Financial Law Board
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Legal Issues Concerning Notes on the Call Market

Study on Issues Presented by the Study Group for Activation of Short-term Money Markets

(Issues Presented by the Study Group for Activation of Short-term Money Markets)

(1) Does any legal difficulty occur in the creditor's collection on claims if call transactions are conducted without exchanging promissory notes as compared to the situation in which promissory notes are exchanged?

(2) From the perspective of preserving trust assets, does engaging in call transactions without exchanging promissory notes violate a duty of care to a trustor of a trustee bank (a trustee of an investment trust, a securities trust, or a pension trust)? In the same manner, would this violate a duty of care to a beneficiary of the trustor of an investment trust, a securities trust or a pension trust?

(Conclusion)

(1) For practical purposes, it is difficult to envision that legal difficulties will occur in the creditor's collecting on claims in the event that call transactions are conducted without exchanging promissory notes when compared to the situation in which promissory notes are exchanged.

(2) Carrying out a call transaction without exchanging promissory notes will not constitute a violation of the duty of care to the trustor of the trustee bank (the trustee of an investment trust, a securities trust or a pension trust), or a violation of the duty of care to the beneficiary of the trustor of investment trust, the securities trust or the pension trust.

(Background)

I. A call transaction is a loan for consumption that is made in a large amount of money (in principle at least ¥500 million) over a short period of time on the interbank market (a market in which financial institutions in the broad sense of the term participate). In most cases the transactions have a period of one day (overnight call transaction) or less than one day (intraday call transaction), but

there are transactions that have a duration of one month, three months or even one year.

II. There is no standard contract such as a master agreement that is used widely in a common format by market participants, although the Association of Call Loan and Discount Companies (*Tanshi Kyôkai*) publishes guidelines called "Interbank Market Transaction Guidelines (*Intaabanku Shijô Torihiki Yôkô*)" that consolidate general commercial practices.

III. Settlement between financial institutions and liquidity management of financial institutions are carried out through the current accounts they hold with the Bank of Japan (BOJ account), and a call transaction has the characteristics of borrowing and lending funds in a BOJ account for the purpose of adjusting the balance in the BOJ account. Therefore, both the delivery and the receipt of funds in the call transaction (i.e., placement of the funds by the lender to the borrower at the starting time, and payment for the loan from the borrower to the lender at the time the loan ends) are normally conducted through transfer into the BOJ account of the recipient.

IV. It has become common practice in call transactions to have a promissory note (hereinafter a "call note") exchanged in the following manner between the parties. However, since around 1999 it has become possible to conduct the transactions without exchanging a call note (hereinafter "noteless transactions") on agreement between the parties when a *tanshi* company (money market broker-cum-dealer) is not involved, and from May 2002 it has become possible to conduct noteless transactions even when a *tanshi* company is involved.

<Key Features of Call Notes>
The drawer is the borrower, and the recipient is the lender, with payment of the amount equivalent to the principal at sight. The place of payment is a branch of the borrower if the borrower is a depository institution, or a branch of the borrower's bank if the borrower is a non-depository institution.

V. Market participants are divided in their views of the legal significance of exchanging a call note. Some are of the opinion that the absence of a call note does not present a problem since normally the call note is returned by the lender to

the borrower after the loan is paid at the time the loan ends, and is not presented for the payment. On the other hand, others are of the opinion that a call note is necessary as a means of preserving the claim.

VI. The Financial Law Board has solicited opinions regarding topics for review.[1] We received the opinion from Study Group for Activation of Short-term Money Markets,[2] which consists of representatives from major sectors participating in the interbank market, that there was some legal uncertainty with respect to V. above and that a clarification of interpretation was necessary. We therefore selected this issue as a topic for review. This article presents the views of the Financial Law Board with respect to the issues as stated in the beginning hereof.

(Analysis)

1. Creation of Claims and Obligations in a Call Transaction

When a contract has been created in a call transaction and the lender has delivered the funds to the borrower, the borrower will have an obligation in accordance with the contents of the contract (the amount, the due date of performance and the interest rate, etc.) to pay (repay) the lender the principal and interest (creation of claims and obligations in a call transaction).

