Newsletter

ATSUMI & SAKAI
www.aplawjapan.com

February 2024
No.FIN_010

Overview of the various private fund schemes for real estate investment in Japan

As international business continues to develop and grow, we are seeing increased interest from foreign investors and companies targeting investments in the Japanese real estate market.

When investing in the Japanese real estate market, foreign companies need to understand the structure of real estate funds available. While the real estate fund business in Japan is historically based the fund/REIT model of the U.S.A., there are unique structures and terminologies rooted in Japanese laws and systems.

This newsletter seeks to provide a basic explanation of each of the schemes used in the real estate fund business in Japan, focusing on private fund schemes. We provide a comprehensive overview and characteristics of each scheme as well as the necessary documentation involved in these transactions.

1. Overview/Comparison of the four private fund schemes

(1) The below provides an overview and comparison of the four principal private fund schemes that are practically used for real estate finance in Japan:

Diagram 1. Overview/Comparison of private fund schemes

	GK-TK Scheme	TMK Scheme	FTK Scheme	Private REIT Scheme
Investment Target	Trust beneficial interest	Real estate in kind/ Trust beneficial interest	Real estate in kind	Real estate in kind/ Trust beneficial interest
Connection with property	Strong	Strong	Strong	Weak
Equity Liquidity (ease of converting an asset into cash)	Conversion into cash basically not permitted during the period	Conversion into cash basically not permitted during the period	Conversion into cash basically not permitted during the period	Conversion into cash is possible under certain conditions in addition to a bilateral trading

First, we provide a detailed overview and comparison of each of the private fund schemes. There are two key points of focus for distinguishing between the key schemes:

- The first distinguishing feature is to consider whether the target of the investment is (1) real estate in kind (*genbutsu-fudosan*); or (2) a trust beneficial interest (*shintaku juekiken*). In order to make the investment target a trust beneficial interest, the underlying real estate has to be of a type that will be acceptable to a trust bank or trust company, with the trust bank/ or trust company being willing to accept a trust of the underlying real estate so that trust beneficial interests can be issued with respect to such trust.

- The second distinguishing feature between the funds is whether the transaction focuses on the property itself or on the corporate sponsor.

Based on these two distinguishing points, private fund schemes are classified into four distinct categories (as shown in Diagram 1 above). These are:

(i) the GK-TK Scheme;
(ii) the TMK Scheme;
(iii) the FTK Scheme; and
(iv) the Private REIT Scheme.

(2) An investor or asset manager will select a scheme based on the target of the investment (whether the target is a trust beneficial interest or real estate in kind) indicated at the first line of Diagram 1. Because it is not possible under Japanese law for a GK-TK Scheme to directly invest in real estate , the GK-TK Scheme should only be used where the investment target is a trust beneficial interest.

Conversely, where the underlying target real estate is not suitable for the issuance of trust beneficial interests (for example, some issues exist such as the real estate not passing the trust bank's screening for acceptance into a trust), a fund has to be created with the investment target being real estate in kind. In this case, the TMK Scheme, FTK Scheme or Private REIT Scheme can be utilized.

In the case of a Private REIT Scheme, the emphasis is placed not on the specific property, but on:

