such assets constitute the trust assets cannot be asserted against a third party unless such acquisition, loss or change is registered or recorded. On the other hand, the law does not require such perfection with regard to assets other than those mentioned in Article 14 of the New Trust Law in order to secure the recognizability of the fact that the assets constitute the trust assets.] Consequently, if a Declaration of Trust is created for real estate, being an asset mentioned in Article 14 of the New

Trust Law, then with respect to (2), the trust would have to be registered in order to assert to a third party the fact that the real estate constitutes trust assets. If, however, claims against deposits in ordinary deposit accounts are placed into a Declaration of Trust, it would be possible to assert to a third party the fact that the claims constitute trust assets without taking any particular steps to secure recognizability of the trust, since claims against deposits in ordinary deposit accounts are not one of the assets mentioned in Article 14 of the New Trust Law.

The Declaration of Trust introduced in the New Trust Law, however, presents the issue of how to deal with (1) above, since no transfer of assets to another person occurs when the trust is created. One problem is that of a situation of double assignment in which, for example, a certain person (Party A) creates a Declaration of Trust as a settlor, over certain assets, and then assigns these assets to another party (Party B). In this situation questions arise as to whether (i) Party A as the settlor and trustee and Party B are subject to the rules of "perfection" (i.e., the first person to complete the applicable "perfection" procedure will be able to assert its rights and interests over the subject assets against all others**)**, and (ii) if that is the case, what are the requirements for perfection?

With respect to real estate or personal property for which a registration system exists, a Declaration of Trust is to be treated as being a type of change in rights, and the applicable steps for perfection should be completed (see e.g., Civil Code, Article 177, and Real Estate Registration Law, Article 98). With respect to claims, however, the rule of perfection only applies to an "assignment" of claims under Article 467(1) of the Civil Code, and since no particular adjustments were made in the legislation to take a Declaration of Trust into account, it is understood that no particular step for perfection in the sense of (1) above are required in connection with a Declaration of Trust of claims. In the example stated above, as there is no assignment between Party A as settlor and Party A as trustee, the rule of perfection will not apply. If Party A assigns the claims to Party B, Party B will need to perfect the assignment as against third parties under Article 467(1) of the Civil Code but is not required to take any action to perfect the assignment against Party A.

Nevertheless, it should be noted that if a Declaration of Trust has occurred, the assignment of claims by Party A to Party B in the above example may be considered to be a breach of trust by the trustee in connection with the trust assets**,** and will be subject to Article 27(1) of the New Trust Law. That is, the priority contest would ultimately be determined by whether the assignment to Party B by Party A can be rescinded pursuant to the said provision of the New Trust Law. More specifically, if, and only if, the third party (Party B) has acted willfully or with gross negligence regarding the unauthorized action on the part of Party A as the trustee, the assignment to Party B can be rescinded, and the interests of the beneficiary in the Declaration of Trust would be protected.

4. Special Covenants Prohibiting Assignment of Claims

Normally, an ordinary deposit account agreement prohibits the assignment of claims to deposits in the ordinary deposit account. Further analysis would be necessary concerning whether a clause that prohibits assignment of such claims to deposits would be interpreted as applying to a Declaration of Trust in connection therewith, but in any event if approval from the bank is obtained, then it would be possible to create a Declaration of Trust despite such special clause.

C. Right to Rescind a Fraudulent Act or a Right of Avoidance, and the Public Order and Good Morals

1. Essence of Issue

As mentioned above, a Declaration of Trust makes it easy to achieve bankruptcy remoteness of deposits in collection accounts vis-à-vis the relevant servicer, but this does address the question as to whether there may be any limitations on this (particularly when the servicer's creditworthiness deteriorates).

In discussions regarding creating a security interest in deposits in ordinary deposit accounts, the right to rescind a fraudulent act under the Civil Code and the right of avoidance under the bankruptcy law constitute the substantive legal doctrines available to prevent a specific creditor from gaining an improperly advantageous position in relation to other creditors. In addition, there has been some separate examination as to whether such security arrangements may be considered void against the public order and good morals.

Where a Declaration of Trust is used, the same kind of conflict exists between the SPV, as beneficiary, and the other creditors of the servicer as between a secured creditor who obtains a security interest in deposits in ordinary deposit accounts and other creditors. Thus, we will first consider the right to rescind a fraudulent act or right of avoidance and then consider the issue of the public order and good morals, while making reference to discussions concerning the collateralizing of deposits in ordinary deposit accounts.

