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Financial Law Board

Issues Concerning the Interest Rate Regulations with regard to Mezzanine Loans
- Treatment of Contractual Compound Interest -
(Summary)

<Relevant issues>

While debt financing involving senior loans and bonds or equity investments made through stock acquisitions are major forms of financing in Japan's financial markets, the mezzanine finance market has yet to become established. Mezzanine finance is positioned between senior loans and equities, includes instruments such as subordinated loans, subordinated debts and preferred shares, and has already infiltrated markets in Western countries. There is a range of possible factors behind the lack of development of such financing in Japan. One of the constraints on the structuring of mezzanine loans is the interest rate restrictions imposed by the Interest Rate Restriction Act (the "IRRA") and the Act Regulating the Receipt of Contributions, the Receipt of Deposits, and Interest Rates (the "Contributions Regulation Act"). In mezzanine loans, PIK (payment in kind) interest rates are often employed to allow for some interest payments to be carried over and incorporated into principal for the calculation of compound interest. The employment of PIK interest rates makes economic sense considering the subordinated nature and relatively high risk of mezzanine loans. Moreover, they have already become standard practice overseas. In Japan, however, it is not clear how contractual compound interest is treated under the restrictions on maximum interest rates. This uncertainty becomes a major constraint in practice. This article, after reviewing the issues raised in judicial precedents and academic discussions concerning contractual compound interest, demonstrates that the current laws may be flexibly interpreted to reach a reasonable conclusion.

1. What is PIK interest?

PIK interest payments are to be carried over to maturity date to be paid in a lump sum, without being paid on each interest payment date. Specifically, for each compounding interval, PIK interest amounts calculated using the agreed interest rate and the principal balance (the total of the original principal and accumulated preceding PIK interest amounts) are accrued as interest and incorporated into the principal.

Mezzanine loans have characteristics akin to those of equities because they are subordinate to senior loans and are economically equivalent to preferred share investments. Therefore, on each interest payment date, the repayment of principal and interest on senior loans should be given priority. With regard to mezzanine loans, only a portion of the interest payments due are actually made, using the applicable interest rate, while the remaining interest amounts are carried over until the loan matures.

2. Concept of compound interest in the Civil Code

In academic discussions, "compound interest" is defined as the interest amount calculated by incorporating the amount of interest owing on the due date into the principal and applying the original interest rate to that accumulated interest and principal. These include statutory compound interest based on Civil Code provisions if there is no agreement between the parties, as well as contractual compound interest if there is an agreement between the parties.

(1) Statutory compound interest

Article 405 of the Civil Code provides that "Where the payment of interest corresponding to one year or more is delayed, and if the debtor does not pay such interest notwithstanding the demand by the creditor, the creditor may incorporate such interest into principal." Even without a specific agreement on compound interest, default interest may be added to principal after creditors declare their intentions if (i) interest payments are delayed for a year or more; and (ii) the creditors demand payment.

(2) Contractual compound interest

Contractual compound interest, based on the parties' agreement, may generally be classified into the following types:

(a) Ex post facto incorporation agreement: If interest payments are not made on their due dates, the parties may agree that default interest is incorporated into the principal.

(b) Prior agreement on compound interest: Parties agree to incorporate interest into principal before the interest due date.

   (i) An agreement to incorporate default interest into the principal if interest payment is delayed;

   (ii) An agreement not to make interest payments on the interest payment dates and instead to incorporate those interest payments into the principal.

3. Application of the IRRA to contractual compound interest

(1) Development of judicial precedents

Pre-World War II precedents took the unanimous position that a prior agreement on compound interest (where the parties agreed that interest in arrears was to be incorporated into principal) was valid under the principle of freedom of contract as long as the interest rate applied was no greater than the maximum interest rate), as Japan's Civil Code did not prohibit compound interest. However, some precedents indicated that contractual compound interest should not have been valid without qualification only because the interest rates applied were no greater than the maximum interest rate.

Moreover, there were also influential opinions supporting the view that contractual compound interest (specifically, where incorporation of interest was scheduled several times a year) should be subject to the IRRA (annual rate restrictions).