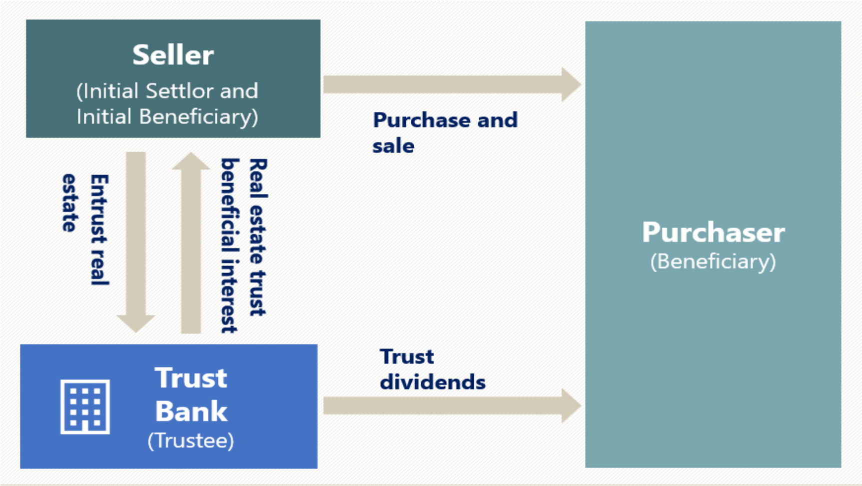
- the sector focus of the sponsor company (such as whether it is an insurance company, logistics company, railway company or a real estate developer);
- what criteria the sponsor company is expected to apply to property acquisitions (such as whether it will target office properties in the Tokyo metropolitan area, or shopping centers throughout the country); and
- the capabilities of the asset management company.

In contrast to the Private REIT Scheme, the GK-TK Scheme, TMK Scheme and FTK Scheme focus on the property itself (i.e., the kind of property that is intended to be acquired) rather than the sponsor company's sector focus.

The position on liquidity of equity (the ease with which an asset can be converted into cash) differs significantly between:

- the GK-TK Scheme, TMK Scheme and FTK Scheme: for these schemes, equity is not intended to be converted into cash during the term of the scheme. Therefore, until the real estate or trust beneficial interest is sold, the scheme will not terminate; and
- the Private REIT Scheme: in this scheme, the investment equity (*toshi guchi*) can be sold via bilateral trading or, in certain circumstances, the equity can be refunded by the real estate investment trust (*toshi hojin*).

Diagram 2 "What is a real estate trust beneficial interest?"

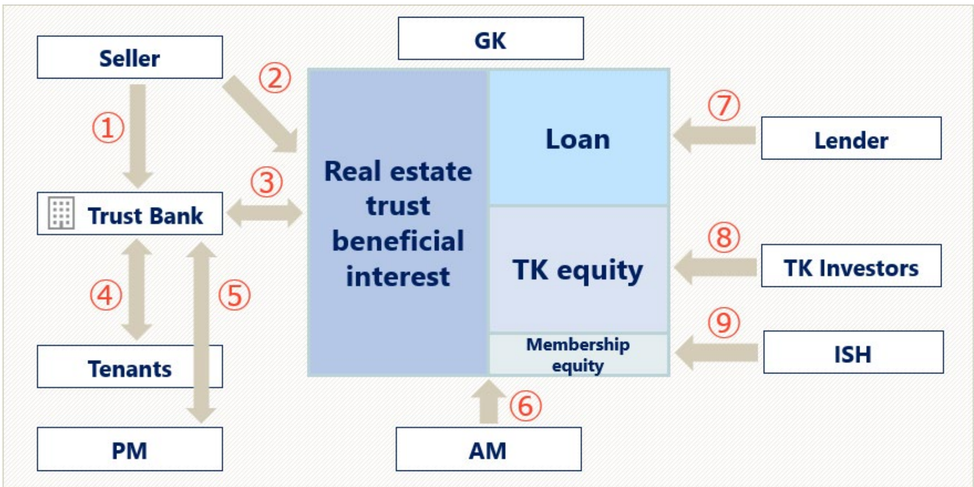


(3) The concept of a real estate trust beneficial interest can be summarized as follows: the trust bank is granted ownership of the real estate, and the beneficial interest is traded by the seller to the purchaser.

As shown in Diagram 2 above, the seller holds the real estate in kind. It then transfers the same to a trust bank and a trust is created. As a result of such transfer, the seller, as the initial settlor and initial beneficiary, acquires certain rights (the real estate trust beneficial interest) against the trust bank. These include the right as a beneficiary to receive trust dividends from the trust bank. Subsequently, the real estate trust beneficial interest is sold by the seller and purchased by the purchaser, and as a result, the purchaser becomes the beneficiary and gains the right to receive the trust dividends from the trust bank as the holder of the real estate trust beneficial interest. This is the basic mechanism of a real estate trust beneficial interest.