(Explanation)

(1) There is no dispute that a call transaction constitutes a loan for consumption. As to the question of whether it is a loan based on a consensual contract or a loan in the form of a real contract, given the way the terms relating to commitment and formation of contract are used in the Interbank Market Transaction Guideline, it would appear that a call transaction would be in the

[1] See the Financial Law Board website (www.flb.gr.jp).

[2] The Study Group for Activation of Short-term Money Markets (*Tanki Kinyû Shijô Torihiki Kasseika Kenkyûkai*, abbreviated as "*Tantoriken*") is a voluntary organization and acts as a forum for meeting and deliberating among representatives from major sectors participating in the short-term money markets (such as banks, securities companies, settlor companies of an investment trust, trust banks, insurance companies and *tanshi* companies). The bank, whose president chairs the Japan Bankers Association (JBA), serves as the organizer of this group, and the JBA is delegated with responsibilities as the administrative secretariat thereof.

form of a consensual contract. However in either event there is no doubt that the claims and obligations under the call transaction have accrued at the stage in which the transaction has executed through delivery of the funds.

(2) Since the claims and obligations under a call transaction accrue as a result of the formation of the contract and the delivery of funds, the accrual of these claims and obligations itself is unrelated to the existence or absence of a call note. Records in the contract confirmation system or broker's reports from that system (in the event that a *tanshi* company is involved), or confirmation records by FAX (in the event of a direct dealing transaction) would constitute evidence of formation of the contract, but these would not be a requirement for the contract itself to be formed. If a call note is exchanged, this exchange could be an indirect evidence that would create the presumption of the formation of the contract and the delivery of funds, but the call note by itself cannot necessarily prove that the contract has been formed and the funds has been delivered.

2. Coexistence of Claim under the Call Transaction (the Underlying Claim) and Claim on the Note

When a call note is exchanged, the claim under the call transaction (the underlying claim) and the claim on the note are understood as coexisting.

(Explanation)

(1) If a note is exchanged in connection with performing monetary obligation, the purpose of exchanging the note in terms of the effect on the obligation (the underlying obligation) is theoretically divided into the three categories of being (i) in lieu of payment, (ii) for the purpose of payment, and (iii) for the purpose of collateral. In the event of being (i) in lieu of payment, the underlying claim will be extinguished and only the claim on the note will survive, while in the case of (ii) and (iii) the underlying claim and the claim on the note will coexist.

(2) It depends on (the interpretation of) the intention of the parties that which of (i) through (iii) would be the case. However, in general, having the underlying claim be extinguished would be adverse to the interests of the

creditor, (ii) or (iii) would be interpreted as applying unless the circumstances are exceptional. In the case of a call note, since payment is made without presentation of the note and there is no statement in the Interbank Market Transaction Guidelines that would imply an intention of the parties to extinguish the claim under the call transaction with only the claim on the note surviving, it is not conceivable that the parties would have an intention of (i).

3. Exchange of a Note for the Purpose of Collateral—Order of Precedence in Exercise of Underlying Claim and Claim on the Note

It is understood that either the claim under the call transaction (the underlying claim) or claim on the note may be exercised first, meaning that the note has been exchanged "for the purpose of collateral" as prescribed by (iii) above. This legal relation is similar but not identical to the case in which a loan on a bill has been made by a bank.

(Explanation)

(1) The difference between (ii) for the purpose of payment and (iii) for the purpose of collateral is that of the order of exercise of the underlying claim and the claim on the note. In the event of (ii) the creditor has a duty to exercise the claim on the note first, while in (iii) the creditor may exercise either first.

(2) The question of which of (ii) or (iii) would apply is an issue of (the interpretation of) the intentions of the parties. However, it is generally accepted that if Party A draws a note in favor of Party B in connection with an underlying relationship between Party A and Party B, the note is treated as being exchanged for the purpose of payment, i.e., (ii), and payment is made when Party B actually exercises the claim on the note. Recently, almost all of the places of payment of promissory notes are branches of the drawers' banks, according to the terms in a standard form of a promissory note. That being the case, the Debtor Party A will be required to keep funds in a current account at the Debtor's bank in order to prepare for settlement of the note, while for the Creditor Party B collection will be made easier by

consigning the note for collection, and consequently it would be reasonable to understand that there is an agreement among the parties that the creditor will first exercise the claim on the note and obtain satisfaction. Moreover, Party B may assign the note to Party C, and in this event it is expected that the underlying relationship between Party A and Party B will also be settled by the exercise of the claim on the note by Party C.

