



Newsletter

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Creation of Business Growth Security Interests

The "Report of the Working Group on the System to Support Business Focused Lending Practices" (the "Report") has been released by the Working Group on the System to Support Business Focused Lending Practices (the "Working Group") of the Financial System Council. The business growth security interest proposed in the Report is expected to be enacted by the end of 2023. In this newsletter, we discuss some points of interest for international readers. It should be noted that future steps in the legislative process may ultimately result in a system that differs from the one envisioned in the Report.

What is a Business Growth Security Interest?

The business growth security interest proposed by the Working Group is a single security interest that takes all of the debtor's current total assets as collateral, including tangible assets, intangible assets, contractual relationships, assets generated by business activities, and future cash flows to be acquired.

The following points should be noted.

- The financial authorities have proposed business growth security rights to create a venture debt market in Japan.
- When conducting a material transaction with a company that has created a business growth security interest, consideration should be given to obtaining the prior consent of the business growth security interest holder.
- DIP Finance loan claims are expected to be repaid in priority to business growth security interests even if a reorganization or rehabilitation proceeding progresses to a bankruptcy proceeding.

What is the purpose of the business growth security interest scheme?

Business growth security interests are expected to be used for loans to companies in the start-up, growth, succession, and rehabilitation phases. The purpose of business growth security interests is to enable borrowing by firms that do not have sufficient tangible fixed assets to serve as security. A second priority business growth security interest also is available for lenders with a higher tolerance for risk.

What makes a business growth security interest different from a traditional security interest?

The following proposals made in the Report are all being introduced for the first time in Japan.

➤ Collateral

As noted at the beginning of this newsletter, all assets including future cash flows of the company are subject to a business growth security interest.¹ For loans backed by all of the borrower's assets, such as LBO loans, security interests conventionally have been established separately for each type of collateral. On the other hand, a business growth security interest is created by a single contract covering all collateral.²

➤ Priming lien

The Report proposes that if insolvency proceedings against a borrower progress from corporate reorganization or rehabilitation proceedings to bankruptcy proceedings, loan claims on DIP financings will be paid in priority to loan claims subject to a business growth security interest. This treatment is similar to that of a Chapter 11 priming lien in the U.S., and is a mechanism intended to facilitate access to DIP financing for companies that have established business growth security interests when they are in distress.

➤ Carve-out

Since all assets of the company are subject to a business growth security interest, the Report proposes that 3% of the amount obtained by realization of the collateral should be distributed to general creditors when the security interest is executed.

➤ Limitations on management guarantees

In Japanese financings to small and medium sized entities, approximately 70% of the principal amount of such loans would be expected to be guaranteed by company management. The report states that management guarantees are an obstacle to aggressive corporate investment by borrower firms. The report then proposes that, in principle, management guarantees should not be attached to loans with business growth security interests.

Creation, perfection and execution of business growth security interests

➤ Debtor and creditor

The debtor of a business growth security interest must be a for-profit legal entity which is publicly registered in the commercial registry. The Report proposes that a business growth security interest creation agreement should be a trust agreement with the debtor of the business growth security interest as the settlor, the creditor as the trustee, and lenders and other general creditors as the beneficiaries. Only licensed trust companies, financial institutions licensed under the Act on Engagement in Trust Business Activities by Financial Institutions, and trust companies with a newly created trust license for business growth security interests may become creditors of the security interest.

There are currently 57 financial institutions, including foreign-affiliated institutions that are licensed to engage in trust business.³

➤ Method of perfection

The method of perfection of a business growth security interest is registration in the commercial register of the debtor. A business growth security interest is validly established by contract between the creditor and the debtor. However, without the registration, the business security interest may not be asserted against a third party. The commercial register can be obtained by anyone. It is already in widespread use as a document proving the existence of a legal entity.

¹ Labor contracts are also subject to the business growth security interest. This means that the status of the employer is transferred to the security interest holder by the exercise of the security interest. However, the terms and conditions of employment will be unchanged, and the employee is, in any event, free to leave the employer. The purpose of using labor contracts as collateral is to secure a company's experience, know-how, and customer base. The working group also proposes further protection for workers in future legislation, such as securing continuity of employment.

² If security interests have been perfected against any of the debtor's assets prior to the perfection of the business growth security interest, those security interests take priority over the business growth security interest. If another lender's business growth security interest is created later, the status of the earlier lender remains the same and will take priority over the subsequent business growth security interest.

³Source: FSA website <https://www.fsa.go.jp/menkyo/menkyoi/kenei.pdf>

➤ **Execution procedures**

The procedures for execution of the business growth security interest are still under consideration. It is envisioned that courts will be involved, and a trustee appointed by the court will conduct a bulk transfer of the business by auction or voluntary sale.

As mentioned above, general creditors are guaranteed a recovery of 3% of the cash proceeds from the sale. The report does not specify whether this is to be 3% of the gross or net proceeds from the sale.