(4) Next, we focus on the key points and characteristics of each private fund scheme.

Diagram 3 "GK-TK Scheme"

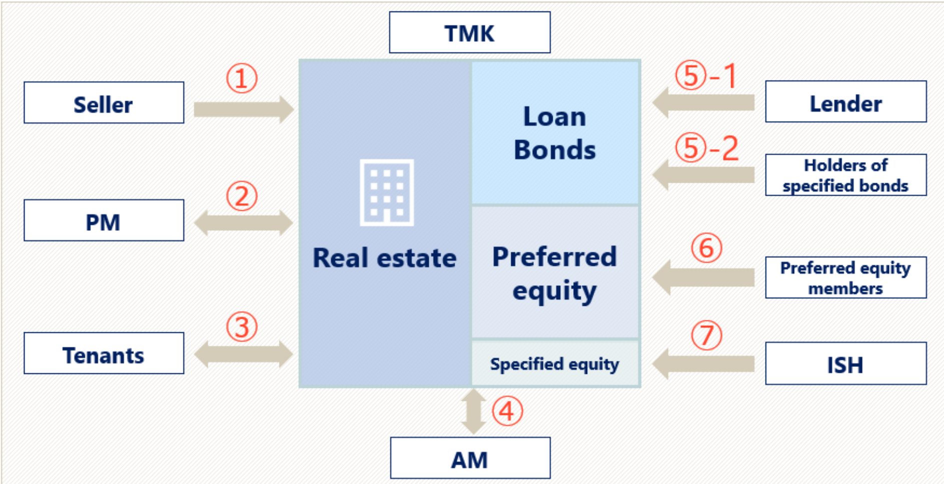


The GK-TK Scheme is a typical scheme which is adopted by a significant proportion of private funds. In this scheme, a limited liability company (*godo kaisha*, *GK*) raises funds from investors by investing through a silent (anonymous) partnership (*tokumei kumiai, TK*) agreement under the Commercial Code The Commercial Code provides that a TK contract is a bilateral contract between the investor and the operator of an enterprise (in this case, the GK), under which the investor makes a capital contribution to the operator and the operator distributes the profits generated from the enterprise to the investor pro rata according to the percentage of the investor's contribution to the enterprise.

There are two key points to note:

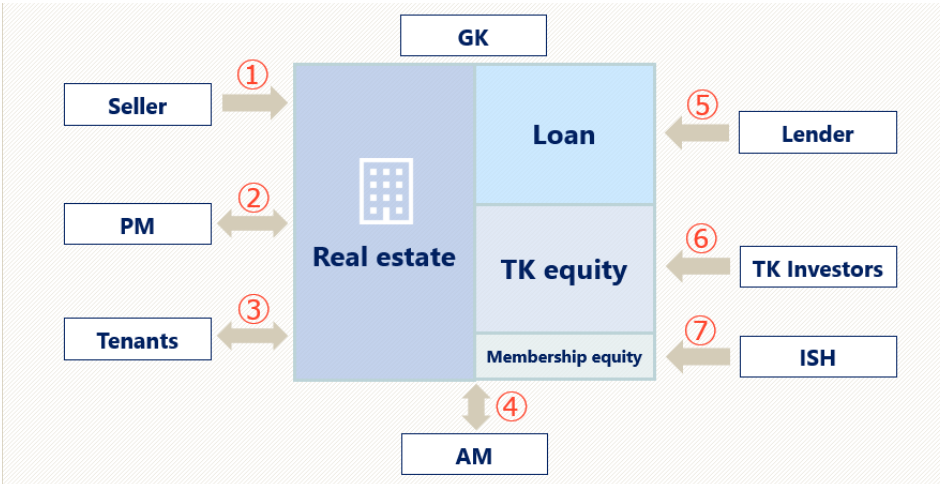
- The first is that, under Japanese regulations, a GK-TK Scheme cannot directly invest in real estate . Therefore, the only investment target under a GK-TK Scheme is a trust beneficial interest.
- The second point is to consider whether the asset management company offers investment management services (*toshi un-yo gyo*) or investment advisory services (*toshi jogen gyo*).

