

THE TRANSPORT  
FINANCE LAW  
REVIEW

SIXTH EDITION

Editor  
Harry Theochari

THE LAWREVIEWS

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TRANSPORT  
FINANCE LAW  
REVIEW

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# PREFACE

*The Transport Finance Law Review* is intended to provide the industry with a guide to transport finance today, in each of the key jurisdictions globally in which aircraft, rolling stock and ships are financed.

The transformation of the asset finance industry triggered by the global financial crisis has been well-documented. Before the crisis, traditional asset finance, in the form of bank debt, had been the mainstay of the transport sector.

Now, regulation introduced with the intention of preventing future crises, such as Basel III and Basel IV, has made long-term lending to the transport sector significantly less attractive. This has, in part, led certain banks to exit the asset finance market altogether, by selling all or part of their loan books to help them to meet their capital requirements.

At the same time, the aviation, rail and cruise industries have required a steady stream of finance to acquire additional assets to help them to meet growing demand from passengers, particularly in developing economies. This, coupled with the desire, and in many cases the requirement, for more environmentally friendly and sustainable transport, the advent of new and disruptive technologies (such as autonomy, blockchain and artificial intelligence) and the introduction of increasingly sophisticated technology (such as high-speed rail and high-specification ships) is leading to increased funding requirements in many areas of the transport sector.

Asset finance in its traditional form is now available from relatively few banks, who in turn are prepared to lend to relatively few names, which are usually leaders in their relevant sectors and have green credentials, which satisfy new environmental standards set out in, for example, the Equator Principles or the Poseidon Principles. Tenors tend to be shorter, and borrowing more expensive. It is clear that debt finance alone is no longer sufficient to meet the needs of the global aviation, rail and shipping industries. Other financiers and investors have recognised this and have identified significant opportunities to secure returns, using innovative new funding structures, and often in collaboration with traditional lenders who have remained in the market.

These developments have meant that legal advisers to the transport finance sector are now required to provide a far broader set of legal skills and market knowledge than has previously been required.

At the time of writing, capital is readily available to much of the aviation industry, which is benefiting from rising demand for air travel and industry forecasts anticipating a doubling of passenger numbers in the next 20 years. The capital markets are also open for business for the aviation industry, and there is a flow of equity investments from both hedge funds and private equity as well as large-scale investments from Asia (and China in particular).

In the rail market, passenger demand is also increasing and significant investment is being made in new and existing rail assets globally. Increased appetite for high-speed rail and light rail transit is encouraging rail market participants to look outside of their traditional markets in search of new opportunities in developing countries, including those forming part of China's Belt & Road Initiative.

Attitudes towards the shipping industry are generally more cautious. The amount of debt finance available to shipping has fallen dramatically, and alternative sources of finance, such as private equity, hedge funds, bond markets and capital markets, have also reduced. This is not surprising to many as shipping gradually emerges from possibly the worst recession it has ever experienced in modern times, impacting across the entire spectrum of the industry. Shipping is still a hugely entrepreneurial business with more than its fair share of dynamic owner principals who are still making sizeable commercial bets as to where the industry is heading and this has led, in a number of sectors, to an over ordering of ships in recent times, which has kept the market depressed.

Today, capital markets, private equity structures and leasing account for a substantial proportion of the transport finance market. A number of private equity players are buying loans from traditional banks at a large discount to see immediate returns. Others have invested directly in shipping in the belief that the cyclical nature of shipping will result in returns in the medium to long term. In the aviation industry, leasing firms, which are frequently supported by private equity players, now account for about 40 per cent of the major aircraft manufacturers' sales. In the case of rail, new investors are being attracted to the industry by the commitments made by governments worldwide to improve existing infrastructure and invest in new, sophisticated rail links.

Against this evolving financing landscape, new environmental regulation and disruptive technology is bringing about further changes. Artificial intelligence, distributed ledger technology such as blockchain, and low carbon technology are creating new funding requirements, as well as bringing new participants into the transport sector, with new ideas for raising finance.

