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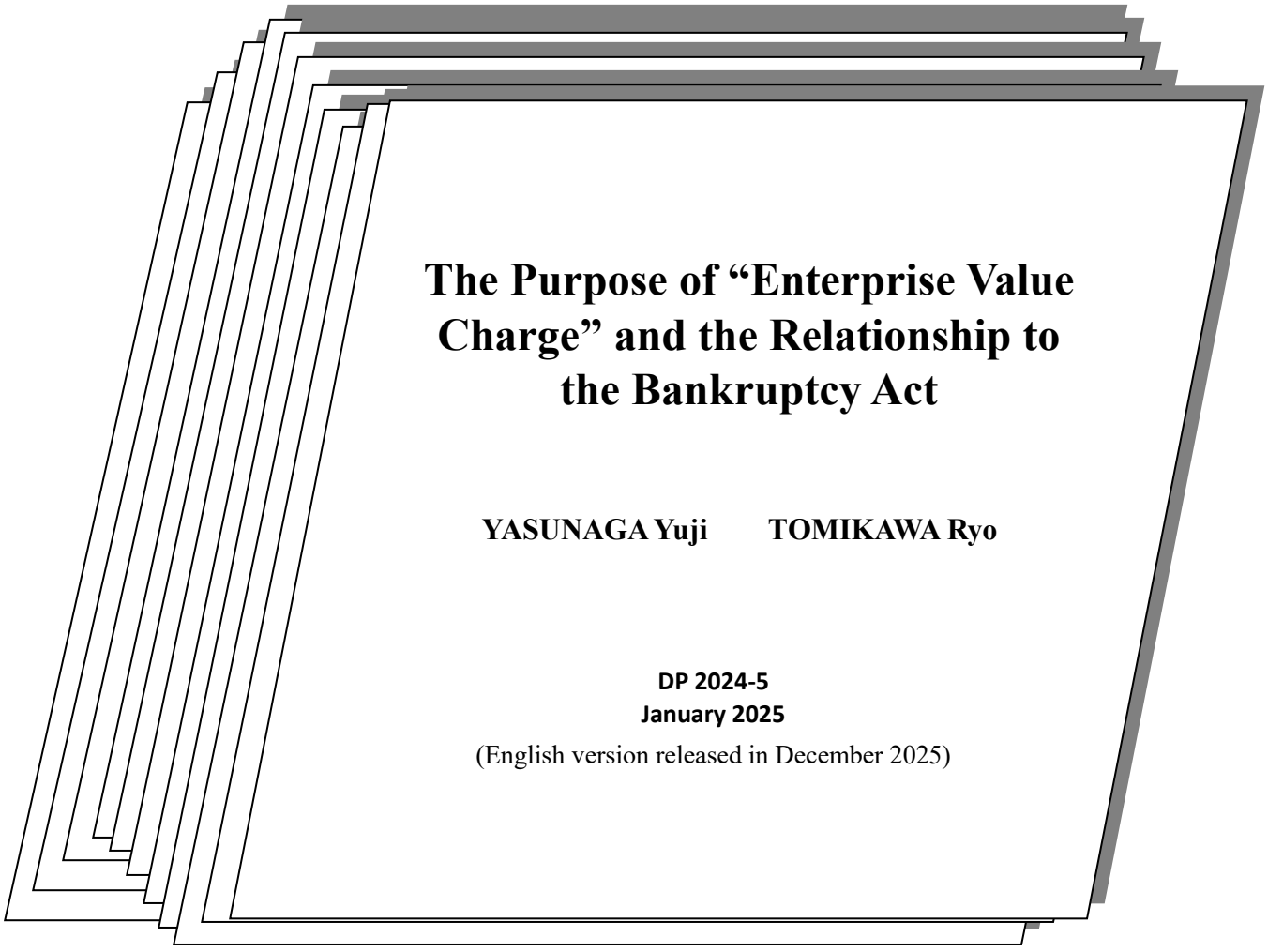