Diagram 4 "TMK Scheme"



To better understand the TMK Scheme, it is useful to compare it with the GK-TK Scheme. The key characteristics of the TMK Scheme are that: first, it is necessary for the TMK to prepare an asset liquidation plan (*shisan ryudoka keikaku*) and file the same (as well as any subsequent changes or amendments) with the local Finance Bureau. Second, it is often a prerequisite of establishing a TMK Scheme that qualified institutional investors (*kikan toshika*) should hold certain specified bonds (*tokutei shasai*) issued by the TMK in order to meet tax-conduit requirements under Japanese tax laws. In Diagram 4 above, the specified bond holders can be located at ⑤ - 2. The issuance of specified bonds in addition to borrowing is a common characteristic of the TMK Scheme.

Diagram 5 "FTK Scheme"

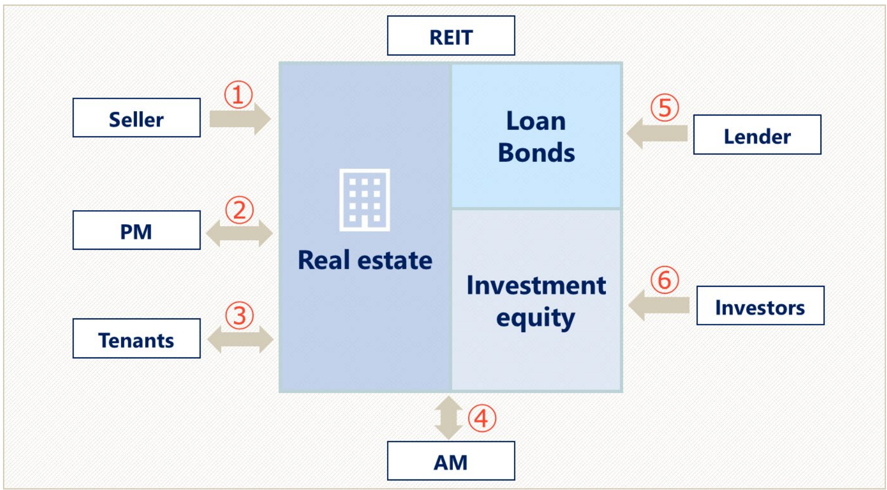


Prior to its amendment, the Act on Specified Joint Real Estate Ventures (*fudosan tokutei kyodo jigyo ho* [Act No. 77 of June 29, 1994]) provided that before establishing/commencing a FTK Scheme, a real estate company was required to (1) obtain a Type I Permission;[1] (2) receive capital contributions from investors; and (3) conduct a Specified Joint Real Estate Venture (*fudosan tokutei kyodo jigyo*). However, because it was legally difficult for special purpose companies (SPC) to obtain a real estate developer license, it was challenging for the SPC to obtain the Type I Permission. A recent revision to the Act has now made it possible to adopt a "qualified special investors only scheme" (*tekikaku tokurei toshika gentei jigyo*) using an SPC. The result is that it is no longer necessary under the specific requirements of the Act for an SPC to

[1] Note: A Type 1 Permission was one of four types of permission under the Act, which are granted to companies that demonstrate the ability to act in a trustworthy manner in their operations.

obtain a license or approval to establish an FTK Scheme: only a filing is required (and therefore the GK as an SPC is no longer required to obtain Type I Permission). This has made the scheme easier to utilize.