The aviation, rail and shipping industries each have their own unique characteristics and need lawyers with a deep understanding of how each of these complex industries operates. A detailed knowledge of the principles of asset finance is now also required, combined with the ability to advise on new capital markets, leasing and corporate structures. In addition, while the majority of asset financings in the transport sector tend to be governed by English or New York law, an understanding of the principles of local law in the key jurisdictions in which transport assets are registered is also of great importance.

We have sought contributions from jurisdictions that play a leading role in the financing of transport assets. Each chapter provides an overview of the transport finance industry in these jurisdictions, with an analysis of how key lenders have changed over the past five years and how the financing of assets has developed as a result. Contributors have provided an overview of the legislative framework for transport finance and financial regulation affecting lenders to the transport sector. Authors have also been asked to review any significant innovations and notable recent and pending financings and cases, and to provide assessments of how the transport sector is likely to continue to develop in their markets.

I would like to thank the contributors to this volume. Their efforts are deeply appreciated and represent a substantial contribution to the transport law library as the sector continues its transformation.

Each contribution reflects the significance of the transport sector today, and the need for readily available funding for industries that underpin the global economy by transporting people and commodities around the world every day.

Lawyers have had to become increasingly nimble as clients require advice on developing intricate joint-venture agreements and complex capital market products, and increasingly on the opportunities and threats presented by environmental challenges and disruptive change throughout the transport sector. It is an incredibly exciting time to be a lawyer in this field, as our contributors demonstrate in the following chapters.

**Harry Theochari**

Norton Rose Fulbright

London

April 2020

# JAPAN

*Kosuke Shibukawa and Ryuichi Sakamoto<sup>1</sup>*

## I INTRODUCTION

### i The transport finance industry

Aviation is one of the few growing fields for financiers, because the market has recently opened up to low-cost carriers. Japanese financiers (including banks, leasing companies and trading companies) have ambitiously started to participate in aviation finance or investment focusing on the profits brought by aeroplanes themselves rather than the credit capabilities of airlines.

Unlike the aviation industry, there has been fierce competition in the shipbuilding field within Southeast Asia, especially in Japan, China and Korea,<sup>2</sup> which is because there are many ship types,<sup>3</sup> sizes<sup>4</sup> and quantities. Since the global financial crisis, order numbers for new vessels have reduced. However, in conjunction with the recent development of the shipping market, the number of new ships and finance transactions has increased in Japan.

In the rail business, the Japan Railway Construction, Transport and Technology Agency (JRJT)<sup>5</sup> issued a 'green bond' for the construction of train lines in east Kanagawa in November 2017, of which fitness for the guidelines on green bonds was officially confirmed for the first time by the Ministry of the Environment.<sup>6</sup>

In the general area of transport finance, the Basel Capital Accords have required financial institutions to be careful in examining financing. Liquidation of credit receivables, such as securitisation of aviation finance or loan participation in ship finance, has gradually increased. Basel III, which deals with liquidity coverage ratios (LCRs) and net stable funding ratios (NSFRs), may also have a certain influence on the field of transport finance.

### ii Recent changes

#### *Aviation*

As a result of amendments to the tax regime in fiscal year 2005, all the benefits gained from leveraged leases in aviation were removed; thus, the operating lease has become the most frequently used structure for aviation finance. Although there are a large number of varieties in the structure of the operating lease, from the perspective of investor participation, it is

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1 Kosuke Shibukawa is a partner and Ryuichi Sakamoto is an associate at Nishimura & Asahi.

2 Examples of this include CSSC, Daewoo, Hyundai, Imabari, and Samsung.

3 Examples of this include bulk carriers, container ships, oil tankers, chemical tankers and reefer ships.

4 Examples of this include Handysize, Panamax and Capesize.

5 An independent Japanese administrative institution.

6 Mizuho Securities Co, Ltd, 'Capital Market Letter', 18 January 2018.

typically the case that: (1) the investors directly own the aircraft; (2) a voluntary partnership set up by the investors, which usually consists of more than three special purpose companies, owns the aircraft; or (3) a silent partnership is set up and the operator of the partnership, which is usually a special purpose Japanese corporation, owns the aircraft. Among these, the structure of either a silent partnership or a voluntary partnership is often utilised. Further, when the lease and loan are back to back and a call option by the lessee to purchase the aircraft is then also granted under the lease agreement, it is called a JOLCO.<sup>7</sup> The JOLCO structure is often used by domestic and international airline companies to maintain their fleets. However, although funds for purchasing an aircraft are often financed in the form of loan financing, as indicated in Section IV.i below, the limitation of including interest payments based on loans outside Japan into deductible expenses for tax purposes has expanded, starting the business year from 1 April 2020, pursuant to the amendment to the tax regime promulgated as of 29 March 2019 and, accordingly, it may affect the investors' tax merits regarding the JOLCO structure financed by foreign financial institutions.