# The Purpose of "Enterprise Value Charge" and the Relationship to the Bankruptcy Act

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**DP 2024-5**
**January 2025**
(English version released in December 2025)

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# The Purpose of "Enterprise Value Charge" and the Relationship to the Bankruptcy Act

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## Abstract

The Act on the Promotion of Cash Flow-based Lending was enacted on June 7, 2024. This act has received considerable attention from the public, as it introduced a new collateral scheme, namely, "enterprise value charge," which enables a borrower entity to use all of its assets, including both tangible and intangible assets, as collateral for loans, and the act also stipulated special foreclosure procedures to implement this security interest. This study first examines what kind of messages this new act has conveyed to the financial market (particularly financial institutions). Then, it discusses the significance of this new type of collateral for mortgages, considerations for its use, and the treatment of the new collateral scheme in the Bankruptcy Act.

**Keywords: The Act on the Promotion of Cash Flow-based Lending, cash flow-based lending, and "enterprise value charge."**

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There are following articles and a book explaining the purpose of the Act on the Promotion of Cash Flow-based Lending: Tomikawa, Ryo. 2024. "The Impact of New Security Interests on Financial Practices." *Kinyu Ja-naru*. No. 823. P.22 onward; Tomikawa, Ryo, and Shun Komiya. 2024. "Financial institutions' organizational arrangement indispensable for promoting the new collateral scheme." *Kinyu zaisei jijo.* No. 3547. P.20 onward; Tomikawa, Ryo and Shun Komiya. 2024. "How has discussion on enterprise value charge progressed?" *Kinyu homu jijo.* No. 2237 & 2238 (joint issue) p.14 onward.; and Tomikawa, Ryo. 2024. *Q&A Key Points of The Act on the Promotion of Cash Flow-based Lending and Lending Operations: Enterprise Value Charge*. Business Education Publishing Co., Ltd.

# 1. Introduction—Initiatives to promote commercial loans

In the ever-changing business environment, financial institutions need to develop sustainable business models through innovation to meet their customers' diverse needs, such as providing working capital and supporting business improvement. The Financial Services Agency of Japan (JFSA) has been making various efforts to improve business environment that facilitates financial institutions to better support business activities. Some of the measures implemented over the past five years include amendment of the Regulation for Enforcement of the Banking Act in 2019 to allow exceptions to restrictions on the holding of voting rights related to business revitalization, regional revitalization projects, and business succession, and to clarify its views on authorization of "a company engaged in services that contribute to increased sophistication of banking business." In addition, the JFSA reviewed its excessively detailed, prescriptive supervision, abolished the Financial Inspection Manual, and devised the basic policy on inspection and supervision as well as concepts and procedures for each financial sector. Furthermore, in 2021, the Banking Act was amended to significantly relax restrictions on the scope of business and equity investment, including the creation of "non-financial companies engaged in services that contribute to increased sophistication of banking business." These measures are expected to contribute to facilitating banks' business and improving their business operation.

Various measures have been implemented, but there remains one issue that needs to be addressed, which is the improvement of lending practice by financial institutions. That is, many financial institutions still employ lending practice that places importance on "property collateral" and "personal guarantees provided by business owners." Needless to say, soundness of financial institutions (particularly, deposit-taking institutions) must be ensured, and there have been legitimate reasons for conventional practice focusing on property collateral and personal guarantees, such as benefits of reducing monitoring costs and improving debtors' management discipline through guarantees. However, it has long been pointed out that such loan practices tend to make financial institutions reluctant to make loans to businesses that cannot provide collateral, possibly not providing necessary funds, and so the overall lending practice should be modified. Specifically, startup businesses are one example; they do not have real estate or other property assets and so there are cases they find it difficult to obtain financing without diluting their holdings. In addition, it has been pointed out recently that requiring business owners' personal guarantees has become a factor that hinders filing of a petition by business owners themselves to smoothly commence bankruptcy proceedings and business succession that accompany changes in owners.[1]

