LEGAL NEWS

JOL market update


The industry has been eagerly anticipating the National Tax Agency’s (NTA) response to inquiries made to them by the Japan Leasing Association (JLA) in May regarding changes in Japanese tax regulations that became effective on April 1 2005.

At first glance the regulations had negative implications for the Japanese operating lease (JOL) market. A response was expected towards the end of summer 2005 but that later changed to about October or November. The industry is still sitting tight with the understanding that the NTA’s response should come in early 2006.

Uncertainties about the new regulations have resulted in a sluggish JOL market since April 1, but deal flow has started to pick up. A few deals have gone ahead but without residual value guarantees or future fair market value purchase options based on day one valuations. Some JOL market participants, however, are rumoured to be proceeding more aggressively without the benefit of tax opinions. The general market consensus is that residual value guarantees in some form and fair market value purchase options based on day one valuations will be acceptable to the NTA.

The new regulations have resulted in a move away from equity being arranged through traditional investment TK (tokumei kumiai) agreements, which was the standard form used for equity investments in JOLs before the new regulations came into effect. In most of the pre-April 1 2005 deals, a Japanese leasing company would arrange equity to be funded through a special purpose company (SPC) with the equity investors having bilateral TK agreements with the SPC. After the bilateral TK agreements, the SPC would act as the sole decision maker (eigyosha) for all matters relating to the JOL. Under that structure, a TK investor would neither have the right nor legal ability to be involved in any decisions related to the JOL, nor would one TK investor know the identity of the other TK investors involved in the same deal because of the bilateral nature of TK agreements.

The new regulations make it clear that equity investors acting as certain types of kumiai-in may no longer enjoy the full benefit of the tax losses arising from JOLs because of the passive nature of their investment. In almost all cases, a TK investor would be considered as an ineligible kumiai-in (tokutei kumiai-in) and would limit the amount of tax losses they could utilize.

In response to the new regulations, some equity arrangers have moved towards using a nin-i-kumiai (NK) structure for their equity investors. An NK is similar in many ways to a traditional partnership. An NK is formed by execution of an NK partnership agreement by the NK partners. If events and circumstances, such as liquidation, lead to only one NK partner in the NK, the NK partnership ceases to exist and automatically dissolves.

In the old Japanese leveraged leases and some of the pre-April 1 2005 JOLs, NK structures were used. But in those structures, the equity investors were usually merely NK partners who had, per the NK partnership agreement, no decision-making authority. In order to ensure bankruptcy remoteness, the equity arranger(s) established two SPCs with nominal equity contributions and those SPCs were also NK partners. One of the SPCs was designated by contract as managing partners of the NK with full authority to make decisions on behalf of the NK partnership.

Given the passive nature of the equity investors in the old NK structures, it is likely that under the new regulations they would be treated the same as equity investors operating through TK structures – in that there would be greater limitations on the tax losses from the JOL that they could utilize. Bankers are exploring new NK structures, which have the two SPCs with nominal equity contributions owned by the equity arranger(s) to ensure bankruptcy remoteness just like the old NK structures. Unlike the old structures, they generally have the equity investors as managing partners with authority to make decisions on behalf of the NK.

Having the equity investors this involved in the transaction may raise concerns for lessees, lenders and even equity arrangers. Latham & Watkins has been advising JOL market participants on ways to structure NKs and language to include in NK agreements to ameliorate these concerns. For many JOL transactions, these new structures should be workable.

It is unlikely that the market will move completely away from the TK structures but there are a few JOL equity investors that will not want to be active in the management of JOL transactions as managing partners in an NK. The new NK structures should work best for equity arrangers seeking to arrange JOLs for one or two savvy equity investors willing to act in the management of an NK partnership. Other JOL equity investors will probably still be best served by the TK structure if they can accept the limitation on tax losses.

It is impossible to know for sure what is going to be the market standard under the new regulations, but regardless, 2006 should be an active year for the JOL.