In recent years, aviation financing through Japanese enhanced equipment trust certificates – securitised products backed by security interests created in aircraft assets – has been implemented, where a trust governed by the Trust Act of Japan obtains funds by issuing trust beneficial interests to Japanese financial institutions and then purchases aircraft from manufacturers and leases them to airlines.

### ***Shipping***

Because of the weakness of the Japanese yen against foreign currencies, the financial condition of domestic shipowners has recently improved as financiers have begun to focus on ships as investments with a good rate of return. In the context of ship finance, JOLCO transactions are often adopted as a financial option for ship operators. Thus, the structure is, like aircraft JOLCO, either that of a silent partnership or a voluntary partnership, and ownership of the vessel is held by the operator or the voluntary partnership. A call option by the charterer to purchase the vessel is granted under the charter agreement, and the charter and loan are back to back. In recent years, the number of cross-border JOLCO transactions – where ships are owned by Japanese partnerships or special purpose vehicles (SPVs) and then chartered to non-Japanese shipping companies – has been increasing. Meanwhile, with almost the same structure, JOLCO transactions in relation to containers are also being set up by Japanese or non-Japanese shipping companies, lease companies and financial institutions. However, the tax regime amendment as indicated above may also have an effect on the investors' tax merits regarding the JOLCO structure in relation to ships or containers financed by foreign financial institutions.

Under Annex VI of The International Convention for the Prevention of Pollution from Ships, 1973, as modified by the Protocol of 1978 relating thereto (MARPOL), vessels operating in emission control areas may, as of 1 January 2015, only burn bunker oil with a maximum 0.1 per cent sulphur content, so there is a demand for liquefied natural gas (LNG) as fuel in these areas. The Japanese government and shipping industry are trying to

---

7 In cases where the lessee exercises the call option, the investors can receive a full refund of their investments, but if the lessee does not exercise the call option, the operator should sell the returned aircraft to a third party and the sale price should be applied to the investment refund. At this point, the investors should take the risk associated with the residual value of the aircraft (however, it is the investors taking a risk on the residual value of the aircraft that is the basis from which the investors can receive benefits from the depreciation of the aircraft).

put LNG-fueled vessels into practical use, which will also lead to a greater demand for LNG tankers and LNG-bunkering vessels. In 2017, the world's first LNG-bunkering vessel, *Engie Zeebrugge*, jointly owned by Nippon Yusen Kaisha, Mitsubishi Corporation and FLUXYS SA, was completed at the shipyard of Hanjin Heavy Industries and Construction. It is likely that finance for LNG vessels and projects will become progressively more attractive.

An amendment to the Commercial Code of Japan in relation to transportation law and maritime law came into effect on 1 April 2019. With respect to ship finance transactions, in accordance with the amendment, certain types of claims, such as accrued freight charges and expenses of preservation after judicial sale or at last port, have not been covered by maritime liens and 'time charter agreement' was newly defined.

## II LEGISLATIVE FRAMEWORK

### i Domestic and international law and regulation

#### *Aviation*

Broadly, the Aviation Act covers the relevant issues of aircraft safety, air navigation, as well as proper and rational management of the air transport business.<sup>8</sup>

The person who has the ownership right of an aircraft may apply for registration of that right. Upon registration of an aircraft with the aircraft register, the aircraft becomes eligible for a certificate of airworthiness from the Japanese aviation authority and operation in Japan. Ownership of an aircraft can be perfected upon registration in Japan,<sup>9</sup> but an aircraft owned by (1) persons who do not have Japanese nationality; (2) foreign governments, foreign public bodies or any other similar associations; (3) legal persons or other associations established under foreign law; or (4) a legal person whose representative falls within one of the above categories, or of which one third or more of the directors or the people who hold voting rights fall into one of the above categories, and those under foreign state flags, may not register.<sup>10</sup> A party that intends to participate in the air transportation business must also obtain permission from the Ministry of Land, Infrastructure, Transport and Tourism.