However, an adequate legal framework has not been in place: that is, a framework which secures an environment where banks can provide loans based on future cash flows of borrowers' businesses, without taking real estate collateral or personal guarantees, in response to customers' needs for timely access to an appropriate amount of funds, and moreover offer partnered support. Even if a financial institution actively provides cash flow-based lending and support to a firm as its main bank, if the borrower firm has also received loans from other financial institutions, the loan claims will be repaid on a pro rata basis. Furthermore, if another financial institution creates security interests, the loan claims will even become subordinated to other secured loans. If financial institutions that have contributed to maintaining and continuing borrowers' business are unable to secure priority in repayment, it would be difficult for financial institutions to change their conventional lending practices and meet the needs for cash flow-based lending. As we discuss in "2.1 The Current System and

[1] "Guidelines for personal guarantee provided by business owners" issued in 2013, were developed in response to these concerns.

Challenges" below, while there are various types of collateral systems that guarantee financial institutions' preferred repayment rights, these conventional collateral frameworks have not always been sufficient.

In light of the issues discussed above, the JFSA has begun designing a new collateral facility as part of its efforts to create an environment that contributes to provision of cash flow-based lending and partnered support. After a wide-ranging discussion and considerations, the Act on the Promotion of Cash Flow-based Lending (hereinafter referred to as the "Act") was enacted on June 7, 2024.[2] We first look at Article 1 of the Act. The objective of this act is to "change financing practices which rely on security interests in real estate or payment warranty backed by personal guarantees, and to facilitate financing of funds necessary for businesses, thereby supporting [...] the continuation and growth of businesses." This objective indeed addresses the challenges identified above. In order to find solutions to the issues, this Act created a new security interest (enterprise value charge) that uses the entire asset of the debtor, including its future cash flows, as collateral assets (Article 7 of the Act), and established procedures for foreclosure of security interests (articles 70 to 192 of the Act). We expect that the "enterprise value charge" will make it easier for financial institutions to provide loans that focus on the value and future cash flows of business. In addition, there is a provision that limits the use of personal guarantees in principle when this security interest is applied (Article 12 of the Act), and it is evident from this provision that the Act aims to promote "cash flow-based lending." The Act will come into effect in the near future, and it is fair to say that the process for creating a legal framework for financial institutions to provide "cash flow-based lending" and partnered borrower support have made progress.[3]

The fundamental objective of this Act is, as its title suggests, to promote cash flow-based lending, and the Act has instituted a system to achieve the objective. The central core of this Act is a new security interest and their foreclosure procedures. In this report, we examine the purpose and elements of this new security interest and its treatment in bankruptcy proceedings to grasp the idea and characteristics of the enterprise value charge set forth in this Act.[4]

# 2. The Purpose and Elements of Enterprise Value Charge

## 2.1 The Current System and Challenges

In what follows, we examine corporate loans that are available currently, such as foundation mortgage scheme (*zaidan-teito* scheme), enterprise mortgage, asset-based lending (ABL), and security trusts. These lending schemes have shortcomings and are insufficient to solve the challenges discussed above.

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[2] For details of discussion and considerations, see Tomio Mizutani et al., "Summary of the Act on Promotion of Cash Flow-based Lending (Part I): Focusing on enterprise value charge," *NBL,* No. 1270, 2024, p.4.

[3] It has long been pointed out that financial institutions should provide the kind of financing described in this paper from their standing as main banks. See, for example, "Toward better functioning of relationship banking" (March 27, 2003), a report issued by the Second Subcommittee on Financial System under the Financial System Council. The difference between the (future) image of a main bank assumed when using this Act and the (past) image of a main bank following the bursting of the bubble economy can be found in, for example, "Issues paper 2.0" by the study group on approaches to financing and rehabilitation practices that support businesses (November 30, 2021, P.10), and "Benefits of Becoming a Main Bank" by Hideaki Horiuchi, *Ginko Jitsumu,* No. 786, 2024, p. 23.

[4] For the outlines and explanations of the system, books and articles discussing in details will likely be published in the future, but at this point, see articles such as, Mizutani et al. (see footnote 2) p.4, and Mizutani et al., "An outline of the Act on Promotion of Cash Flow-based Lending (Part II): Focusing on enterprise value charge," *NBL*, No. 1271, 2024, p.23.