Transactions with the debtor

A business growth security interest naturally includes the debtor's inventory goods and products, as well as works in progress. Therefore, when dealing with a company that has created a business growth security interest, the counterparty should be careful to ensure that it is able to acquire goods in accordance with the terms of the transaction.

➤ **WG's discussion**

Any disposition of property "within the scope of ordinary business activities" of the debtor is valid. Any person who acquires such property as a result of a valid disposition of property by the debtor may acquire such property.

On the other hand, transactions that are not "within the scope of ordinary business activities" are invalid unless conducted with the consent of the creditor of the business growth security interest. However, the debtor cannot assert invalidity of a transaction against a counterparty who, acting in good faith and without gross negligence, does not know that (i) the transaction is beyond the debtor's scope of ordinary business activities, or (ii) the creditor of the business growth security interest has not given its consent.

Transactions that are not "within the scope of ordinary business activities" are those that, in effect, alter the risks of the business, such as loss of corporate value. The typical example pointed out by the Working Group is fraudulent low-cost sales.

Transactions with overseas companies

Even in transactions between domestic companies, it is not always possible for the buyer to be assured that a transaction is "within the normal course of business" for the seller. This is because whether a transaction is "within the ordinary course of business" or not is an internal matter of the seller. If the buyer makes a mistake in judgment, there remains a possibility that the business growth security holder may later demand revocation of the transaction or additional payment.

This issue emerges especially in offshore transaction. This is because, compared with domestic transactions, it is usually difficult for a foreign company who has not had ongoing transactions, to know whether a given transaction is "within the normal scope of business" of the seller. The anticipated practical response is for the offshore counterparty to ask the debtor to obtain prior blanket consent from the creditor of the business growth security interest for transactions up to a certain value, or to obtain prior consent from the creditor of the business growth security interest for sales at a value determined by a certain calculation method, or through the market at a fair market price.

Relationship with bankruptcy proceedings

In Japan, as in the U.S., there are two types of bankruptcy proceedings: liquidation-type and restructuring-type. The liquidation type corresponds to Chapter 7 of the Federal Bankruptcy Code. Restructuring proceedings include civil rehabilitation proceedings and corporate reorganization proceedings. These correspond to Chapter 11 of the U.S. Bankruptcy Code.

➤ **Bankruptcy proceedings**

Since a business growth security interest is treated as a right of separate satisfaction in bankruptcy proceedings, the creditor of the security interest may enforce the business growth security interest outside of bankruptcy proceedings.

Even if bankruptcy proceedings are initiated against a debtor during the execution of a business growth security interest, the execution procedure will not be suspended. In such case, the procedure for execution of the business growth security interest and the bankruptcy procedure will coexist, and at least a carve-out of the money obtained from the realization of the collateral will be distributed to general creditors.

➤ **Civil rehabilitation proceedings**

A civil rehabilitation proceeding is a procedure to modify debts (discharge, reduction, rescheduling, or conversion to equity). Civil rehabilitation proceedings are available to all individuals and corporations. Only unsecured and non-priority claims can be resolved in this procedure.

Since a business growth security interest would not be resolvable in rehabilitation proceedings, the creditor of the security interest, in principle, may exercise the business growth security interest outside of rehabilitation proceedings.

However, in rehabilitation proceedings, the bankruptcy trustee can request permission from the court to extinguish security interests. In practice, permission to extinguish security interests is widely used. In this case, the security interest holder is paid an amount equal to the value of the collateral. Under current practice, however, the value of future claims is usually calculated as worthless. Lenders with business growth security interests supposedly take into account future cash flows, as well. If so, a calculation of collateral value according to current practice would be unfair for the business growth security interest holder.

➤ **Corporate reorganization proceedings**

Corporate reorganization proceedings are available only to stock companies. Unlike civil rehabilitation proceedings, secured claims and priority claims are also subject to modification. In corporate reorganization proceedings, a business growth security interest is treated as a secured reorganization claim. A secured reorganization claim is resolved as part of the reorganization proceeding.

Growth potential of the venture debt market

Conventional loans secured by individual tangible assets capture a portion of a company's liquidation value. For financial institutions, there is a rationale for holding a diversified portfolio of loans in small lots to avoid default risk. On the other hand, the incentives to pay close attention to understanding the debtor's business have been weak.

However, a business growth security interest captures the fluctuating value of a business. This inevitably creates a stronger incentive to monitor and support the debtor's business. On the other hand, the high cost is likely to result in bigger transactions and higher interest rates. The WG noted that the venture debt market in Japan is immature, and the business growth security interest scheme can be viewed as an attempt to spur the growth of the Japanese venture debt market.

End.

https://www.fsa.go.jp/singi/singi_kinyu/tosin/20230210/01.pdf

For a more detailed introduction to business growth security interests, please refer to our Japanese-language newsletter.

https://www.aplawjapan.com/application/files/2716/8655/4776/Newsletter_FIN_007.pdf

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