The 2006 Cape Town Convention on International Interests in Mobile Equipment has not been ratified in respect to mortgages or liens on aircraft, so the domestic Aviation Mortgage Law is applicable.

#### *Shipping*

There are several Japanese laws broadly covering the marine transportation business in relation to ships and vessels. For example, the Ships Act stipulates the requirements for owners of Japanese-flagged vessels, the Marine Transportation Act sets the rules on the marine transportation and ship chartering business, the Mariners Act sets the rules on the working conditions for crew on Japanese-flagged vessels, and the Ships Safety Act stipulates the standards on navigation of vessels for the safety of human life.

Under the Ships Act, there are statutory requirements for owners of Japanese-flagged vessels, which limit ownership to: (1) the Japanese government or public authorities; (2) Japanese nationals; or (3) legal entities incorporated under Japanese law of which the

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8 Section 4 of the Aviation Act.

9 Section 3-3 of the Aviation Act

10 Section 4 of the Aviation Act.

representative director and two-thirds of the executive officers must be Japanese nationals. There are, however, no particular regulations applicable to owners of foreign-flagged vessels, who are always subject to the law governing the registration of the vessels.

Registration of ownership or mortgages on Japanese vessels takes place in accordance with the Ships Act,<sup>11</sup> the Ship Registration Rules, or the relevant regulations. In terms of maritime liens and ship mortgages, which concern financiers, Japan has ratified neither the International Convention for the Unification of Certain Rules relating to Maritime Liens and Mortgages of 1967 nor the International Convention on Maritime Liens and Mortgages of 1993. Enforcement of liens and mortgages on ships is dealt with under the Civil or the Commercial Code.

Chapter 3 of the Commercial Code (maritime law) broadly covers commercial transactions or issues concerning shipping, maritime and admiralty.

### ***Rail***

According to the Railway Business Act,<sup>12</sup> parties that enter the railway business must obtain permission from the Minister of Land, Infrastructure, Transport and Tourism. Before 1999, the railway business was licensed by the government only taking into consideration supply and demand, but competition was subsequently introduced into the field.

The Railway Mortgage Act makes provisions for mortgages secured on complete railway facilities incorporated as 'foundations'.

## **ii Specific practices**

### ***Aviation***

Because of the requirements for ownership registration as described in Section II.i above, a structure has been developed in Japan to allow an aircraft to be registered in Japan while the economic ownership thereof remains with a foreign entity. Under this structure, the aircraft is sold by a foreign entity, usually to a Japanese special purpose company (the Japanese owner) that is wholly owned by a local Japanese entity (usually a Japanese trading company). This satisfies the nationality and corporate structure requirements of the Aviation Act. The aircraft is registered in the name of the Japanese owner, and all the rights to possess and use the aircraft are transferred back to the foreign owner pursuant to a conditional sale arrangement. Additionally, the Japanese owner must transfer the ownership rights of the aircraft to the foreign owner upon the foreign owner's exercise of its repurchase option in exchange for payment of a nominal sum. The Japanese owner also grants a priority mortgage in favour of the foreign owner to secure the obligation to transfer the ownership.

### ***Shipping***

Japanese maritime law was originally intended to cover Japanese-flagged vessels owned by Japanese owners, and there have been many disputes over the issues of whether mortgages on foreign-flagged vessels are recognised, and whether liens on foreign vessels are created for credit or claims brought under contracts governed by foreign law. This is a matter of international conflict law, and no clear answer has yet been supported by Japanese statute.

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11 The Ships Act regulates qualification, registration and national certification for Japanese vessels.

12 Section 3 of the Railway Business Act.

## **Rail**

In the established Japanese system, the JRJT directly finances each railway operator, upon obtaining funds from a variety of financial resources.<sup>13</sup> Railway operators obviously prefer to undertake railway construction or provide services in a stable investment environment so that the investment is beneficial in the long term. Railway facilities are leased or assigned to railway operators by the JRJT, which retains ownership. Finance for train construction is usually obtained by debt finance, vehicle trust, lease or leveraged lease.