### 2.1.1 Foundation mortgage (*zaidan-teito* scheme)

In 1905, foundation mortgage scheme was established, and land, buildings, machinery and equipment, other physical facilities, and industrial property rights were combined into a single foundation to be mortgaged, based on the factory mortgage act and other similar acts. Today, there are nine authorized foundations: factory foundation; mining foundation; fishery foundation; port and transportation foundation; road and traffic foundation; tourist facility foundation; railway foundation; tramway and facilities foundation; and canal foundation. The purpose of the foundation mortgage scheme was to overcome challenges associated with security interests, such as the inability to make the entire business asset subject to a single security interest, and the unbundling of the business due to security interest being exercised separately. The scheme has played a significant role in promoting corporate finance.

However, the use of this scheme is limited because of its weakness and burdensome procedures. Specifically, projects that can use this scheme are limited to nine foundations above, assets that can be used to form a foundation are limited to physical facilities and property rights, and a list of assets, which compose a foundation, need to be prepared and officially registered.

### 2.1.2 Enterprise mortgage

In 1958, the Floating Charge Act was enacted, which provides for corporate security interests to be placed on the "entire property of a stock company." The purpose of this law was to overcome the problems associated with the foundation mortgage scheme described above and to make the entire business asset to be eligible as collateral for a security interest more easily. Registration in the commercial registry is required for enterprise mortgage to have legal effect.

This type of security interest has the advantage of facilitating to include all the assets of a company in the scope of the security interest, but at present it is rarely used due to the following reasons. It is not convenient because the secured claims are limited to corporate bonds, and its legal effectiveness is weak because it is subordinated even to other security interests which are set on individual assets after an enterprise mortgage was placed.

In addition, while transfer of business was considered as one method to realize the debtor's assets at higher prices, there was no mechanism in this act to encourage this. Even if a value equivalent to "goodwill" is recorded on the book as a result of a transfer of business, it was left to interpretation whether this value would be included in the "entire property" and allocated to enterprise mortgage holders.[5] Furthermore, even if the "goodwill" value were included in the "entire property," due to its allocation to the value of each asset, it could be that individual security interest holders have priority in repayment, and so it was not clear whether distribution to enterprise mortgage holders will be implemented.

### 2.1.3 Asset-based lending (ABL)

Asset-based lending (ABL) is a financial tool that applies security interests on individual assets (i.e., mortgage on movables and claims), using firms' business assets such as inventories, receivables, and equipment as collateral. This type of lending could have been a solution to the problems mentioned above, because setting of mortgage was based on the operational cycle of firms' business, and this enabled banks to grasp firms' cash flow.

However, there are constraints on ABL given that the maximum lending capacity of ABL

[5] According to the commentary by a person in charge of drafting the Floating Charge Act, this is clearly denied (Yasukazu Kagawa, "Article-by-article commentary on the Floating Charge Act (1)," *Kinyu Homu Jijo*u, No. 172 (1958), p. 281).

was limited to the valuation of receivables and inventories. In addition, there was a limitation to lenders (security interest holders) in receipt of repayment, because lenders do not have preferred repayment right from the "goodwill" value of the assets when the transfer of business takes place. Repayment the lenders would receive from business transfer would be the realization value of individual assets at a maximum.

### 2.1.4 Security trust

A security trust is a mechanism in which a secured claim and the security interest are separated, and a trustee, who is an entity other than the creditor, manages the security interest. In Japan, traditionally, the prevailing view has been that security interest holders are limited to creditors of secured claims, and only secured bonds issued pursuant to the Secured Bond Trust Act were recognized as the only exception legally. However, the amendment of the Trust Act in 2006 explicitly permitted entities other than creditors to manage security interests on loan claims through trusts. Security trusts have advantages such as enabling management of security interests collectively by the security interest holder (trustee) even when there are multiple creditors, as in the case of syndicated loans, and not requiring registration procedures to effect a transfer of security interests when secured claims are assigned.