(3) Cases that would be understood as those in which a note is exchanged for the purpose of collateral as in (iii) above would be those of loans on bills. In loans on bills, the Debtor Party A draws a promissory note in favor of Bank B in connection with an underlying relationship between Debtor A and Bank B (a loan claim in loans on bills). The reasons for using a note in this case are explained as being: (A) because the stamp tax is cheaper than would be the case in a loan on deeds; and (B) because the coexistence of the claim on the note and the underlying claim (loan claim) is advantageous to collecting on the claim. Specific advantages under Reason (B) are (a) collection can be made by using the note to withdraw funds from the current account if the debtor does not make payment, (b) interest can be collected in advance (including renewal interest in the event the payment deadline of a note is extended), (c) the note can be used to obtain financing such as by selling the note on the bill market, (d) it is possible to bring the note to a clearing house and have it dishonored thereby putting pressure on the debtor, (e) it is possible to amend terms such as interest to correspond to changes in financial conditions of the debtor at the time of renewing the note, and (f) it is easy to obtain a title of obligation by bringing an action on bills and notes. It must be noted that in (B)(c) above Bank B has to repurchase the note by the time of maturity so that double payment by Debtor A will not be made, and that (B)(d) above applies only to cases in which a comparatively small financial institution receives the note with the place of payment not being its own branch but rather being the branch of another financial institution, and not to cases in which the place of payment is a branch of the debtor.

(4) In the case of loans on bills, it is understood, as discussed above, that a note is exchanged for the purpose of collateral and the creditor bank does not have an obligation to exercise the claim on the note first. This is not only because it is to the advantage of the creditor, but also because it would not be

to the debtor's disadvantage even if the underlying claim is exercised first since the Debtor Party A must keep funds in the current account at the bank for the purpose of satisfying the underlying claim. As a matter of practice, it seems to be understood that underlying claims (loan claims) are collected without presentation of a note.

(5) A call note has the same attribute as in loans on bills with respect to the fact that a note is drawn by debtor in a loan for consumption (the borrower) in favor of a creditor (the lender). Moreover, since payment of the obligation in a call transaction may be made without presenting the note, either of the underlying claim or the claim on the call note may be exercised first, and thus the note is understood as being exchanged for the purpose of security as set forth in (iii) above.

(6) In this manner, the legal relations in the event of the exchange of a call note are similar but are not absolutely identical to those in the case of loans on bills.

- In the event of loans on bills, the place of payment on the note is the branch of the creditor (the lender), while the place of payment of a call note is a branch of the drawer (the borrower) itself when the drawer is a depository institution, and is a branch of the drawer's bank if the drawer is a non-depository institution, which is not a branch of the lender. Therefore in the case of a call note the lender will not easily collect on the debt using the note to withdraw from the current account (as described in (3)(B)(a) above).
- A call transaction does not envision advance payment of interest, use of the call note to obtain financing, presentation of the call note through clearing, or renewal of the call note, and consequently the call note does not have the significance discussed in (3)(B)(b) through (e).
- In a call transaction, the causes for forfeiture of benefit of time are limited to the cases set forth in Article 137 of the Civil Code because a call transaction does not have an explicit agreement such as an agreement on bank transactions. Moreover, there is no agreement such as in Article 8.1 of (the standard form of) Agreement on Bank Transactions, and consequently when the claim in a call transaction is

to be setoff, then doubts may arise regarding the validity thereof if the note is not delivered at the same time.

4. Collection on Claim Through the Call Note

It is almost inconceivable that the holding of the call note will improve actual collection on the claim, and to put it the other way around, it is almost impossible to conclude that for practical purposes not receiving a call note would pose an impediment on collecting on the claim.

(Explanation)

(1) According to the analysis of 3. above, if the borrower does not voluntarily perform on its obligation in the call transaction, the lender will not be able to collect easily on the call note. It is not possible to find a method of collecting on the note that does not require some cooperation or action on the part of the borrower which is the obligor.