### **III FINANCIAL REGULATION**

#### **i Regulatory capital and liquidity**

According to the Banking Act, the prime minister may set the levels of capital adequacy for financial institutions; under this Act, the minimum capital adequacy ratios were set at 8 per cent for financial institutions subject to international standards and at 4 per cent for financial institutions subject to domestic standards as stipulated in the Pronouncement of the Financial Services Agency of 27 March 2006, in accordance with Basel I and II.

The Financial Services Agency published the revised pronouncement following Basel III: (1) of the international standards for financial institutions on 30 March 2012, effective from 31 March 2013; and (2) of the domestic standards for financial institutions on 8 March 2013, effective from 31 March 2014.

The LCR under Basel III was implemented on 31 March 2015 with a required level of at least 60 per cent, and as a result of being raised in a phased manner, the required level reached 100 per cent as of 1 January 2019. The NSFR, which requires financial institutions' medium to long-term funding to be covered by their medium to long-term financial resources, was scheduled to be introduced on 31 March 2019, and thereafter financial institutions having foreign branches were supposed to need to maintain an NSFR of not less than 100 per cent.<sup>14</sup> However, the Financial Services Agency announced, as of 22 March 2019, that the introduction of the NSFR will be postponed in light of the status of each country's implementation of the regulations about LCRs.

In the meantime, the Deposit Insurance Act, which secures funds of depositors in the event of a bank's failure under the management of the Deposit Insurance Corporation, was revised on 12 June 2013.

#### **ii Supervisory regime**

If a non-Japanese person intends to make a loan to a Japanese ship or aircraft owner set up under a JOLCO transaction, such person, in general, needs to fulfil one of the following conditions: (1) to establish a joint stock corporation in Japan and cause it to obtain a permission under the Banking Act; (2) in the case where the person is an authorised foreign

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13 The JRJT obtains certain funds from commercial banks, such as by way of syndicated loan schemes. According to recent information from the JRJT, it currently plans to finance by way of syndicated loans in March 2020, ¥42.6 billion for a maximum of four years.

14 Yuki Kanemoto 'Publication of Draft Pronouncement Regarding Net Stable Funding Ratios', Daiwa Institution of Research on 20 July 2018.

bank, to open a branch in Japan and cause it to obtain a permission under the Banking Act; or (3) to complete a registration as a Money Lending Business under the Money Lending Control Act.<sup>15</sup>

## IV SECURITY AND ENFORCEMENT

### i Financing of contracts

#### *Ships*

In many cases, newly built ocean-going vessels are registered in Panama or other tax-haven countries<sup>16</sup> and are owned by SPVs established there, and below we outline examples of foreign-registered vessels. The finance schemes for such vessels depend on the laws of the countries in which they are to be registered, as the enforceability and effect of the security interests can be governed by such laws. There are two major schemes that are used to finance these vessels: ship-owner finance schemes and JOLCO schemes.

Under a shipowner finance scheme, the vessel is owned by an SPV established and controlled by the shipowner, the financier makes the loan to the SPV and the loan is guaranteed by the shipowner and secured by the vessel mortgage, insurance assignment and charter hire assignment. Typically, the following agreements are prepared:

- a* a loan agreement between the loan financier and the SPV;
- b* a loan guarantee between the loan financier and the shipowner;
- c* a mortgage agreement between the loan financier and the SPV;
- d* a charter hire assignment between the loan financier and the SPV; and
- e* an insurance assignment between the loan financier and the SPV.