However, it has been pointed out that this mechanism has not been widely used due to the following problems: (i) with the separation of security interest holders and creditors, legal interpretation issues arise for laws that presume creditors and security interest holders to be the same (e.g., civil law, civil execution law, bankruptcy law); and (ii) trust fees and other costs have increased.[6] In addition, a security interest holder cannot receive preferential payment from the so-called goodwill value, as in enterprise mortgage and ABL.

## 2.2 Benefits of "Enterprise Value Charge"

As we examine below, "enterprise value charge" would facilitate provision of cash flow-based lending by financial institutions using this new collateral scheme compared to loans based on the conventional collateral schemes.

### 2.2.1 The value of enterprise value charge

Article 7 of the Act provides for assets that are eligible as collateral for enterprise value charge. The article stipulates, "All the assets of a company (including those assets that will belong to the company in the future [...]) may be used, in its entirety, as the subject of enterprise value charge to secure specified and unspecified secured claims against that company." When compared with the provisions of Article 1 of the Floating Charge Act, which reads "the entire property of a stock company (hereinafter referred to as "company") may be used as the subject of enterprise mortgage as one body in order to secure a bond which the company issues," although the same terms are used in the provisions generally, there is a significant difference as the phrase "those assets that will belong to the company in the future" are included in the enterprise value charge. The phrase aims at incorporating, as eligible collateral for enterprise value charge, the value of the company that would increase with the continuation of business (here, we set aside the case where the value of company's assets

[6] We would like to touch on the relationship between enterprise value charge and security trusts for the discussion of this paper. In the enterprise value charge, as in the case of security trusts, security interest holders and creditors can be separate entities. This Act has explicit provisions to sort out the relationship with foreclosure procedure and bankruptcy proceedings. In addition, since security interest holders and creditors can be the same entities, it is possible to avoid trust fees and other expenses.

decreases). In short, the principal feature is that the value of a debtor's entire business asset is eligible as collateral for enterprise value charge.

This point is clear when we look at an actual example, in the case where a transfer of business takes place. When a debtor company transferred its business, the value allocated to "goodwill"[7] as well as the value of individual assets[8] has been recognized as the value of business transfer, in terms of accounting. Therefore, when there is a certain value of goodwill, it is considered possible to repay a certain amount to general creditors even if security rights were established on most of debtor's individual assets.[9] Under the new Act, however, the value of such goodwill would also be, in general, a value that would belong to the enterprise value charge holder. As such, the fact that security interest holders can get the value equivalent to goodwill at the time of business transfer has advantages compared to the conventional security interests. However, it should be noted that there are some types of claims to which preferential repayment or distribution is admitted before holders of enterprise value charge. We will discuss this point in "2.3.2 Priority given to labor claims and trade receivables in foreclosure of security interests and retained value of unspecified secured claims."

### 2.2.2 Priority and legal effect of enterprise value charge

Enterprise value charge is considered as a mortgage in bankruptcy proceedings, as discussed below, and it has priority over other security interests. This is a significant advantage for enterprise value charge holders compared to "enterprise mortgage," which subordinates to individual security interests.

In addition, while enterprise value charge allows the liquidity of collateral assets, it has measures to counter disposal or compulsory auction of individual assets that would deter continuation of business or reduce the value of business (articles 19 and 20 of the Act). The enterprise value charge scheme has adequate measures to prevent impairment of collateral, without unduly restricting the debtor's ordinary transactions.

### 2.2.3 The efficiency of enterprise value charge

Registration in the commercial registry is required for enterprise value charge to have legal effect (Article 15 of the Act), and preferential treatment in relation with other security interests is determined in the order of registration (articles 16 to 18 of the Act).[10] The scheme is designed so that security interest is perfected by registration in the commercial registry, which declares that assets of the company concerned is subject to the enterprise value charge, and this has a significant advantage given that security interests in individual assets can be asserted against third parties without any registration

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[7] Given that "goodwill" is an intangible asset, security interest cannot be placed on it.

