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Alert | Gaming/Real Estate

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Financing Integrated Resort Facilities in Japan

On April 27, 2018, in Japan, the IR Implementation Bill (the Bill) was approved by the Cabinet and introduced to the National Diet. The principal purpose of the Bill is to set out the measures necessary to proceed with development of integrated resort (IR) areas as required under Article 5 of the IR Promotion Act (enacted Dec. 15, 2016).

The Bill sets forth the regulatory framework applicable to IRs generally, and casino operators more specifically. However, although methods of financing IR facilities may gather significant attention from stakeholders, such as prospective casino operators and lenders in light of the inevitable funding required for IRs, the Bill does not discuss this issue in sufficient detail to provide a high level of understanding on this topic. Nevertheless, based on the contents of the current draft bill, there are potential issues related to financing IR facilities, discussed in this GT Alert.

Please note in advance that the Bill may undergo significant changes by the National Diet prior to any passage. Furthermore, additional regulatory details to be set out in the Cabinet Order following passage of the Bill are also unknown. Accordingly, the analysis below is subject to change after enactment of the Bill and publication of the Cabinet Order and other regulatory pronouncements.

Possible Financing Structures

Roughly speaking, there are two categories of financing available to IR facilities, depending on the ownership structure of the IR facilities – corporate financing and non-recourse financing.

Corporate Financing

In cases where the IR facilities are owned by the IR operator itself, debt financing from outside lenders would be provided to the IR operator (or alternatively, credit facilities may be provided to the sponsors, and then the funds will be provided by them to the IR operator by means of equity injection or debt financing). Further, credit facilities would be provided based on the entire cash flow from the IR operator's IR business. In this sense, the financing structure may be relatively simple. However, it is not clear what type of security interests lenders would require. Furthermore, the security interest would be negotiable, and would depend in part on the investment and business structure. If the lenders require guarantees from sponsors, or more specifically IR consortium members, or sponsor support with limited-recourse nature, as well as security interests over all of the operator's material assets and equity interest in the IR Operator, then the nature of the financing will be closer to that of project finance. In practice, given that the Bill prohibits the IR operator from operating any business other the IR operation business (Article 18, Paragraph 1 of the Bill), it seems that the financing to the IR operator will have a project finance nature to some extent. However, even if the lenders have a step-in right like lenders have in other project finance transactions, it is notable that transfer of the casino business, or a certain amount of equity interest in the casino operator, is subject to the Casino Control Board's prior consent (Article 47, Paragraph 1 and Article 58, Paragraph 1 of the Bill), and therefore it is unclear how the value of the security interest will be assessed.

In relation to the provision of credit facilities for IR facilities, in particular, the two following points are worthy of note:

- As a requirement for a casino license, not only certain equity holders, but also certain creditors of the casino operator must also have "sufficient social credibility"[1] (Article 41, Paragraph 1, Item 3 of the Bill); and
- Casino operators must obtain an approval from the Casino Control Board prior to the execution of the agreements regarding fund raising in relation to their business (Article 95, Paragraph 1, Item 3 of the Bill).

Because of the second item above, the terms and conditions of the financing documents in relation to casino operator's business will be scrutinized by the Casino Control Board, and it may be the case that those terms and conditions are quite different from those adopted for transactions in other industries. At this juncture, we do not have a clear picture of the Casino Control Board's criteria in relation to its examination of the financing documents, and we do not have information on whether or how the Casino Control Board will differentiate agreements regarding fund raising in relation to the business conducted as part of the casino operators' business and the non-gaming IR business. Nevertheless, it is important to be prepared for a case where all the financing documents for credit facilities provided in relation to the IR facilities as a whole will be scrutinized by the Casino Control Board. At a minimum, it will likely be important to communicate the financing terms and conditions with the Casino Control Board in advance.

[1] The Bill does not define "sufficient social credibility." The authors believe that this definition may be further defined or clarified in a future Cabinet Order or other regulatory pronouncements like in the Comprehensive Guidelines for Supervision of Insurance Companies published by the Financial Services Agency of Japan. While we cannot state with certainty until further clarification, we believe that "sufficient social credibility" will incorporate one or more concepts of regulatory "suitability" such as those in effect in other jurisdictions.