Under a JOLCO scheme, the vessel is purchased from the ship operator by an SPV established in a flag of convenience country and controlled by a leasing company, which then becomes the registered owner. The registered owner SPV then sells the beneficial ownership of the vessel on an instalment sale basis to an SPV established under Japanese law and also controlled by the leasing company and obtains funds to purchase the vessel through a loan from loan financiers and a silent partnership investment from Japanese investors. Further, the vessel is bareboat chartered from the Japanese SPV to the ship operator (or its SPV). The loan is secured by the vessel mortgage, insurance assignment and charter hire assignment or other security interests. For a JOLCO scheme, typically the following agreements are prepared:

- a* a loan agreement between the loan financier and the Japanese SPV;
- b* a bareboat charter agreement between the Japanese SPV and the ship operator;
- c* an instalment sale agreement<sup>17</sup> between the registered owner SPV and the Japanese SPV;
- d* a silent partnership agreement between the investors and the Japanese SPV;

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15 Japanese financial regulations are quite complicated, and there is a grey area as to whether such non-Japanese lenders actually need to obtain permission or registration set out above under the respective Japanese financial laws. Non-Japanese lenders should consult with a Japanese law firm specialising in cross-border financial transactions before participating in lending to Japanese borrowers.

16 However, some JOLCO transactions adopt Japan registered vessels.

17 The registered owner SPV sells the vessel to the Japanese SPV on an instalment sale basis under an instalment sale agreement, provided that the last instalment purchase amount, which is nominal, is not due until the charter of the vessel is terminated.

- e* a mortgage agreement between the registered owner SPV and the loan financier;
- f* a charter hire assignment between the loan financier and the Japanese SPV; and
- g* an insurance assignment between the loan financier and the Japanese SPV.

### ***Rolling stock***

Railway construction is characterised as public infrastructure development, even if it is operated by a private railway company. Railways are constructed by the JRJT and sold to each railway company on an instalment basis, and there is a railway mortgage system in place to secure such loans. Under this system, the railway, rolling stock, and any other facilities necessary for railway operations are treated as a monolithic property known as a 'railway foundation' to prevent railway facilities from being sold off in pieces by public sale.

So far, in most cases, rolling stock is self-financed and lease schemes have not been used often in Japan.

### ***Aircraft***

In general, there are a number of varieties of aircraft finance transactions; however, given the space constraints, we focus on two typical schemes: (1) where a foreign SPV has economic ownership of the aircraft and leases it to a Japanese airline; and (2) where Japanese investors, directly or through an SPV or partnership, have economic ownership of the aircraft and lease it to a Japanese or non-Japanese airline.

With respect to scheme (1) above, as described in Section II.ii above, to enable an aircraft to be registered in Japan while the economic ownership thereof remains with a foreign SPV, the aircraft must be sold by a foreign SPV to a Japanese SPV that is wholly owned by a local Japanese entity (usually a Japanese trading company). Meanwhile, the Japanese SPV sells back its beneficial ownership to the foreign SPV pursuant to a conditional sale arrangement<sup>18</sup> but continues to hold the legal title to the aircraft during the lease period for registration purposes, and the Japanese SPV also grants a priority mortgage in favour of the foreign SPV to secure the obligation to transfer the ownership to the foreign SPV. This scheme also requires a lease agreement, an aircraft sales agreement, a participation agreement, a share pledge agreement and (in the case where loan finance is additionally obtained) a loan agreement, a mortgage agreement and a security assignment agreement for the loan financier. Please refer to the following breakdown:

- a* an aircraft operating lease agreement between the foreign SPV and the lessee;
- b* a (second priority)<sup>19</sup> mortgage agreement between the Japanese SPV and the foreign SPV;
- c* an aircraft sales agreement between the foreign SPV and the Japanese SPV;
- d* a conditional sales agreement between the Japanese SPV and the foreign SPV;
- e* a share pledge agreement between the foreign SPV and the parent company of the Japanese SPV;
- f* (in case of loan financing) a loan agreement between the loan financier and the foreign SPV;

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18 The Japanese SPV sells the aircraft on an instalment sale basis under the conditional sales agreement, but the last instalment (usually a nominal amount) will not become due until the end of the lease to the operator.

19 If loan finance is additionally obtained, the lender holds the first priority mortgage and the foreign SPV holds the second priority mortgage.

- g* (in case of loan financing) a first priority mortgage agreement between the loan financier and the Japanese SPV;
- b* (in case of loan financing) a security assignment agreement regarding lease and insurance receivables between the loan financier and the foreign SPV; and
- i* a participation agreement between, inter alios, the Japanese SPV, the foreign SPV, the lessee and, as the case may be, the loan financier.