[8] Even if security interest is placed on individual assets, the value recognized as the value of the security interest in the event of a bankruptcy is, in general, the value obtained by disposing assets individually. Regarding the disposal values, calculation methods are determined for different phases of security interests: for foreclosure of security interests, auctioned prices (under the Bankruptcy Act and the Civil Rehabilitation Act) and market value (under the Corporate Reorganization Act); and where a request for extinguishment of security interest is made in a reorganization proceeding, early disposal value is used in practice (see Article 150 of the Civil Rehabilitation Act and Article 79 of the Rules for Civil Rehabilitation, Article 105 of the Corporate Reorganization Act and Article 27 of the Rules for Corporate Reorganization).

[9] As a practical example, see, for example, Nakai, Yasuyuki, "The case of Setouchi International Marine Hotel," *Recovery and Restructuring Cases (1),* Shoji Homu Co., Ltd., 2004, p. 75. Assuming that the business transfer is realized, the general creditors mentioned in this report are most likely to be financial creditors. Other trading and tort creditors would also be included.

[10] Public notice of enterprise value charge is essential to ensure the predictability of related parties, including new lenders. Considering the time and monetary costs needed for developing a new designated public notice system for enterprise value charge, public notice by registration in the already-existing commercial registry is a reasonable method, as registration is easy to make.

for individual assets.[11]

## 2.3 Foreclosure Procedure of Enterprise Value Charge

### 2.3.1 Phase before foreclosure of enterprise value charge

As we said earlier, financial institutions who are "main" relationship banks are expected to support borrower firms through partnered support for loans provided using enterprise value charge. In this respect, financial institutions are expected to assist business improvement by conducting timely and appropriate loan management (see section 3.2.2, "Monitoring during loan terms"). The borrower would be able to initiate measures for business improvement themselves upon consultation with lenders, starting it at an earlier timing, and so an upturn in business is thought to be more likely.[12]

When it is difficult for the borrower firm to improve its business on its own, the borrower firm would consider transferring its business, hearing from enterprise value charge holders. Even after sufficient discussion between the borrower and the financial institution, there would be cases where they fail to reach a consensus on business transition, such as when the borrower wishes to rebuild on its own or when the borrower and the bank differ on the selection of the transferee, and at that point, enterprise value charge holder would file a petition for commencement of foreclosure procedure.[13]

If it has become difficult to make profits and also business transfer is not realistic, procedures for disposition and realization of all the assets will be followed. Such procedures can be initiated by filing of foreclosure by security interest holders, but in many cases it may be more appropriate to commence bankruptcy proceedings which have strong measures such as prohibition of "set-offs" and "right of avoidance" (see also "4.1.2 Cases where a bankruptcy proceeding commences first").

### 2.3.2 Priority given to labor claims and trade receivables in foreclosure of security interests and retained value for unspecified secured claims

In foreclosure procedure of enterprise value charge, some creditors are given priority in repayment over holders of enterprise value charge. This is another distinct feature of enterprise value charge.

First, priority is given to labor claims and trade receivables. To foreclose a security interest, it would be appropriate to first consider business transfer so as to explore the possibility of maximizing the value of debtor's assets. Therefore, in the foreclosure processing, from the viewpoint of achieving business transfer to third parties and maintaining the value of the business at the same time, it is essential to give special protection to employees and counterparties who are indispensable for maintaining the value of the business. Labor claims are defined as "common benefit claims" in Article 129 of the Act and are repaid in priority and as necessary. Further, Article 93 stipulates, "when deemed

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[11] This point is noted by the following papers: Ohkita, Shiro, et al. "Panel Discussion (the second topic): Bankruptcy and enterprise value charge." *NBL,* No. 1279, 2024), p. 43, (see comments by Inoue Satoshi); Koyasu, Tomohiro. "Recent trends and future developments in security interest in acquisition finance: corporate value security interest in focus," *Shoji Homu,* No. 2373, 2024, p. 23; and Sato, Tomohiro, and Akira Yamamoto, "Possibility of enterprise value charge in project finance," *Ginko Homu 21 (Banking Law Journal 21),* No. 920, 2024, p. 24. It is also pointed out that registration and license tax for enterprise value charge (Article 39 of the Supplementary Provisions of the Act) is JPY 30,000 and is less costly compared to a security interest in the entire asset.

