JAPAN

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OVERVIEW

Typical transaction structures – public companies

1. What is the typical structure of a business combination involving a publicly traded real estate-owning entity?

Several possible structures exist under Japanese law to create a business combination involving a publicly traded real estate-owning entity. These are:

1. share acquisitions;
2. business transfers;
3. mergers;
4. corporate splits;
5. allocation of shares to a third party; and
6. a mix of the above.

Further, this transaction can incorporate a share exchange and a share transfer. These elements are often utilized as a part of a share-acquisition transaction in addition to purchases of existing or newly issued shares. In a business combination of real estate investment trusts (REITs), the transactions in points (2) and (4) are unavailable, although REITs can sell any or all of their assets.

However, it is our view that a share acquisition is the most typical business combination involving a publicly traded real estate-owning entity in Japan,

owing to the tax effects of this transaction and the difficulty of obtaining an approving resolution at a shareholders' meeting in general. The responses that follow focus on the share acquisition method as the typical transactional structure. Share acquisitions of publicly traded entities are usually affected by the commencement of a tender offer. In the case of REITs, share acquisitions and mergers are the most typical business combinations.

Typical transaction structures – private companies

2. Are there any significant differences if the transaction involves a privately held real estate-owning entity?

There are almost no significant differences. However, generally, transactions involving a privately held real estate-owning entity will not:

- be subject to a disclosure requirement under the laws, regulations or rules of the applicable stock exchange as discussed in 'Typical transaction process', 'Public disclosure' and 'Board considerations in take-private transactions';
- be subject to regulations related to tender offers; or
- potentially be subject to difficulties in obtaining shareholder approval.

A publicly held entity may face all of these issues.

Typical transaction process

3. Describe the process by which public and private real estate business combinations are typically initiated, negotiated and completed.

In each of the structures referenced in 'Typical transaction structures – public companies' above, the board of directors (if any) of each entity must approve the transaction, unless the value of the real estate or the entity is significantly smaller than the relevant parties to the business combination. Also, acquisitions of shares in public companies will in many cases be subject to tender offer

regulations. Further, the share acquisition structure described in

(1) requires a special resolution (requiring affirmative votes from 75 percent of those with voting rights) approved at the seller's shareholders' meeting if the seller is selling shares of its subsidiary and the ratio of the seller's voting right in the subsidiary falls to less than 50 percent following the sale, and the book value of the shares held by the seller exceeds 20 percent of its total assets.

The structures described in points (2) to (5) in 'Typical transaction structures – public companies' all require a special majority resolution (requiring affirmative votes from 75 percent of those with voting rights) at a shareholders' meeting. Concerning point (5), this is only required if the share price is favourable to the third party. Obtaining this resolution at a shareholders' meeting of a publicly traded entity is difficult, but it is not necessary for the transactions referenced in points (2) to (4) if the book value of the assets subject to the transfer is 20 percent or less of the party's net assets.

LAW AND REGULATION

Legislative and regulatory framework

4. What are some of the primary laws and regulations governing or implicated in real estate business combinations? Are there any specific regulations or laws governing transfers of real estate that would be material in a typical transaction?

The Companies Act of Japan (Law No. 86 of 2005, as amended) (the Companies Act) primarily applies to most real estate business combinations.

The Financial Instrument and Exchange Act of Japan (Law No. 25 of 1948, as amended) (FIEA) and the listing rules of the relevant stock exchange can apply too, especially if the transaction involves a publicly traded real estate-owning entity.

The Foreign Exchange and Foreign Trade Control Law of Japan (Law No. 228

of 1949, as amended) (FEFTC) governs cross-border transactions.

Finally, the Act on Prohibition of Private Monopolization and Maintenance of Fair Trade of Japan (Law No. 54 of 1947, as amended) might be applicable if the combination of businesses has significant sales revenue in Japan, or if the business combination might result in a possible monopoly in a certain market in Japan.

Cross-border combinations and foreign investment

5. Are there any specific material regulations or structuring considerations relating to cross-border real estate business combinations or foreign investors acquiring an interest in a real estate business entity?