With respect to scheme (2) above, as described in Section I.ii above, it is typically the case that the investors directly own the aircraft or a voluntary partnership or a silent partnership is set up and the voluntary partnership or the operator (usually a Japanese SPV) of the silent partnership (collectively, ‘owner’) owns the aircraft. In either case, the aircraft is leased to an airline (or its SPV), and a loan financier makes a loan to the owner and the loan is secured by the aircraft mortgage, assignment of insurances and lease receivables, and airframe and engine warranties, and typically the following agreements are prepared:

- a* a loan agreement between the loan financier and the owner;
- b* an aircraft operating lease agreement between the owner and the lessee;
- c* (in case of a silent partnership) a silent partnership agreement between the investors and the owner;
- d* a mortgage agreement between the loan financier and the owner;
- e* a security assignment regarding lease and insurance receivables between the loan financier and the owner;
- f* an airframe warranties agreement between the airframe manufacturer, the lessee, the owner and the loan financier; and
- g* an engine warranties agreement between the engine manufacturer, the lessee, the owner and the loan financier.

## ii Enforcement

### *Ships*

Ship mortgages may be established and registered in Japan only for ships registered in Japan. Ship mortgages may not be enforced against third parties unless they are registered under Japanese law. However, maritime liens on vessels arise with respect to claims for pilotage, towage, bunker expenses, crew wages, and salvage,<sup>20</sup> and also claims in connection with marine casualties such as collisions or oil pollution,<sup>21</sup> and these have priority over ship mortgages.<sup>22</sup>

### *Rolling stock*

The Railway Mortgage Act provides the railway mortgage system. Under this system, railway mortgages should be placed on the railway foundation, which is the collateral railway facility, and may be registered.<sup>23</sup>

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20 Section 842 of the Commercial Code. However, as described in Section I.ii, claims such as accrued freight charges, expenses of preservation after judicial sale or at last port are no longer covered by maritime liens in accordance with the amendment to the Commercial Code.

21 Section 95 of the Act on Limitation of Liability of Shipowners.

22 Section 848 of the Commercial Code.

23 Section 2 of the Railway Mortgage Act.

## ***Aircraft***

The Aircraft Mortgage Act and Civil Execution Act provide the aircraft mortgage system, which is only available for aircraft registered in Japan. Under this system, aircraft mortgages may not be asserted against third parties unless they are registered.<sup>24</sup>

### ***Effect of insolvency proceedings***

There are three types of insolvency proceedings under Japanese law: bankruptcy proceedings pursuant to the Bankruptcy Act, civil rehabilitation proceedings pursuant to the Civil Rehabilitation Act, and corporate reorganisation proceedings pursuant to the Corporation Reorganisation Act. The object of bankruptcy proceedings is the dissolution of the company, while the purpose of civil rehabilitation proceedings and corporate reorganisation proceedings is reconstruction of the company. The requirement for use of corporate reorganisation proceedings is very restrictive (i.e., only a joint stock corporation is permitted to utilise these proceedings).

Mortgages on vessels or aircraft, security interests in railway facilities, and any other perfected security interests can be enforced outside bankruptcy proceedings and civil rehabilitation proceedings (however, with respect to civil rehabilitation proceedings, a claim for removal of security interests may be made by a bankruptcy administrator or a court order for stopping the exercise of security interests may be issued). On the other hand, with respect to corporate reorganisation proceedings, security interests are dealt with as secured reorganisation claims, and they can be exercised within the corporate reorganisation proceedings in accordance with the reorganisation plan.

In addition, with respect to mortgages on vessels or aircraft, not formal registration but provisional registration is often used because of the high charges of formal registration incurred in the registration process, and provisional registration reserves the priority order as a security right of the mortgage, subject to the condition that the provisional registration is transformed into a formal one. However, if insolvency proceedings commence in relation to a vessel or aircraft on which a mortgage is created but the transformation process from provisional registration to formal registration has not been completed, there remains a risk that the validity of the mortgage may be avoided by a court or trustee on the grounds that the registration of the mortgage is still a provisional one.

Further, certain types of lease agreements or bareboat charter agreements that include, for example, full pay-out clauses or those prohibiting intermediate termination may be interpreted as finance lease transactions, in which case, the lease transactions are dealt with like the above-mentioned secured reorganisation claims if corporate reorganisation proceedings are in progress. Additionally, in this case there is a possibility that repossession or disposal of the leased property will be restricted.