After the war, based on these influential opinions, the Supreme Court gave a decision that limited interest incorporation to the inclusion of interest on an annual basis. The Supreme Court decision delivered on April 21, 1970 established the rule which required that the total annual incorporated amount should not exceed the total annual amount of interest permitted under the IRRA where the parties agreed to incorporate interest several times a year. Specifically, the decision stated that "…considering that Article 405 of the Civil Code specifies interest being overdue for one year and a payment demand as requirements for interest incorporation in statutory compound interest, and that the IRRA clarifies, in the form of annual rates, the maximum amount of interest that lenders can charge, if the parties to a loan contract agree to compound interest where interest is incorporated several times a year, such compound interest is valid as long as the annual rate of interest for such incorporated sum and interest thereon relative to the original principal is no greater than the maximum rate under the IRRA. If the total amount exceeds said limit, the excess portion is not valid."

These precedents, however, concern only a prior agreement on compound interest with an interest payment delay requirement. There is no precedent that directly deals with a prior agreement on compound interest where interest is incorporated into principal without delay of interest payments being required. Therefore, the scope of the 1970 decision outlined above may be somewhat unclear.

(2) Academic discussions

Though acknowledging that there are two types of prior agreements concerning compound interest (one that requires delayed interest payments and one that does not), the majority of commentators today agree with the Supreme Court's handling of compound interest without specifying whether or not payment delay is required.

Before the 1970 decision, however, some academics claimed that prior agreements on compound interest should be clearly classified into those that require delayed interest payments and those that do not, in order to assess the validity and limitations of contractual agreements on compound interest. For example, where a creditor is not obliged to receive interest when interest becomes payable and the interest is automatically incorporated into the principal, some considered that the difference between the total amount to be paid on the maturity date and the original principal sum was the true amount of interest. Thus, it is argued that the sum of the original principal amount and aggregated interest is paid on maturity date and the rate restrictions of the IRRA should be assessed against the original principal amount. However, these opinions were developed before the 1970 decision, and it is not clear how much support they can draw from academia today.

4. Calculation of PIK interest rates

The below analyses are undertaken from two perspectives: (1) whether the 1970 decision supports the IRRA interpretation that a prior agreement on compound interest does not require interest payment delay; and (2) whether PIK interest in mezzanine loans is different in nature from a prior agreement on compound interest that does not require interest payment delay.

(1) The scope of the 1970 decision: Interpretation of the IRRA

Based on the following criteria, it is reasonable to assume that the 1970 decision supports the IRRA interpretation that a prior agreement on compound interest does not require interest payment delay.

(a) Principles of respecting parties' intentions and freedom of contract

From pre-war Supreme Court jurisprudence to the 1970 decision, precedents focused on the parties' intentions (the principle of freedom of contract) to treat interest as principal, and expressed the view that contractual compound interest was valid if delayed interest was incorporated into principal to the extent that the interest rate was no greater than that specified in interest rate restrictions. From this perspective, if the parties agree to compound interest without a payment delay requirement, there should be no reason to apply the interest rate regulations in a more restrictive manner than to contractual compound interest with a specific interest payment delay requirement.

(b) Annual interest incorporation limit

The 1970 decision established the safety framework to limit the total amount of interest incorporated per year and to subject this amount to the interest rate regulations, as the effective annual rate may rise dramatically under compound interest with incorporations several times a year, even when the agreed nominal interest rate itself appears to be in compliance with interest rate restrictions. Also, for a prior agreement on compound interest with no interest payment delay requirement, there should be no reason to apply the interest rate regulations in a more restrictive manner, as the undesirable social effects of contractual compound interest should be avoided as long as the total amount of interest that can be incorporated per year is limited to the same extent as for statutory compound interest.