Non-Recourse Financing

In some cases, sponsors to the IR operator may wish to raise funds for the IR facilities separate from the IR operator's IR business itself or the IR Operator's own or the sponsors' creditworthiness. That is to say, sponsors to the IR operator may wish to raise funds based only upon the cash flow generated from the real estate business, partially because they want to minimize their potential liabilities resulting from the IR operator's whole IR business and partially because it may be possible to obtain debt financing at a lower interest rate in comparison to corporate financing. In this regard, the method of real estate non-recourse financing should be taken into account in the context of financing IR facilities as well.

In determining the real estate financing structure, it is essential to take into consideration not only the legal framework, but also accounting and tax implications in choosing the investment structure with respect to real estate. On that basis, it is quite common in Japan to have a special purpose company (an SPC) own the real estate with financing from outside lenders. One of two types of entities, i.e., *godo kaisha* (GK) and *tokutei mokuteki kaisha* (TMK), is usually used for the SPC entity in real estate financing transactions.[2]

A GK is a limited liability business entity similar to the limited liability company under U.S. law, and is provided under the Companies Act of Japan.[3] Separately, a TMK is an investment vehicle incorporated under the Act on Securitization of Assets (*shisan no ryudouka ni kansuru houritsu*) of Japan, and is not provided in the Companies Act.

Although it is true that a *kabushiki kaisha* (KK), or a joint stock company, is another option for real estate ownership, and is also an entity provided under the Companies Act, a GK is much more commonly used as an SPC than a KK mainly because of the GK's relaxed corporate governance requirements.

When a GK is used as an SPC to own real estate, the membership interest in the GK is usually held by an independent corporate entity (typically, an *ippan shadan hojin*, or general corporation; ISH[4]) the members of which are independent, credible individuals like certified public accountants due to the request by lenders for bankruptcy remoteness with respect to the GK. In such cases, a *tokumei kumiai* (TK),[5] or "silent partnership," arrangement is adopted in order for the investors to enjoy profits from purchase, management, and sale of the real estate in a tax-efficient manner.[6]

In the GK-TK structure, another key player is the asset manager. Under Japanese law, TK investors are just passive investors, which means they do not have any substantive rights to make decisions as to the business operated by the TK operator. Further, with a bankruptcy remote structure as stated above, the ISH is not supposed to, and does not have the ability to, make material decisions on its own as to the business operated by the TK operator. Therefore, the asset manager must make such necessary decisions (or at least provide advice necessary for decision making).

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[2] Another option would be to have a *toshi hojin*, or an "investment corporation" (J-REIT), own the real estate. A J-REIT is a business entity under a special act (namely, the Investment Trust and Investment Corporation Act) designed for investment in assets meeting certain criteria with funds provided by a number of investors.

[3] The Companies Act is the primary corporation law of Japan.

[4] An ISH is a corporate entity provided under a special act (namely, the Act on General Incorporated Associations and General Incorporated Foundations), which is a unique entity in that it has members with voting rights separate from its fund contributor.

[5] A TK is a bilateral contractual relationship between the operator and investor, whereby the profits and losses generated from a certain business operated by the operator under its own name will be distributed to the investor in accordance with agreed terms and condition.

[6] Please see the structure diagram below.

Overview of Regulations Applicable to Casino Facilities Provider

In a case where an SPC other than the IR operator owns IR facilities including casino facilities, the regulations applicable to owners of IR facilities will inevitably apply to that SPC. Accordingly, in order to consider the feasibility of each financing structure, it would be crucial to grasp the regulatory framework in the Bill applicable to facilities providers, or "Casino Facilities Provision Business," which is the term provided in the Bill.

The Bill defines "Casino Facilities Provision Business" as essentially meaning the business of managing casino facilities for the purpose of providing the facilities to an IR operator which will use them exclusively for the IR business (Article 2, Paragraph 14 of the Bill). Further, under the Bill, facilities providers must obtain a license from the Casino Control Board prior to the commencement of a Casino Facilities Provision Business (Article 124 of the Bill).