2. Analysis Based on Model A

(a) Framework of Analysis

If a Declaration of Trust over deposits in ordinary deposit accounts is analyzed based on Model A, then such Declaration of Trust would be considered to have been made over a single claim that would

maintain consistency from start to finish. Nevertheless since the deposits of collections would cause an increase in the property covered by the Declaration of Trust, this would present the issue of whether the deposits after the time of near-bankruptcy would be subject to a right to rescind a fraudulent act or right of avoidance.

(b) Discussions on Collateralizing Deposits in Ordinary Deposit Accounts

The discussion of collateralizing deposits in ordinary deposit accounts developed in the aforementioned article by Professor Dôgauchi, at B.1.(a)[9] may be summarized as follows:

(i) Recent court opinions and dominant academic views use the level of harmfulness and inappropriateness as the substantive criterion for deciding whether a right to rescind a fraudulent act or a right of avoidance can effectively be exercised, and in view of this substantive criterion it is necessary to analyze the level of harmfulness and inappropriateness in each case based on relevant facts in order to reach a conclusion on this matter.

(ii) "Generally, the creation of a pledge over claims against deposits in ordinary deposit accounts could cause the pledgor's other creditors losses or detriment due to the nature of such depository claims, i.e., their amounts fluctuating in the course of business, for example, where the assets (such as cash) that could otherwise have been subject to recourses from such other creditors were to be transferred into the pledged ordinary deposit account when the pledgor was nearly bankrupt and to come to serve the benefits of the pledgee solely." Nevertheless, where the servicer grants a pledge over[, or assigns as security,] an ordinary deposit account in which the servicer deposits collections to secure the SPV's claims for moneys collected by the servicer, the collections of the servicer "are nothing more than cash that has been collected on behalf of the pledgee," and "at no time would they be assets subject to recourses from another creditor."

(iii) Consequently, unless the (amount of) collateral has been deliberately inflated, "it is fair to say that neither the creation of the pledge nor the servicer's action which results in an increase in the amount of the collateral (after the creditworthiness of the servicer deteriorates), would be

[9] Dôgauchi, *supra* note 2, at 59.

subject to the right to rescind a fraudulent act or the right of avoidance."

(c) Discussions as to *Shûgo-Dôsan-Jôto-Tanpo*

Here, as a related discussion, we shall present an overview of the discussions concerning a *Shûgo-Dôsan-Jôto-Tanpo*, which is a contract-based security interest by means of assignments (*Jôto-Tanpo*) of personal properties in bulk (*Shûgo-Dôsan*), including after-acquired personal properties.

(1) Right of Avoidance

The dominant theory is that in a *Shûgo-Dôsan-Jôto-Tanpo*, the act of delivering personal properties to a place (such as a warehouse, factory or any place where individual personal properties are gathered in the course of the debtor's business and as would be pre-designated in the relevant security contract) during a time of near-bankruptcy would be subject to a right of avoidance (the "avoidance supporting theory").

As justification for avoidance in these circumstances, the avoidance supporting theory, which also accepts the "personal properties in bulk doctrine" (i.e., the doctrine that a group of assets as demarcated in some way, constitutes in its entirety, a single block of property and can be pledged or assigned for security purposes as such, notwithstanding the fact that individual assets comprising such "group" may change from time to time in the course of the debtor's business), states that (i) the personal properties in bulk doctrine only enables us to explain why the effect of the assignment as security automatically extends to any individual personal property that is delivered to the pre-designated place by the debtor/assignee, however, (ii) the doctrine would not necessarily leads to the conclusion that the assignment as security over such individual personal property would retroactively become effective (i.e., the assignment as security would be treated as having been effective since the security contract was entered into between the parties at the outset), and (iii) under the doctrine, the assignment as security over such newly delivered individual personal property would only become effective and perfected at the time when they were delivered to the pre-designated place. Consequently the doctrine does not completely exclude the possibility of the avoidance of an assignment as security over such individual personal property that is delivered to the pre-designated place at a time of near-bankruptcy of the debtor/assignee. Note that the court adopts the "personal properties in bulk doctrine" and holds that the

initial creation and perfection of security interest in the property automatically extends to newly delivered personal properties, but has not taken a definite position regarding when the creation and perfection of security interest over the newly delivered individual personal property occurs (i.e. whether at the time of entering a security agreement or at the time of delivery of each personal property.).

In summary, on the basis of the avoidance supporting theory, (i) avoidance of a fraudulent act (avoidance of willful act) would be allowed in connection with "acts of delivering individual personal property in a way which deviates from the normal conduct of business of the debtor/assignee,"[10] which may include, for instance, the "cases where inventories are deliberately increased."[11] Moreover, (ii) the delivery of individual personal property might also be subject to avoidance on the grounds of its "preferential" nature as set forth in Article 162(1)(i) of the Bankruptcy Law.