Under the FEFTC, if a foreign investor holds more than a 10 percent shareholding in a Japanese entity after the transaction, an ex post facto report is required to be completed by the investor with the Bank of Japan by the 15th day of the calendar month after the month the transaction was closed. However, a prior filing will be required if the target company engages in certain designated businesses, in addition to the real estate business, including:

- armaments manufacture, aviation, nuclear power plants and satellites;
- infrastructure (eg, energy, gas, telecommunication and transportation); and
- public safety (eg, a vaccine manufacturer).

Choice of law and jurisdiction

6. What territory's law typically governs the definitive agreements in the context of real estate business combinations? Which courts typically have subject-matter jurisdiction over a real estate business combination?

The parties can select the governing law of an agreement and the courts with subject-matter jurisdiction concerning the agreement. In the context of real

estate business combinations, the laws of Japan typically govern definitive agreements. If the structure involves any merger, corporate split, share exchange or share transfer, the laws of Japan will govern the agreement, as these transactions are based on, and should fulfil, the requirements under the Companies Act.

Although other laws might govern a share acquisition or a business transfer (eg, depending on the parties' locations and enforceability), the laws of Japan govern the agreement for these transactions in many cases.

APPROVAL AND WITHDRAWAL

Public disclosure

7. What information must be publicly disclosed in a public-company real estate business combination?

If the acquirer purchases shares of a public real estate company through a tender offer, the acquirer needs to file a tender offer registration statement with the Kanto Local Financial Bureau (KLFB), and the public real estate company needs to file a position statement with the KLFB under the Financial Instrument and Exchange Act of Japan (Law No. 25 of 1948, as amended) (FIEA). Also, a press release concerning the tender offer is required to be publicly issued under the applicable stock-exchange rule. The disclosure documents would contain:

- the purpose of the acquisition;
- the opinion of the public real estate company as to whether the offer should be accepted;
- material matters of the tender offer agreement;
- the policy of reorganisation planned for the acquired company after successful completion of the tender offer;

- the overview of the public real estate company;
- the schedule for the tender offer;
- the purchase price and the basis for calculating the purchase price; and
- other conditions and methods of purchase.

Although uncommon in Japan, if the consideration for the acquisition is to be in the form of shares (ie, an exchange offer), the acquirer must provide the information regarding those shares that will be the consideration paid in the tender offer in the tender offer registration statement, in addition to the items described, and the issuer must file a securities registration statement with the relevant jurisdictional KLFB.

In a merger between real estate investment trusts (REITs), the parties involved in the merger must file an extraordinary report under the FIEA and issue a press release under the applicable stock-exchange rule, disclosing:

- the purpose of the merger;
- the schedule for the merger;
- the method of the merger;
- details of allotment in the merger;
- the basis for calculating the merger ratio;
- the outline of the parties involved in the merger; and
- expected conditions after the merger.

Duties towards shareholders

8. Give an overview of the material duties, if any, of the directors and officers of a public company towards shareholders in connection with a

real estate business combination. Do controlling shareholders have any similar duties?

Under the Companies Act of Japan (Law No. 86 of 2005, as amended) (the Companies Act) and the Civil Code of Japan (Act No. 89 of 1896, as amended) (the Civil Code), the directors of Japanese corporations have a fiduciary duty towards the company, and under the Act on Investment Trusts and Investment Corporations of Japan (Act No. 198 of 1951, as amended) (AITIC), the Companies Act and the Civil Code, officers of a REIT have a similar duty towards the REIT. Shareholders or unitholders may demand that a Japanese corporation or REIT bring a suit against its directors or officers (a derivative suit) if the corporation or REIT incurred damages as a result of those individuals violating their fiduciary duties. Also, shareholders or unitholders may directly bring a claim for damages against directors or officers if they incurred damage as a result of a violation of fiduciary duty.

The Supreme Court of Japan has upheld the applicability of the business judgment rule to merger and acquisition transactions like real estate business combinations, and a violation of fiduciary duty will be found if there has been negligence (discerned from the relevant facts) in the decision-making process or the underpinning of the decision, or if the substance of the decision is considerably unreasonable.