(c) Requirements of interest payment delay and payment demand by creditors

Article 405 of the Civil Code provides that statutory compound interest cannot be charged unless (i) there has been a delay in interest payments for one year or more; and (ii) payment demand has been made by creditors. This is based on balancing considerations. It would put an undue burden on debtors if creditors were allowed to unilaterally impose compound interest and incorporate interest into principal when there was no agreement between the parties, unless debtors were at least given notice and an opportunity to avoid compound interest. On the other hand, it would be unfair to creditors if the right to incorporate interest into principal was not given to creditors despite the fact that interest payments were not made for one year or more and a demand for payment was duly made. In contractual compound interest, however, there is no need for such a consideration (because both parties agreed to incorporate interest into the principal on payment dates, being fully aware of its effect).

(d) Consistency with the Contributions Regulation Act and the Money Lending Business Act

While there is no specific provision concerning compound interest in the IRRA, the Contributions Regulation Act specifies that "if the contract incorporates less than one year's interest into principal, interest is deemed to be the amount in excess of the original principal." The Money Lending Business Act has a similar provision. In order to prevent the repeated incorporation of less than one year's interest into principal, relying on the fact that the agreed interest rate itself appears to be in compliance with interest rate restrictions, these provisions limit the incorporation of less than one year's interest into principal to the same extent as for statutory compound interest (in other words, incorporated interest is valid as long as the total annual amount of interest incorporated complies with the interest rate regulations). Both provisions are considered to be based on the same conceptual framework as that employed in the 1970 decision concerning the IRRA. These provisions are interpreted as applying not only to a prior agreement on compound interest with an interest payment delay requirement, but also to an agreement on compound interest without such a requirement.

Whether or not interest payment delay is required, the Contributions Regulation Act and the Money Lending Business Act provide a framework for assessing the validity and limitations of contractual agreements on compound interest, using a one year window. Thus, it is logical to take the view that the interpretation of the IRRA formulated in the 1970 decision covers prior agreements on compound interest with no interest payment delay requirement.

Based on (a) through (d) above, it should be concluded that the interpretation of the IRRA formulated in the 1970 decision covers prior agreements on compound interest without an interest payment delay requirement.

(2) Analyses in the context of mezzanine loans

(a) Debtors' right to prepayment

Debtors, senior lenders and mezzanine lenders usually consent to intercreditor agreements in which debtors promise not to prepay mezzanine loans without senior lenders' consent before the senior loans are paid off. Thus, when debtors are able to secure the senior lenders' consent or pay off senior loans, they are entitled to an option to prepay mezzanine loans in full or in part (mezzanine lenders cannot reject such voluntary prepayments). In this respect, debtors are given an opportunity to avoid compound interest through prepayment.

(b) Restrictions in relation to senior loans

The maturity dates of most senior loans are structured to precede those of mezzanine loans, and mezzanine loans are often refinanced along with senior loans within a few years of execution. Considering these circumstances, it can be said that prepayment of mezzanine loans is quite common. Furthermore, given that mezzanine lenders cannot reject valid prepayments, the restriction on prepayment of mezzanine loans prior to full repayment of senior loans can be considered a sort of extrinsic and temporary restriction arising from the subordination arrangement among senior and mezzanine lenders.

In addition, the purpose of carrying over some mezzanine loan interest is to secure funds for repayment of senior loans. Mezzanine loans are subordinated in the payment of principal and interest by way of credit enhancement to senior loans, and senior loan interest rates are therefore set lower to that extent. Certainly, debtors are restricted from prepaying mezzanine loans before senior loans are paid off, but there is a trade-off between the lower interest rates on senior loans and such restrictions. This should never be considered an unfair arrangement depriving debtors of an opportunity to avoid the burden of compound interest.

In light of (a) and (b) above, PIK interest agreements are different in nature from the aforementioned prior agreements on compound interest without an interest delay requirement, where creditors have no obligation to receive interest payments from debtors. The foregoing discussion shows that the scope of the 1970 decision covers PIK interest.

5. Conclusion

The scope of the 1970 decision covers PIK interest agreements typically found in mezzanine loans. The IRRA should be interpreted as allowing the incorporation of interest into principal within the limitations imposed by the interest rate regulations.

End

Note: The full text of this paper is available in Japanese only.