(2) Right to Rescind a Fraudulent Act

In discussing *Shûgo-Dôsan-Jôto-Tanpo*, it is explained that even if the delivery of individual personal property is subject to a right of avoidance on the grounds that the act adds to a security**,** it is not subject to a right to rescind a fraudulent act under the Civil Code since under the personal properties in bulk doctrine the act of delivering individual personal property would be characterized as a physical act (as opposed to a juridical act), which may not be rescinded under the Civil Code (unlike avoidance under the Bankruptcy Law).

(d) Analysis of a Declaration of Trust of Claims against Deposits in Ordinary Deposit Accounts in Connection with Collections by the Servicer

Based on the above discussions of collateralizing deposits in ordinary deposit accounts as well as *Shûgo-Dôsan-Jôto-Tanpo*, we will examine whether, with respect to claims against deposits in ordinary deposit accounts in connection with collections of a servicer, deposits made on or after a time of near-bankruptcy would be subject to a right to rescind a fraudulent act or right of avoidance.

First, our review of the avoidance supporting theory indicates that deposits made during or after a time of near-bankruptcy might be

[10] Emiko Chiba, *Assignment as security and bankruptcy law: Shûgo-Dôsan-Jôto-Tanpo and right of avoidance*, 65-9 Hôritsu Jihô 43 (1993).
[11] Makoto Itô, *Bankruptcy and Civil Rehabilitation Act* 396 (Yûhikaku 2007).

subject to a right of avoidance, given that the portion of the depository claims that is deposited during or after this time would become trust assets as of the time that each such deposit is made.

Nevertheless when considered together with the discussion on creating a security interest in deposits in ordinary deposit accounts, even if deposits made during or after a time of near-bankruptcy may generally be subject to a right of avoidance, as long as normal servicing is being carried out, such collections and deposits would not result in a reduction of the servicer's proprietary/personal assets to which its other creditors may have recourse or a willful increase of the trust assets. Consequently even if the deposits are made during or after a time of near-bankruptcy, they would not be harmful or inappropriate (which are requirements for avoidance), and it is therefore possible to conclude that avoidance would not be permitted. In the same manner, a right to rescind a fraudulent act under the Civil Code would also not be exercisable as long as normal servicing is carried out.

Moreover, given the discussion on *Shûgo-Dôsan-Jôto-Tanpo*, the individual deposits would not be subject to a right to rescind a fraudulent act under the Civil Code since the making of these deposits are not juridical acts but physical acts.

(e) Public Order and Good Morals

The next topic is an analysis of cases which present an issue of infringement of public order and good morals. [Article 90 of the Civil Law of Japan is a general provision relating to the validity of contracts, which denies the validity of contracts for a purpose contrary to public order and good morals, for example, unconscionable contracts.] In general, cases which involve issues of public order and good morals would include those involving excessive collateralization, but since the amount of money that the servicer should deliver to the SPV and the balance of the deposits in ordinary deposit accounts in connection with the collections would be equal, excessive entrustment of assets and other problems will not occur. Likewise, even if the Declaration of Trust is made in respect of the general account, which may contain collections of securitized receivables together with collections of the servicer's other claims that are not the object of the securitization transaction, because the beneficial interests corresponding to such other collections would inure to the proprietary account of the servicer, we would not see any element of excessive entrustment, either. Consequently, we cannot foresee an event in which an issue of the infringement of public order and good morals will arise in connection with a Declaration of Trust of the deposits in ordinary deposit accounts involving the collections of the servicer.

3. Analysis Based on Model B

(a) Right to Rescind Fraudulent Act and Right of Avoidance

(1) In General

If we conduct our analysis based on Model B, in analyzing the validity and other issues involving the disposition of deposits in ordinary deposit accounts, including a Declaration of Trust, in principle, we can refer to the discussions on *Shûgo-Saiken-Jôto-Tanpo*, which is a contract-based security interest by means of assignments (*Jôto-Tanpo*) of receivables in bulk (*Shûgo-Saiken*), including future receivables.

Professor Morita explained that the discussions in connection with collateralizing deposits in ordinary deposit accounts should lead to the conclusion that as long as the assignment comes into effect at the time of the contract for *Shûgo-Saiken-Jôto-Tanpo*, then even if the deposit balance increases during a time of near-bankruptcy, it is not possible to use this as a reason to justify an interpretation that would deny the validity of the security interest over the portion of increase in value at the time of near-bankruptcy, based on a right to rescind a fraudulent act or an avoidance.[12]

The conclusion should be the same with a Declaration of Trust. At the time of the act of entrustment, the validity of the trust extends to all of the depository claims including those created in the future, and even if the servicer's credit position subsequently declines, the increase in the balance of deposits will not be subject to a right to rescind a fraudulent act or a right of avoidance.