### **iii Arrest and judicial sale**

#### ***Ships***

Even if a vessel and mortgage are registered in a foreign country, the mortgagee may apply for arrest and judicial sale of the vessel by submitting documentation proving the existence of the mortgage on the vessel<sup>25</sup> to a court, as long as the vessel is in Japan. Usually, the mortgagee will

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<sup>24</sup> Section 5 of the Aircraft Mortgage Act.

<sup>25</sup> It is usually a certificate of registered matters.

get a court order to obtain the certificate of the vessel's nationality and any other documents necessary for its sailing before its arrival at a Japanese port; upon arrival, an enforcement officer will then confiscate the foregoing documents from the vessel so that it cannot sail from the port. Within five days of the documents being apprehended, the mortgagee must formally apply for commencement of the judicial sale of the vessel to the court that has jurisdiction where the vessel has been arrested. The court has the discretion to decide to commence the judicial sale proceedings, and then, upon the mortgagee's application, to appoint a trustee to manage the vessel until completion of the sale. By this stage, the mortgagee will have had to pay the advance anticipated costs and expenses for the proceedings, which amount will be returned out of the proceeds of the sale. For example, a mortgagee paid about ¥13 million in a case of judicial sale under a ship mortgage before the Hakodate District Court.<sup>26</sup> It usually takes about six months from the commencement of the judicial sale to distribution of dividends.

In addition to the length and high costs of the judicial sale process, taking into consideration that: (1) a vessel or aircraft is movable and it is necessary to check its location prior to applying to a court; (2) in case of a foreign registered vessel, procedures in the nation where the vessel is registered may also be required; and (3) negotiation with the lessee or charterer may be necessary because the compulsory arrest and judicial sale process has a material effect on the lessee's or charterer's rights or interests, a private sale process is taken in normal practice.

### ***Rolling stock***

The mortgage on a railway foundation is enforceable by auction or compulsory administration, at the mortgagee's choice.<sup>27</sup> If the mortgagee selects auction proceedings, the railway foundation will be sold to a winning bidder as a single property.

### ***Aircraft***

Basically, the arrest and judicial sale procedures for an aircraft are similar to those for a vessel. Thus, if a mortgagee applies to a court for enforcement of a mortgage through judicial proceedings, the mortgagee has to submit to the court documentation proving the existence of the mortgage on the aircraft. Further, the mortgagee may ask the court to issue a court order to obtain the certificate of registration of the aircraft and any other documents necessary to prevent the aircraft from leaving the parking apron.

Unlike in the case of a vessel, the enforcement procedure for an aircraft mortgage as stipulated in the Civil Execution Act is restricted to aircraft registered with the Japanese aviation authority; therefore, foreign registered aircraft should be subject to the enforcement procedure for ordinary movable assets. However, since such provisions are not meant to cover assets as large as aircrafts, it will be highly difficult to proceed with an arrest and judicial sale procedure for a mortgage on a foreign registered aircraft.

Further, as is the case with vessels, a private sale process is taken in normal practice rather than the compulsory arrest and judicial sale process.

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26 Yasumori Takase, 'Introduction of a judicial sale case based on a mortgage before the Hakodate District Court, 1941', *Kinyu Houmu Jijo* 116 (2012).

27 Section 40 of the Railway Mortgage Act.

## **V CURRENT DEVELOPMENTS**

As the amendment to MARPOL took effect in January 2020, many vessel operators or shipowners have started (or will start) equipping scrubbers for emission gases. Although scrubbers are strongly connected to a vessel, it may become a legal question whether ownership of the scrubbers installed by an operator, or a person other than the vessel owner, is automatically vested in the vessel owner or if it belongs to the operator, or other such person.

Further, in light of the amendment to the tax regime in relation to the limitation of including interest payments based on loans outside Japan into deductible expenses as described in Section I.ii above, JOLCO structures financed by foreign financial institutions may lessen or shift to ones funded by Japanese financial institutions, or a Japanese branch or subsidiary of foreign financial institutions.

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