Controlling shareholders do not have any similar duties, fiduciary or otherwise.

Shareholders' rights

9. What rights do shareholders have in a public-company real estate business combination? Can parties structure around shareholder dissent or rejection of a real estate business combination, and what structures are available?

In a share acquisition sought to be effected solely through a tender offer, while the shareholders decide whether to tender their shares, they neither have the

right to approve the acquisition nor the right to a fair price for their shares (appraisal rights).

On the other hand, in a squeeze-out following the tender offer, which is the common structure in a going-private transaction, if the acquirer purchased shares equivalent to 90 percent or more of the voting rights of the public real estate company through the tender offer, shareholder approval at a shareholders' meeting of the public real estate company is not required, and the acquirer may squeeze out the remaining shareholders without this approval. In this case, the remaining shareholders only retain their appraisal right by petitioning the court under the Companies Act if they have sent a notice objecting to the squeeze-out before the shareholders' meeting, and vote against the squeeze-out in the shareholders' meeting. If the acquirer is not able to purchase shares holding 90 percent or more of the voting rights in the tender offer, two-thirds approval by the shareholders at the shareholders' meeting is necessary for a squeeze-out. Also, in this case, shareholders have an appraisal right.

In a merger between REITs, unitholder approvals at a unitholders' meeting of the surviving REIT are necessary if the total number of units of the surviving REIT delivered to the unitholders' dissolving REIT does not exceed 20 percent of the total number of outstanding units of the surviving REIT. In any event, unitholder approval at a unitholders' meeting of the dissolving REIT is necessary. Also, unitholders of both the surviving REIT and the dissolving REIT have an appraisal right, and an appraisal right in the event of a squeeze-out.

Termination fees

10. Are termination fees typical in a real estate business combination, and what is their typical size?

Termination fees are typical in Japan and their size depends on the agreement

between the parties.

Takeover defenses

11. Are there any methods that targets in a real estate business combination can employ to protect against an unsolicited acquisition? Are there any limitations on these methods?

Although there have been few unsolicited acquisitions in Japan, targets of a real estate business combination can employ several methods to protect themselves against an unsolicited acquisition, depending on the potential structure of the acquisition.

If faced with a hostile tender offer, the target may file a position statement with the KLFB in which it expresses its opinion advising shareholders not to accept the tender offer. The target may also ask the hostile offeror questions, and the latter is obliged to file its answers with the KLFB within five business days. Also, a Japanese corporation may adopt a 'poison pill', so that the corporation gives its shareholders share options without contribution if the hostile acquirer does not comply with the condition set out in the plan. However, the number of Japanese corporations with a pill in place has been decreasing annually.

The Supreme Court has determined that the allotment of share options without the contribution and having discriminatory terms is permissible if a hostile takeover damages the company's interest (ie, the common interest of its shareholders) and that discriminatory treatment among its shareholders is reasonable.

Notifying shareholders

12. How much advance notice must a public target give its shareholders in connection with approving a real estate business combination, and what factors inform this analysis? How is shareholder approval typically sought in this context?

In a tender offer, an acquirer must set at least 20 business days as the tender offer period, which commences on the filing date of the tender offer registration statement and ends on the last specified day of the offer.

If the acquirer intends to squeeze out the remaining shareholders following the tender offer, thereby making the target company a wholly owned subsidiary of the acquirer, and has purchased shares equivalent to less than 90 percent of the target's voting rights through the tender offer, then two-thirds shareholder approval is necessary at the shareholders' meeting of the public target. The convocation notice for this meeting would be given to shareholders at least two weeks before the date of the shareholders' meeting under the Companies Act.

Also, a merger among REITs generally requires two-thirds unitholder approval at a unitholders' meeting of both the surviving REIT and the dissolving REIT, and unitholders of both entities must receive the respective convocation notice from each REIT at least two weeks before the relevant unitholder meeting under the Act on Investment Trusts and Investment Corporations.

TAXATION AND ACQUISITION VEHICLES

Typical tax issues and structuring

13. What are some of the typical tax issues involved in real estate business combinations and to what extent do these typically drive structuring considerations? Are there certain considerations that stem from the tax status of a target?