(2) Trends in Court Holdings

The discussions in connection with collateralization of deposits in ordinary deposit accounts, as mentioned above, are based on the 2001 Supreme Court Judgment discussed below, but as is widely known, the 2004 High Court Judgment, also mentioned below, was rendered thereafter, and between that time and the 2007 Supreme Court Judgment discussed below, some debate existed concerning when the assignment of future receivables (which are included in the bulk of receivables) comes into effect in connection with *Shûgo-Saiken-Jôto-Tanpo*. This article provides an overview of these judgments since they relate

[12] Morita, *supra* note 3, at 320.

to whether the act of increasing the deposit balance after the *Jôto-Tanpo* contract would be subject to the exercise of a right to rescind a fraudulent act or a right of avoidance. Since there have been no disputes concerning the timing of perfection, and in the event of a Declaration of Trust, the requirements to perfect are not issues as discussed above, and thus the following summary focuses on when the assignment becomes effective.

(i) Saikô Saibansho [Sup. Ct.] Nov. 22, 2001, 55-6 Saikô Saibansho Minji Hanreishû [Minshû] 1056 (Japan) ruled that if a contract for *Shûgo-Saiken-Jôto-Tanpo* had been executed, then "receivables that are to come into existence in the future are held to be definitively assigned from Party A to Party B." In general this was understood as meaning that the assignment of future receivables is effective at the time of the execution of the contract of *Shûgo-Saiken-Jôto-Tanpo*;

(ii) Nevertheless Tokyo Kôtô Saibansho [Tokyo High Ct.] July 21, 2004 (Japan), which was the original lower court decision for the case of the 2007 Supreme Court judgment discussed below, stated that "in a contract creating security interest in receivables in bulk (so-called *Shûgo-Saiken-Jôto-Tanpo*), if future receivables that are the subject of the contract have not yet come into existence at the time of the execution of the contract, the receivables become assets subject to security interest (*Jôto-Tanpo*) at the time when the receivables actually come into existence." Because this judgment indicated that the transfer would only be effective once the receivables came into existence, it caused a lot of confusion.

(iii) Saikô Saibansho [Sup. Ct.] Feb. 15, 2007 (Japan) ruled that "if an assignment contract for the purpose of creating a security interest (*Jôto-Tanpo*) is executed in connection with receivables that will come into existence in the future, then unless there is a special agreement reserving the effect of the assignment of the receivables, the receivables that are the subject of such security interest (*Jôto-Tanpo*) shall have been definitively assigned to the secured party from the grantor of the security interest (*Jôto-Tanpo*). In this case, when the receivables that are the subject of security come into existence in the future, the secured party shall automatically acquire these receivables for the purposes of security, without any particular act

being required on the part of the grantor of such security interest (*Jôto-Tanpo*).” This 2007 Judgment is understood as reconfirming that generally a *Shûgo-Saiken-Jôto-Tanpo* will become effective from the time the contract is executed.

(iv) Notwithstanding the above, caution is necessary as the 2007 Judgment is (i) merely an “interpretation of Article 24(6) of the National Tax Collections Law” and “avoids a direct discussion of the timing of assignment”; and (ii) “based on an analysis of the legal status of the secured party under the security (*Jôto-Tanpo*) prior to the time when the receivables actually come into existence, and does not directly focus on the issue of when the transfer takes place.”[13]

As mentioned above, the 2007 Judgment reconfirmed that future receivables subject to a security interest (*Jôto-Tanpo*) are definitively assigned at the time the contract is executed, and the conclusion under Model B concerning collateralization of deposits in an ordinary deposit account would remain unchanged.

Consequently, there would be no particular change to the aforementioned conclusion regarding a Declaration of Trust of claims over deposits in ordinary deposit accounts under Model B.