Diagram 6 "Private REIT Scheme"



Finally, there is the Private REIT Scheme. This is a private fund scheme in which the appropriateness of investment is considered in light of the sponsor company's characteristics. The focus of the investor is on the corporate sponsor as the supplier of real estate and on the management/operation of the property (please note the operator is typically an affiliate company of the sponsor). Therefore, the scheme is largely dependent on the sectors in which the sponsor is involved.

2. Documentation required for the GK-TK and TMK Schemes

(1) As the GK-TK Scheme is the most commonly used, the following diagram provides a list of documents required for establishing the GK-TK Scheme. Many documents need to be prepared in the course of carrying out a project, and the required documents can be broadly classified into three categories: "property", "finance" and "SPC" related documents.

Diagram 7 "Document List for the GK-TK Scheme"

Category	Major contracts
Property (acquisition)	・Trust beneficial interest purchase and sale agreement
Property (operation)	・Real estate trust agreement ・Master lease agreement ・Property management agreement
Finance (fund-raising)	・Project agreement ・Loan agreement
Finance (security)	・Trust beneficial interest pledge agreement ・Mortgage agreement with a condition precedent ・Insurance claim pledge agreement with a condition precedent (・Silent partnership investment equity pledge agreement) (・GK membership equity pledge agreement)
SPC	・Silent partnership agreement (TK) ・Asset management agreement (AM) ・Accounting services agreement
Opinions	・Legal opinion ・Accounting/tax opinions

The property-related documents in the list above can be divided into those related to the acquisition of the property and those related to the operation of the property. Acquisition-related documents include the trust beneficial interest purchase and sale agreement. Operation-related documents include the real estate trust agreement, the master lease agreement (which includes provisions relating to rent, i.e., the income source of the scheme) and the property management agreement (which provides for the management and operation of the property).

Finance-related documents are further sub-divided into fund-raising and security documents. Among the fund-raising (finance) related documents, the highest ranked is the project agreement, which prevails over other agreements and controls them if there is any inconsistency. It is the project agreement which the major parties participating in the project enter into, and under which they make various covenants to the lender. Meanwhile, the loan agreement stipulates the loan terms and additionally contains the conditions precedent for drawdown; representations and warranties; covenants, as well as provisions on cash flow and how the proceeds from the trust beneficial interest should be used. Next, there are five finance (security) related documents. The first three are security documents which provide for typical types of security:

- The first security document, the trust beneficial interest pledge agreement, is an agreement under which a pledge is created over the trust beneficial interest (which accounts for the majority of the assets held by the GK).
- Second, the mortgage agreement with a condition precedent is an agreement under which a mortgage is created, including a condition precedent that the trust agreement has terminated and the GK has acquired the property.[2]
- Third, the insurance claim pledge agreement with a condition precedent is an agreement under which, similarly, a pledge is created over the right to claim insurance proceeds when the trust agreement has terminated and the GK has acquired the property in kind.

The final two documents in brackets may be entered into on a case-by-case basis:

- A silent partnership (*tokumei kumiai, TK*) investment equity pledge agreement may be entered into as a pledge for equities.
- Equally, in some cases, a GK membership equity pledge agreement can be used under which the lender assumes the possibility of exercising a step-in right over the scheme.

The required SPC-related documents are the silent partnership agreement to procure equity, and an asset management agreement, to manage the assets of the GK. In addition, an accounting services agreement is almost always executed to assist the SPC with the preparation of accounting books and filing of tax returns.

Finally, certain documents are typically prepared which relate to opinions necessary to satisfy conditions precedent for drawdown, including a legal opinion and accounting and tax opinions.

[2] Note: If the GK simply acquires real estate, as in this case, such acquisition would not violate the regulations under Japanese law, since this acquisition would not be considered an investment in real estate in the course of its business.