The typical structure for a real estate business combination is a transfer of shares. In this structure, the seller is an individual and is subject to a security transfer tax. The applicable rate of this tax is generally 20 percent and separate taxation applies. However, the profit on the sale of real property consists of the tax base applicable to the income of the target company that possesses the real property and some other taxes, and the effective tax rate that results is generally higher than 20 percent. The dividend to the seller from the target company may

also be subject to income tax applicable to the seller. This taxation advantage is one of the incentives for individual sellers to structure their dispositions of real property as a real estate business combination involving the transfer of shares rather than the sale of the real estate as an asset.

When a seller is a corporation or other legal entity, the profit on the transfer of shares, and the profit on the transfer of real property, consists of the tax base of the applicable corporate income tax. For these sellers, other considerations may be decisive as to whether to use a business combination or a sale of real property as an asset structure.

Mitigating tax risk

14. What measures are normally taken to mitigate typical tax risks in a real estate business combination?

When a seller is an individual, he or she may enjoy a taxation benefit by using a transfer-of-shares structure. The seller will be exempt from taxation imposed on the profit from a transfer of real property, but this means that any unrealized profit from the transfer of real property cannot be recognized by the buyer after the transfer of shares. Therefore, a buyer seeking to have any unrealized gains transferred together with the title to the real property will not acquire a real estate business combination by transfer of shares. This structure is suited for a buyer who will be a long-term owner and operator of the subject real estate.

Types of acquisition vehicle

15. What form of acquisition vehicle is typically used in connection with a real estate business combination, and does the form vary depending on structuring alternatives or structure of the target company?

Currently, typical real estate business combinations use a corporation engaged in real estate-related services as an acquirer, and an acquisition vehicle is not utilized.

TAKE-PRIVATE TRANSACTIONS

Board consideration in take-private transactions

16. What issues typically face boards of real estate public companies considering a take-private transaction? Do these considerations vary according to the structure of the target?

If the management or a controlling shareholder of a real estate public company considers taking the company private, the board would face a conflict of interest between the management or controlling shareholder, on the one hand, and the minority shareholders on the other. To ensure fairness in those transactions, based on the Fair M&A Guidelines announced by the Ministry of Economy, Trade and Industry, and the relevant stock exchange rule, the real estate public company and the management or controlling shareholder putative acquirer generally will take the following measures:

- obtain a share valuation report from a third-party valuation firm independent from the real estate public company;
- obtain advice from an independent law firm;
- obtain an opinion regarding whether the transaction is disadvantageous to minority shareholders of the real estate public company from an independent committee, the outside directors or outside statutory auditors at the real estate public company;
- obtain unanimous approval of directors that do not have conflicts of interest and statements of no objection from all statutory auditors without conflicts of interest;
- set the same tender offer price as the squeeze-out price;
- set a relatively long tender offer period (typically 30 business days);
- establish the minimum of the number of shares to be purchased (the

majority minority in the tender offer); and

- adopt measures to ensure opportunities for other acquirers to purchase the shares of the real estate public company, like there being no provisions designed to protect the transaction (eg, no prohibitions on the real estate public company from communicating with persons proposing a competing acquisition).

In 2016, the Supreme Court ruled that, in the context of appraisal rights in take-private transactions, if the tender offer process was fair and the squeeze-out price was the same as the tender offer price, then the fair price would be the tender offer price.

Time frame for take-private transactions

17. How long do take-private transactions typically take in the context of a public real estate business? What are the major milestones in this process? What factors could expedite or extend the process?

There are no specific regulations that apply to take-private transactions of public real estate businesses. These transactions are subject to the same regulations of tender offers of listed companies under the Financial Instrument and Exchange Act of Japan (Law No. 25 of 1948, as amended) (FIEA).

The tender offer period required under the FIEA ranges from 20 to 60 business days, and the threshold for a successful tender offer usually occurs if two-thirds or more of the total shares of the target company are received. The tender offer period can be extended, namely:

- at the target company's request (if the original period is less than 30 business days);
- when the conditions of the tender offer are altered; or
- if another tender offer is commenced, permitted under the FIEA.