[12] This kind of follow-up is ideal under the Promotion of Cash Flow-based Lending, as pointed out by following reports: Saito, Takashi, and Dai Mizui, "The aim of the special feature, and key elements of enterprise value charge," *Ginko Homu 21 (Banking Law Journal 21),* No. 920, 2024, p. 6; and Senmyo, Ryokichi, and Takahiro Kato, "Issues surrounding foreclosure of enterprise value charge," Ibid., p. 21.

[13] In the case of business transfer under the foreclosure procedure, a resolution of the general shareholders meeting is not necessary (Article 157, paragraph 6 of the Act). Therefore, if time and procedural costs related to the resolution of the general shareholders meeting would be burdensome, it may be an option to use the pre-packaged scheme for foreclosure procedure.

necessary for the continuation of the debtor's business, the protection of the debtor's counterparties, or the fair implementation of other procedures, repayment shall be permitted upon filing by a trustee." This permits preferential payment to creditors who had transactions with the debtor based on the approval by the court. These provisions also apply to cases where transfer of business cannot be consummated, and so business assets are sold individually. In short, creditors who had transactions with the debtor are repaid by the application of Article 93, but labor claims are repaid with priority pursuant to Article 129. In this respect, it has a different feature from security interests in individual assets that have been used conventionally. This leads to motivating holders of enterprise value charge (in effect, specified secured creditors) to provide loans that focus on borrowers' business plans and also to conduct timely monitoring of the feasibility of borrower's business (for details, see "3.2 Financial institutions' organizational arrangement for enterprise value charge").

The second feature is about distribution (repayment) to unspecified secured claims. The value of funds for distribution will be "the amount calculated pursuant to the provisions of the Cabinet Order." The Cabinet Order mentioned here is to be issued in the future. If the amount of funds used for repayment can be calculated in advance, specified secured creditors (financial institutions) can consider the method and timing of debt collection upon estimating the amount of deduction (i.e., their recoverable amount). This scheme was newly introduced in line with making debtor's entire asset available as underlying collateral for enterprise value charge, and therefore this constitutes a major feature of the Act.

Here, we will describe the foreclosure procedures up to distribution of funds regarding specified secured claims and unspecified secured claims. First, according to paragraphs 1 and 2 of Article 166 of the Act, for a trustee to make distribution on specified secured claims, the retained value for unspecified secured claims (the value calculated for distribution to unspecified secured creditors pursuant to Article 8, paragraph 2, (i)c. of the Act) is deducted from the value of distributable funds. Distribution shall be made to holders of enterprise value charge (not specified secured creditors) in the amount not exceeding the above deducted amount. To make distribution to unspecified secured creditors, the retained value for unspecified secured claims is handed to holders of enterprise value charge (Article 166, paragraph 3 of the Act). However, distribution to unspecified secured creditors shall not be made in the foreclosure procedures of enterprise value charge, but through liquidation or bankruptcy proceedings (Article 6, paragraph 5 of the Act). Therefore, the enterprise value charge holder has the obligation to manage the retained value for unspecified secured claims that has been delivered to it (Article 62, paragraph 1 (ii) of the Act), and when the debtor files a petition for commencement of liquidation proceedings or bankruptcy proceedings, the enterprise value security charge holder shall make prepayment of expenses for the proceedings from the retained value (Article 62, paragraph 1 (iii) of the Act). When liquidation proceedings or bankruptcy proceedings are commenced, the enterprise value holder must deliver, without delay, retained funds for unspecified secured creditors (if prepayment has been made, the value deducting that amount) to the liquidator or bankruptcy trustee, so that the money equivalent to retained funds is paid to unspecified secure creditors in accordance with the order of repayment or distribution in the proceedings (Article 62, paragraph 1 (iv) of the Act). The funds shall become property of the liquidating company or property belonging to the bankruptcy estate, and shall be distributed to unspecified secured creditors in liquidation proceedings or bankruptcy proceedings (Article 62, paragraph 2 and Article 6, paragraph 5 of the Act).