In addition to the licensing requirement mentioned above, the following restrictions, among others, will be applied:

- The "Basic Business Plan" in the "IR Area Development Plan," as set out by the relevant prefecture or Cabinet Order-designated city (collectively, the Local Government), must state that the facilities provider will be a business entity stipulated in the Companies Act, and that the facilities provider may only operate the Casino Facilities Provision Business (Article 9, Paragraph 11, Item 3, Sub-Item *ha* of the Bill);
- The Bill itself also prohibits facilities providers from operating a business other than the facilities provision business (Article 18, Paragraph 2 of the Bill);
- Prior to rendering the license to run the Casino Facilities Business, the Casino Control Board must scrutinize matters including: (i) whether the officers of the applicant have sufficient social credibility, (ii) whether those who have dominant influence on the business of the applicant through investment, loans, or the like have sufficient social credibility, (iii) whether the equity holders of the applicant who hold five percent or more of total voting rights or the like in aggregate (and such holders' officers, in the case of a corporation) have sufficient social credibility, (iv) whether the applicant has the ability to run the Casino Facilities Provision Business properly in terms of its human resources and has sufficient social credibility (Article 126, Paragraph 1 and Article 41, Paragraph 1 of the Bill); and
- Facilities providers must obtain an approval from the Casino Control Board regarding fund raising in relation to their Casino Facilities Provision Business prior to executing the agreements (Article 133, Paragraph 2, Item 3).

Analysis on Feasibility of Non-Recourse Financing of IR Facilities

Based on the discussion above, when analyzing the feasibility of non-recourse financing to IR facilities, there are some potential issues of note.

First, due to the IR Area Development Plan condition that requires the facilities provider to be an entity provided under the Companies Act, it seems that a TMK (or J-REIT) cannot own the IR facilities. Accordingly, a GK (or KK) will be required for real estate ownership in Japan (unless the requirements can be met for the legal owner of IR casino facilities to be a trustee; see below).

Second, on the basis that the GK, as the owner of the IR facilities, executes a TK agreement with the real estate investor, it will be necessary to be cautious about the restrictions under the Real Estate Joint Enterprise Act (the REJEA). If a TK operator executes a TK agreement with a TK investor involving profit

and loss distributions generated from a real estate transaction, then the TK operator must obtain a license under the REJEA unless any of the exceptions under the REJEA apply. Accordingly, in most real estate non-recourse financing transactions in Japan, a GK, as the TK operator, owns not the real estate itself, but a trust beneficial interest in the real estate. In such instances, the licensing requirement under the REJEA may be avoided, but in turn, the GK would be subject to strict registration requirements under the Financial Instrument and Exchange Act (the FIEA) applicable to its offering of the TK interest and investment management. In practice, however, these registration requirements can be essentially avoided by either: (i) having a private placement handler registered as a "Type II Financial Instruments Business" operator conduct the private placement matters, and having an asset manager registered as an "Investment Management Business" operator make discretionary investment decisions, or (ii) adopting the so-called QII exemption if available.[7]

However, if the GK owns the trust beneficial interest in the IR facilities, which means the owner of the IR facilities is the trustee, it will be necessary to consider whether and how the trustee can satisfy the requirements applicable to owners of IR facilities. In particular, it is not clear whether the requirement for the facilities provider to only operate the Casino Facilities Provision Business can be met in a case where the purpose of the relevant trust is strictly limited to the Casino Facilities Provision Business. Another possible requirement would be that even in the case of a trust, the trust beneficiary itself (or in addition to the trustee) must satisfy the requirements applicable to the owner of IR facilities (e.g., licensing and limited business scope) because it is the beneficial and substantial owner of the IR facilities. On the other hand, if the trustee can meet those requirements[8], and those requirements are not applicable to the trust beneficiary, then it could be possible for a TMK or J-REIT to own the trust beneficial interest in the IR facilities.

If some of the requirements applicable to owners of IR facilities cannot be met in a case where the trustee is the owner, then the GK must be the direct owner of the IR facilities in compliance with the REJEA. In that case, the GK may seek one of the exemptions to the licensing requirement, essentially by: (i) retaining an asset manager licensed under the REJEA, or (ii) limiting the TK investors to so-called qualified special investors, which are different from QIIs under the FIEA. However, even if the GK can rely on one of those exemptions, it will nonetheless also need to meet the requirement to possess adequate human resources. The GK incorporated as an SPC usually does not hire any employees and its only personnel is an executor of the ISH because the lenders require the GK to do so for the purpose of procuring the bankruptcy remote nature. One possible argument would be that the asset manager's ability can supplement the lack of human resources of the GK, and as a result, the GK may satisfy the human resources requirement above, but it is not clear whether the authorities will have the same interpretation.