There are two possible procedures in a squeeze-out following the tender offer, depending on the number of shares that the buyer obtains in the offer. When a buyer acquires shares equivalent to 90 percent or more of the total voting rights, the squeeze-out process will usually take about one month. When a buyer is unable to acquire 90 percent of the total voting rights, it will take about three months.

A preparation period is required before a tender offer process begins. The duration of this varies on a case-by-case basis.

NEGOTIATION

Non-binding agreements

18. Are non-binding preliminary agreements before the execution of a definitive agreement typical in real estate business combinations, and does this depend on the ownership structure of the target? Can such non-binding agreements be judicially enforced?

Non-binding preliminary agreements, such as letters of intent (LOIs) and memoranda of understanding, are typically executed to confirm the basic conditions of transaction generally understood, as of the date of these preliminary agreements, to form the basis of the definitive transaction. These preliminary agreements generally include:

- a proposed structure for the transaction;
- a proposed price for the target;
- a proposed schedule of the transaction;
- a binding confidentiality clause; and
- a binding exclusivity clause (possibly, depending on the deal).

Whether these agreements are utilized does not depend on the ownership

structure of the target.

Generally, provisions in non-binding preliminary agreements are not enforceable, with some exceptions. However, these provisions are enforceable if both parties agree. In Japan's practice, parties generally agree that the confidentiality and exclusivity clauses will be enforceable for those provisions to bind the parties to the preliminary agreement.

Typical provisions

19. Describe some of the provisions contained in a purchase agreement that are specific to real estate business combinations. Describe any standard provisions that are contained in such agreements.

In real estate business combinations, since the buyer's interest is in the value of the real property that the target company holds, the purchase agreement usually includes representations and warranties (R&Ws) regarding:

- good title to the properties;
- the non-existence of burdens on the properties, such as liens, charges or encumbrances;
- the non-existence of restrictions imposed by governmental or other public entities on use of the properties;
- the non-existence of environmental contamination on the properties; and
- similar matters.

The purchase agreement also typically contains general R&Ws, covenants and other usual provisions contained in an agreement involving the purchase of a company.

Stakebuilding

20. Are there any limitations on a buyer's ability to gradually acquire an interest in a public company in the context of a real estate business combination? Are these limitations typically built into organizational documents or inherent in applicable state or regulatory related regimes?

There is no specific regulation that applies to gradually acquired interests in a public company in the context of a real estate business combination. A transaction like that, however, would be subject to the tender offer rules under the Financial Instrument and Exchange Act of Japan (Law No. 25 of 1948, as amended).

Certainty of closing

21. Describe some of the key issues that typically arise between a seller and a buyer when negotiating the purchase agreement for a real estate business combination, with an emphasis on building in certainty of closing. How are these issues typically resolved?

The most serious issue in a real estate business combination that may arise is the contamination of the real estate, especially if properties that the target company possesses are highly likely to be contaminated, as contamination is often not obvious to parties and third parties. To avoid the risk of contamination, a buyer usually intends to incorporate an R&W clause regarding contamination of the real property in the purchase agreement being made by the target company. However, since liability resulting from contamination can be significant, sellers generally choose not to agree to the clause at least initially and instead have challenging negotiations regarding contamination when finalizing the agreement.

Environmental liability

22. Who typically bears responsibility for environmental remediation following the closing of a real estate business combination? What contractual provisions regarding environmental liability do parties usually

agree?

Depending on the transaction, a buyer usually demands R&Ws from a seller regarding environmental issues (eg, no soil contamination and no chemical or harmful substances (including asbestos and polychlorinated biphenyls) in the relevant property), while a seller resists giving such comfort, either wholly or partly. In some cases, before the negotiation phase of the definitive share-purchase agreement, a seller will impose a condition upon negotiations regarding the absence of any environment representations, and that prerequisite will be stated in the letters of intent (to sell) or the bidding instruction letter.

Other typical liability issues

23. What other liability issues are typically major points of negotiation in the context of a real estate business combination?