(b) Public Order and Good Morals

The aforementioned article by Professor Hiroki Morita at B.1(a) explains the legal nature of deposits in ordinary deposit accounts based on Model B and concludes that the security interest (*Jôto-Tanpo*) comes into effect at the time the contract is executed (i.e. not at the time each deposit is made), and denies that the increase in the balance of deposits during a period of near-bankruptcy would be subject to a right to rescind a fraudulent act or a right of avoidance. That said, Professor Morita also points out that the balance between the interests of the secured party and that of the other creditors of the grantor of the security interest should be pursued from the perspective of whether the agreement creating the security interest violate public order and good morals. In this respect, Professor Morita notes that “an analysis is made of the reasonability of such security interest by examining whether the creation of a comprehensive security interest that includes the portion of the value that increases in the future would violate public order and good morals vis-à-vis the interests of other creditors, and such

[13] Hiroto Dôgauchi, *It was not a simple decision*, *in* < Feature> Decided! Priority between assignment of future receivables for the purpose of security and national tax claim: Comments on Saikô Saibansho [Sup. Ct.] Feb. 15, 2007 (Japan), 854 NBL 46 (2007).

examination is to be made by reference to the way the deposits in ordinary deposit accounts as collateral are used."[14]

For a Declaration of Trust as well, an analysis is to be made of the reasonability thereof by examining whether the creation of a comprehensive trust that includes the portion of the value that increases in the future would violate public order and good morals vis-à-vis the interests of other creditors, judging from the way the deposits in ordinary deposit accounts are used.

Therefore, we are of the view that in principle, a Declaration of Trust of depository claims against collections of a servicer would not constitute a violation of public order and good morals. We also believe this conclusion is reasonable judging from the discussion on the creation of the security interest (*Jôto-Tanpo*).

D. Consideration under Trust Business Law

Finally we shall review the creation of a Declaration of Trust in light of the regulations under the Trust Business Law. The Trust Business Law (*Sintakugyô hô*, Law No. 154 of 2004) amended by the Trust Reform Law (hereinafter the "New Trust Business Law") introduced a registration system in connection with persons who engage in the business of setting up a Declaration of Trust (New Trust Business Law, Article 50-2), and the persons who are registered as such will be subject to the regulations under the Trust Business Law. Considering the above, whether such registration is required of a servicer who makes a Declaration of Trust of the claims against deposits in connection with collections as set out above will need to be examined.

Article 50-2 of the New Trust Business Law states that a person who intends to make a Declaration of Trust must register with the Prime Minister if "many persons" (meaning at least the number of persons prescribed by the relevant Cabinet Order) are to acquire the beneficiary interests created thereunder, as more specifically defined by the relevant Cabinet Order. Nevertheless the proviso to clause Article 50-2 states that this registration shall not be required in "cases prescribed by the Cabinet Order" in which it is recognized that it is unlikely that any impediment to the protection of beneficiaries would arise.

Article 15-3(iv)[15] of the New Trust Business Law Enforcement Order sets forth the "cases prescribed by the Cabinet Order" in accordance with the proviso of Article 50-2 of the New Trust Business Law. This clause of the Enforcement Order stipulates that cases in which a servicer who manages or collects "specified financial receivables (meaning specified financial receivables as set forth in Article 2(1) of the Special Measures Law Concerning the Servicing Business

[14] Morita, *supra* note 3, at 321.
[15] Renumbered as item (v) by a subsequent amendment.

(*Saiken kanri kaisyû gyô ni kansuru tokubetsu sochi hô*, Law No. 26 of 1998))" declares a trust in respect of "cash or other similar assets" which the servicer manages in association with these activities do not require registration.

Then, the first issue here is whether the phrase "cash or other similar assets" referred to above includes claims to deposits in ordinary deposit accounts. We cannot identify any particular reason why claims to deposits in ordinary deposit accounts would not be included, and thus we believe that they should be included.

In addition, since the scope of Article 15-3(iv) of the New Trust Business Law Enforcement Order is limited to "specified financial receivables," this clause cannot be utilized in connection with financial receivables other than specified financial receivables. Nevertheless, item (vii)[16] of Article 15-3 states that registration shall not be required in the event that "a person who receives cash on behalf of another person" declares a trust in respect of "cash, etc., that it manages in association with the receiving of said cash." Given that the servicer receives cash from debtors on behalf of the SPV and manages the collections in association with a servicing agreement, the next question is whether, by virtue of item (vii) of Article 15-3, registration can be dispensed with even if item (iv) of Article 15-3 does not apply. It was then clarified in the response by the Financial Services Agency to the public comments at the time of amendment of the New Trust Business Law Enforcement Order, that item (vii) would apply if a person who collects cash other than specified financial receivables declares a trust in respect of such cash, etc., and that in this case registration would not be required.

On the basis of the foregoing, it is possible for a servicer to make a Declaration of Trust in respect of claims over deposits in ordinary deposit accounts in connection with collections, as described above, without the need to be registered in accordance with Article 50-2 of the New Trust Business Law.

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[16] Renumbered as item (viii) by a subsequent amendment.