Further, since transfer of the Casino Facilities Provision Business, or a certain amount of equity interest in the casino facilities provider, is subject to the Casino Control Board's prior consent, as is the case with a transfer of the casino business (Articles 130, Article 47, Paragraph 1 and Article 131), it is unclear as well in a case of non-recourse financing how the value of the security interest will be assessed. Also, similar to the case of financing agreements in relation to the casino business of IR operators, financing agreements in relation to casino facilities by facilities providers must be scrutinized by the Casino Control Board.

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[7] The requirements for the QII exemption are essentially that: (i) at least one of the TK investors is a qualified institutional investor (QII) under the FIEA, (ii) the number of the TK investors that are not QIIs is 49 or less, (iii) none of the TK Investors fall under the items that disqualify investors as stipulated in the FIEA, (iv) all of the non-QII TK investors fall under the items that qualify non-QII TK investors in the FIEA, and (v) the GK files a necessary notification with the competent governmental authority.

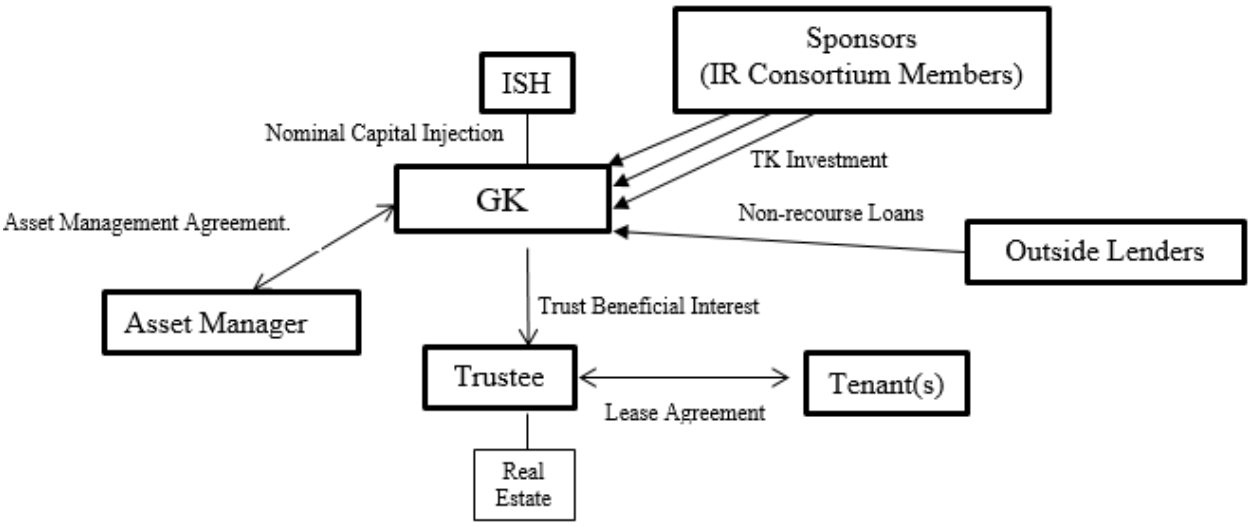
[8] However, considering the licensing requirement and other restrictions applicable to facilities providers, as far as it is interpreted that the trustee is the facilities provider in the case of a trust, it would not be practicable for most trust banks and trust companies to be the trustee of the IR facilities.

Therefore, as discussed in our overview of corporate financing above, it is also essential to communicate with the Casino Control Board with regard to the financing agreements by the facilities providers.[9]

Conclusion

As discussed above, it is still unclear whether it is possible to choose a structure commonly used in real estate financing transactions in Japan for the financing of IR facilities generally, or casino facilities in particular. It seems that a number of issues remain open concerning the financing method of the IR facilities even after the Bill was published. Therefore, it will be important to monitor the future discussions and measures to be taken with regard to the Bill as it passes into law and the subsequent Cabinet Order prior to determining the investment and financing scheme with respect to IR facilities.

Figure 1: GT-TK Structure Diagram



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[9] On a special note in real estate non-recourse financing cases, judging from the discussions made and published by the IR Area Development Promotion Committee, it seems highly likely that facilities providers will not be allowed to share revenue or profit from the casino business, which means that no portions of the rent for casino facilities may be calculated in proportion to revenue or profit of the casino business. Therefore, it is essential to assume that sponsors to the facilities provider will need to invest with that understanding in mind.