Occasionally, owing to a target company in a real estate business combination having a long history, and relatively little or weak corporate governance, one of the typical liability issues is the question of who owns the shares of the target company, including the accuracy of past shareholders' history, which affects the present shareholder. A buyer typically seeks to confirm a past-ownership history through legal due diligence and by securing the seller's representation.

The other major issue is the existence of any off-balance sheet liabilities, like a related company's loan, unpaid salaries or any other labour-related claims by employees.

Other negotiation points vary depending on the deal, but they typically concern the payment schedule, defect liability issues regarding real estate and liability limitation (concerning the amount of a claim and the time in which it can be brought).

Sellers' representations regarding leases

24. In the context of a real estate business combination, what are the

typical representations and covenants made by a seller regarding existing and new leases?

Typical lease-related representations are similar to those in real estate transactions, including:

- the seller discloses all existing lease agreements to the buyer;
- there are no other lease agreements or occupants;
- rents, lease terms, extension rights of tenants and deposit moneys are returned to tenants; and
- other conditions, if applicable, are negotiated by the buyer.

Concerning pre-closing covenants, often, a seller is not permitted to execute new lease agreements without the buyer's prior consent and to notify the buyer if there are any changes in any existing lease, like a rent discount request by a tenant.

DUE DILIGENCE

Legal due diligence

25. Describe the legal due diligence required in the context of a real estate business combination and any due diligence specific to a real estate business combination. What specialists are typically involved and at what point in the transaction are the various teams typically brought in?

Like other combinations or share-purchase transactions, in real estate acquisitions, lawyers, accountants and tax accountants conduct due diligence before the negotiation phase of the definitive share-purchase agreement. Further, a real estate-certified appraiser is often retained to value the real estate held by the target company.

Legal due diligence for real estate acquisitions typically only covers corporate

organization, governance, and debt and equity issues of the target, and conducts title searches, confirmation of the boundary status with adjacent land and other matters specific to real estate diligence matters.

Searches

26. How are title, lien, bankruptcy, litigation and tax searches typically conducted? On what levels are these searches typically run? What protection from bad title is available to buyers, and does this depend on the nature of the underlying asset?

Title searches are conducted by examining the real estate registry, which describes the history of title transfer from the original owner to the current owner as well as past and present liens over the property. Bankruptcy searches are carried out by checking the corporate registry where bankruptcy would be recorded if it had occurred. Japan has no simple or convenient search system regarding litigation and tax searches, and, therefore, a buyer has to depend on its due diligence interviews of the target company and examining accounting records and other documents.

Apart from asset types of real estate, a buyer's protection from the bad title is limited, because insurance or legal opinions do not usually cover bad title. A buyer relies on the seller's representation and its title search through an examination of the real estate registry.

Representation and warranty insurance

27. Do sellers of non-public real estate businesses typically purchase representation and warranty insurance to cover post-closing liability?

No. representations and warranties insurance is uncommon in Japan; neither sellers nor buyers tend to purchase it.

Review of business contracts

28. What are some of the primary agreements that the legal teams customarily review in the context of a real estate business combination, and does the scope vary with the structure of the transaction?

Although it varies depending on the purpose of the deal, a buyer's legal team is usually tasked with examining lease agreements as a source of cash flow from tenants to the target company. Lease agreements in Japan rarely have a change-of-control clause on the owner's side. Despite majority ownership of the target company changing, tenants in the usual cases have no right to terminate their leases. Nevertheless, the buyer's counsel typically reviews the agreements to see if this clause exists.

Legal due diligence usually also covers other arrangements (eg, utility and various service contracts, property management contracts and building-management contracts) reviewing them for any change-of-control clause or any other termination or modification right arising from an acquisition transaction. If the buyer is interested in terminating leases or services agreements, those termination rights by the target company are confirmed through the due-diligence process, although the ability to terminate leases, particularly concerning residential leases, may be precluded by tenant protections afforded under Japanese law.

BREACH OF CONTRACT

Remedies for breach of contract

29. What are the typical remedies for breach of a contract in the context of a real estate business combination, and do they vary with the ownership of target or the structure of the transaction?