Diagram 8 "Document List for the TMK (In-kind) Scheme"

Category	Major contracts for GK-TK Scheme	Major contracts for TMK (In-kind) Scheme
Property (acquisition)	**・Trust beneficial interest purchase and sale agreement**	**・Real estate purchase and sale agreement**
Property (operation)	**・Real estate trust agreement** ・Master lease agreement ・Property management agreement	・Master lease agreement ・Property management agreement
Finance (fund-raising)	・Project agreement ・Loan agreement	・Project agreement ・Loan agreement **・Specified bonds subscription agreement**
Finance (security)	**・Trust beneficial interest pledge agreement** ・Mortgage agreement **with a condition precedent** ・Insurance claim pledge agreement **with a condition precedent** **(・Silent partnership investment equity pledge agreement)** **(・GK membership equity pledge agreement)**	・Mortgage agreement ・Insurance claim pledge agreement **(・Preferred equity pledge agreement)** **(・Specified equity pledge agreement)**
SPC	**・Silent partnership (TK) agreement** **・Asset management agreement (AM)** ・Accounting services agreement	**・Preferred equity subscription agreement** **・Specified asset management and disposition services agreement (AM)** ・Accounting services agreement **・Asset Liquidation Plan**
Opinions	・Legal opinion ・Accounting/tax opinions	・Legal opinion ・Accounting/tax opinions

(2) It is easier to understand the document list for a TMK Scheme where real estate is acquired in kind ("TMK (In-kind) Scheme") by comparing it with the equivalent document list for the GK-TK Scheme. The red highlighted documents in Diagram 8 indicate the key differences between the two schemes. The non-red highlighted documents are essentially the same for both schemes.

In relation to the property acquisition-related documents, the GK-TK Scheme utilizes a trust beneficial interest purchase and sale agreement, whereas the TMK (In-kind) Scheme uses a real estate purchase and sale agreement. As a trust beneficial interest and real estate in kind require different applications of real estate registration and representations and warranties, the respective trust beneficial interest PSA or real estate PSA need to be drafted to reflect those differences. In both schemes, a master lease agreement and property management agreement are required as property (operation) related documents. The key difference is that a real estate trust agreement is necessary for the GK-TK Scheme (because the subject of the transaction is a trust beneficial interest). On the other hand, since there is no trust beneficial interest in the TMK (In-kind) Scheme, a real estate trust agreement is not necessary.

For finance (fund-raising) related documents, both schemes require a project agreement and a loan agreement. However, in the TMK (In-kind) Scheme, a specified bonds subscription agreement is also required, because specified bonds are commonly issued in order to satisfy tax-conduit requirements. In relation to finance (security) related documents, a mortgage agreement and an insurance claim pledge agreement are necessary, the same as for the GK-TK Scheme. As there is no trust beneficial interest in the TMK (In-kind) Scheme, there is no need for a pledge agreement over a trust beneficial interest. In place of the silent partnership investment equity pledge agreement in the GK-TK Scheme, a preferred equity (*yusen shusshi*) pledge agreement is sometimes used in the TMK (In-kind) Scheme. Further, rather than the GK membership equity pledge agreement used in the GK-TK Scheme, the TMK (In-kind) Scheme sometimes uses a specified equity (*tokutei shusshi*) pledge agreement.

For SPC related documents, instead of the GK-TK Scheme's silent partnership agreement, a preferred equity subscription agreement to procure equity is utilized in the case of the TMK (In-kind) Scheme. Further, instead of the asset management agreement in the GK-TK Scheme, there is a specified asset (*tokutei shisan*) management and disposition services agreement. This agreement is an asset management agreement in nature, but in the case of the TMK (In-kind) Scheme, it has a different name pursuant to the Act on the Liquidation of Assets (*shisan no ryudoka ni kansuru horitsu* [Act No. 105 of June 15, 1998]).

As for documents related to opinions, a legal opinion and accounting and tax opinion are required for both schemes. Equally, an accounting services agreement is usually executed for both the TMK (In-kind) Scheme and the GK-TK Scheme.

Finally, as stated earlier in this Article, it is a defining characteristic of the TMK (In-kind) Scheme that an asset liquidation plan is necessary.

End.

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