(2) If the borrower contests the validity of the agreement or denies the existence of the obligation by asserting, e.g., that payment has already been made, then it is possible to use the call note to bring an action on bills and notes. In principle in an action on bills and notes the examination of evidence is limited to documentary evidence (Code of Civil Procedure ("CCP") Article 352(1)), and consequently is said to be more advantageous for the plaintiff (the holder of the note) to win the case in a relatively brief period of time than is the case with an ordinary proceedings. In this aspect, it is not possible to deny an advantage of having a note as a general rule when compared to a noteless transaction. Nevertheless it is necessary to be aware of the following issues, and it is not possible to state that having a note will improve the actual effectiveness of collecting on a claim.

- The limitations in an action on bills and notes apply only to the method of examination of evidence, and do not apply to, e.g., affirmative defenses under substantive law. The drawer (the borrower) can assert an affirmative defense regarding the underlying relationship (a call transaction), and if there is documentary evidence supporting this defense, it is possible for the defendant to prevail.

- Approximately two months would be necessary to obtain a judgment even in an action on bills and notes.
- Even if the lender (the holder of the note) prevails in an action on bills and notes, if the borrower makes a lawful objection then the proceedings would be moved to ordinary proceedings, returning to the stage as it stood prior to the conclusion of oral argument. If a declaration of provisional execution is stated with the judgment of an action on bills and notes, it naturally will not lose effect as a result of the transfer to the ordinary proceedings, but if a *prima facie* showing is made with regard to the circumstances under which the judgment should be revoked or modified, an order of a temporary stay of execution may be issued (CCP Article 403(1)(v)).

(3) There is a strong possibility that a petition for commencement of bankruptcy proceedings will be filed in connection with the borrower, in the event that the borrower has no dispute over the existence of its debt but does not pay its debt because of its solvency problems. In this event, given that the borrower in a call transaction is a financial institution in the broad sense, it is very likely that an order will be issued when a petition is filed such as a stay order of compulsory execution (e.g., Bankruptcy Act Article 24(1)(i)), a comprehensive prohibition order (e.g., Bankruptcy Act Article 25(1)), or a stay order of court proceedings (e.g., Bankruptcy Act Article 24(1)(iii)) in addition to a temporary restraining order that prohibits payment (e.g., Bankruptcy Act Article 28(1) and (6)). Moreover if a decision is made to commence the bankruptcy proceedings, it will in principle be impossible to collect on (an unsecured) claim outside the bankruptcy proceedings (e.g., Bankruptcy Act Article 42(1) and Article 44(1)). That being the case, it would be even more difficult to envision a situation in which collection will be achieved by bringing an action on bills and notes than would be the case in (2) above.

(4) In view of the above, although it is not possible to state that there is absolutely no advantage to holding a call note, it is almost entirely impossible to conceive of a situation in which not receiving a call note will actually constitute an impediment to collection of claims.

5. Issues Resulting From Receipt of a Call Note

It is also necessary to consider the disadvantages and not just the advantages of receiving a call note.

(Explanation)

(1) Although it is likely that there is little awareness of any disadvantage to the lender in receiving a call note, these disadvantages are not entirely absent. For example, the lender will incur a risk of loss of the call note after receiving it. If the borrower knows that the lender lost the call note, it can make an affirmative defense for simultaneous performance arguing that it will make payment in exchange for the note as discussed above in connection with performance of the underlying claim. The lender would also incur the losses in the event that the borrower has made payment to a third party holder of the note in good faith, even after the exercise of the underlying claim.

(2) Moreover even if Lender B asserts that it has set off its claim towards Borrower A under the call transaction against Borrower A's cross-claim towards Lender B on deposits, call or other transactions, the possibility still exists that Borrower A's creditors (e.g., those who have obtained an attachment on Borrower A's cross-claim towards Lender B) may assert that the asserted setoff is invalid, because the right of affirmative defense for simultaneous performance exists against Lender B's claim towards Borrower A.

6. Duty of Care of the Lender

The lack of receipt of a call note cannot be said to constitute a violation of a duty of care to the trustor of the lender (the trustee in an investment trust) or a duty of care to the beneficiary of the trustor

(Explanation)

As explained above, it is difficult to conceive of a situation in which not receiving

a call note would create an actual impediment in collecting on claims. That being the case, it cannot be stated that not receiving a call note would violate the duty of care to the trustor of the lender (the trustee in an investment trust) or the duty of care to the beneficiary of the trustor.