In a share acquisition, while the typical buyer's remedies for breach of a share-purchase agreement are specific to performance, cancellation of the agreement and claim for damage compensation, the typical seller's remedies are cancellation of the agreement and claim for damage compensation.

Concerning a merger between real estate investment trusts, a merger party's typical remedies for breach of the merger agreement is the cancellation of the agreement and claim for damage compensation, although these remedies are not effective after the closing date of the merger.

FINANCING

Market overview

30. How does a buyer typically finance real estate business combinations?

A buyer may internally fund the transaction costs of a real estate business combination, but typically both debt and equity finance these transactions.

Share capital investments (or silent partnership investments, which are quite common in Japan as a means of real estate finance) are used by equity investors, but certain amounts of debt financing may be necessary, depending on the buyer's investment strategy and the size of the transaction. In these cases, a special purpose vehicle that becomes the debtor will be incorporated solely for the transaction, rather than the buyer itself becoming a debtor.

Depending on the structure of the real estate business combination (ie, whether a share deal or an asset deal), the buyer may utilize either property-level indebtedness or senior line indebtedness. Usually, financial institutions are willing to provide funds in the form of senior financing mainly because of low default risk. Further, especially in large-scale transactions, the buyer may need additional capital that could be difficult to obtain through senior financing. To make up the difference between the necessary transaction costs and equity and senior debt amounts, mezzanine financing subordinated to the senior debt, and ranking between the senior funds and the equity, would be required. This carries a higher risk than senior financing, but some leasing or insurance companies may consider being a source of mezzanine financing, expecting higher returns compared with senior tranches.

Seller's obligations

31. What are the typical obligations of the seller in the financing?

Generally, the seller is not a party to financial documents and has no direct obligation to the financing lenders in the transaction. The definitive terms of the transaction documents are negotiated between the seller and the buyer. However, lenders usually request the buyer (which is a party to the finance documents) to include certain provisions into the transaction documents and, upon the request by the buyer, certain obligations may be imposed on the seller.

The terms may change depending on the purpose and the size of the transaction, but the seller is often obliged, among others, to:

- provide a clean title to the property or the target company's shares (depending on the structure of the transaction);
- ensure that the property or the shares, which will be subject to the security interests to be established by the lenders, are free and clear of any encumbrance; and
- maintain and manage the property or the target company with the obligation to act with the due care of a good manager, from the signing to the closing date.

Also, the seller is usually obliged to file registration of the title change and to take other necessary actions to perfect the transfer of the property or the shares.

Repayment guarantees

32. What repayment guarantees do lenders typically require in the context of a property-level financing of a real estate business combination? For what purposes are reserves usually required in the context of property-level indebtedness?

Cash flows resulting from the property or the target company will be used for

repayment of the debt financing. Most often, these cash flows are held in bank accounts established in a lender and controlled under the agreed waterfall that sets out the priority of payments. No funds will be withdrawn and applied from the accounts, except under the terms and conditions of the finance documents. Usually, certain amounts are required to be maintained as reserves in the accounts for there to be sufficient funds to pay real property taxes, other taxes and insurance premiums, and to make necessary capital improvements. Further, the creation of debt service and security deposit reserves might be required to ensure debt repayment and maintain security deposits received from tenants.

The sale proceeds of the property or the target company are usually from a mandatory repayment of the loan. Also, security interests will be established to provide a source of loan repayment, on the presumption that the loan could be repaid following the exercise of the security interests if an event of default occurs.

Lenders usually require a mortgage on the real property, a pledge of the shares or bank accounts or a security interest in other assets held by the borrower or the target company.

Borrower covenants

33. What covenants do lenders usually insist on in the context of a property-level financing of a real estate business combination?

While the definitive terms are finalized after negotiations between the parties and will vary depending on the type and size of the transaction as well as other factors, the covenants of a borrower under the loan facility can be generally categorized as:

- information covenants;
- financial covenants;
- affirmative covenants; and

- negative covenants.

Lenders usually require the borrower to make covenants on matters such as:

- the prompt provision of reports and other information necessary for ongoing assessment of the property and borrower's values;
- the satisfaction of regular debt service coverage ratio and loan-to-value tests;
- proper maintenance of the property;
- compliance with applicable laws;
- maintenance of insurance policy;
- no creation or sufferance of other liens or security interests on any properties related to the financing;
- a prohibition of a change in owner, a prohibition of distributions and dividends except in certain circumstances; and
- the elimination of anti-social forces (ie, criminal or unsavoury elements) being associated with the borrower or the property.

Typical equity financing provisions

34. What equity financing provisions are common in a transaction involving a real estate business that is being taken private? Does it depend on the structure of the buyer?

Share subscription agreements are usually straightforward, but depending on the structure of the buyer, there are cases where a shareholder agreement will be executed to agree on the buyer's governance policy and management structure, including the appointment of directors, the role of each shareholder, the restrictions on and other conditions related to share transfers (ie, tag-along, drag-along and right of first refusal), and other terms. Actions to be taken by

the buyer or the target company (eg, new investments, sales of assets, indebtedness, and issuance of additional shares and share warrants) may be subject to the consent of the shareholders holding a certain percentage of equity interests. However, there are no formal requirements for these agreements in Japan and, therefore, the terms and conditions of these arrangements are decided on a case-by-case basis.

COLLECTIVE INVESTMENT SCHEMES

REITs

35. Are real estate investment trusts (REITs) that have tax-saving advantages available? Are there particular legal considerations that shape the formation and activities of REITs?

Two types of REITs are recognized in Japan: one is a corporation-type and the other is a trust-type, both of which are established under the Act on Investment Trusts and Investment Corporations of Japan (Act No. 198 of 1951, as amended) (AITIC).

A REIT is used as a conduit for the distribution of profits and is permitted to deduct its distributions from taxable income, subject to certain requirements. These requirements include, among others, that more than 90 percent of earnings are available for and distributable as dividends, and more than 50 percent of its ownership is held by one unitholder and its affiliates.

Also, REITs can enjoy other tax benefits, such as reduction of registration and real estate acquisition taxes. In turn, REITs are subject to greater regulatory restrictions and burdens designed to protect investors' rights and interests.

REITs are established to manage certain assets (consisting primarily of the specified assets under the AITIC) and are not authorized to engage in any business other than the management of these assets. Also, after incorporation, a REIT is required to file with the relevant authorities and then is subject to

regulatory supervision. REITs are also required to retain qualified independent professionals to manage their assets, to act as custodians of their assets and to conduct other activities as outlined in the AITIC.

Private equity funds

36. Are there particular legal considerations that shape the formation and activities of real estate-focused private equity funds? Does this vary depending on the target assets or investors?

Typically, in cases where the acquirer is a private equity fund, silent partnerships formed under the Commercial Code of Japan (Act No. 48 of 1899, as amended) or investment business limited partnerships formed under the Limited Partnership Act for Investment of Japan (Act No. 90 of 1998) are used, while other types of vehicles, such as trusts and corporations, may also be considered. These partnerships would be treated as a collective investments scheme and regulated by the Financial Instrument and Exchange Act of Japan (Law No. 25 of 1948, as amended) (FIEA). Generally, the FIEA requires that any person engaging in the self-offering of interests in collective investment schemes or the self-management of assets contributed from investors (where those assets are invested in securities) be registered with the Financial Services Agency of Japan. Certain exemptions from registration are available under the FIEA (generally referred to as 'specially permitted businesses for a qualified institutional investor'), but these have changed recently and the requirements have become stricter.

Further, direct investments into real estate through partnerships are permitted under certain strict requirements outlined in the Act on Specified Joint Real Estate Ventures (Act No. 123 of 2004, as amended).

UPDATE AND TRENDS

Key developments of the past year

37. Are there any other current developments or emerging trends that should be noted?

Real estate business combinations in Japan have attracted more attention from various market participants as real estate prices have risen continuously in recent years. A seller, especially an individual seller, may enjoy a tax benefit from such a transaction, which is different from the direct transfer of the real estate to a buyer.

Although the transaction process is more complicated than a simple real estate transfer, real estate business combinations are becoming, and are expected to remain, more common.

**** The information in this chapter was accurate as of September 2023.***