Where transfer of business is consummated outside a foreclosure proceeding, it is deemed that payment to the employees or counterparties to transactions that constitute the business, and succession of claims will be executed based on each contract. Provisions regarding retained funds for

unspecified secured claims in the Act do not apply. Therefore, whether it is possible to secure retained funds for unspecified secured claims face an interpretation issue. We examine this point at first in a case where a business transfer implemented outside the court in section "3.4 Treatment of creditors in non-mandatory business transfer." We then examine procedures in a case where a business transfer is made under bankruptcy proceedings in "4. The Relationship between Foreclosure Proceedings and Three Types of Bankruptcy Proceedings."

# 3. Considerations Regarding the Use of Enterprise Value Charge

## 3.1 Registration of Enterprise Value Charge and Credit Concerns

First, in business practice, it could be possible that registration of creation of enterprise value charge is taken by other businesses as meaning liquidity concerns. In fact, with regard to challenges associated with creation of security interests in ABL, more than 40 percent of financial institutions raised "concerns that registration of assignment of claims might cause reputational damage" according to Teikoku Databank (2017, "report on challenges associated with ABL").

It should be noted that enterprise value charge was established in the process of developing an environment that promotes cash flow-based lending and financial institutions' partnered support, and therefore it is different from mortgage (assignment of claims), which can only capture the realization value of individual assets. We consider it important to articulate that the creation of security interest is not a sign of credit concerns, because the creation of a security interest in enterprise value means the success of the entity in raising funds. When cash flow-based lending is made pursuant to the creation of security interest in enterprise value, financial institutions' partnered support to the borrower firm can be expected, so this should rather be taken positively as an improvement in its creditworthiness. It would be ideal for such perception to become more general, and to this end the significance of enterprise value charge should be informed widely to parties including financial institutions and businesses.

## 3.2 Financial Institutions' Organizational Arrangement for Enterprise Value Charge

### 3.2.1 Loans using enterprise value charge (evaluation of business)

Enterprise value charge uses the entire property of a company as collateral to secure credits, so one may think that a borrower can request loans up to the collateral value of a company's entire property (corporate value), calculated by combining the values of individual assets owned by the debtor and the profits expected to be earned in the future. However, what is aimed for in enterprise value charge is not provision of funds up to the full value of security interest, but provision of funds upon examination by financial institutions which is necessary and sufficient for the continuation of the business and its future growth.[14]

[14] Where loans pursuant to enterprise value charge is made, there could be cases where the loan value is smaller than the value of collateral (enterprise value). This may cause concerns that creation of security interest may result in over collateralization. Takashi Saito and Dai Mizui write in p.39 of "the use of enterprise value charge in venture debt" (*Ginko Homu 21 [Banking Law Journal 21]*, No. 920, 2024) that such concerns can arise in actual lending operations, and therefore it points out that financial institutions should clarify the issue and make the information available to relevant stakeholders such as venture companies. The authors have made a good point. We would like to stress that loans pursuant to enterprise value charge is aimed at providing funds necessary for realizing borrowers' business plans, and it does not necessarily mean that the amount of loans is determined based on the value of collateral. Borrowers can request additional funds or have existing loans refinanced where necessary (see "3.3 Refinancing and additional loans").

From this perspective, it would be appropriate to assume that while lending pursuant to enterprise value charge is similar to unsecured financing provided upon sufficient examination and assessment of the borrower's business plans, it has priority over other financial claims. In making such a loan, valuation of collateral underlying enterprise value charge is not necessarily required, and so it is expected to be different from conventional loans made against the value of individual assets such as real estate.[15,16]

In any case, financial institutions' ability to assess conditions and the outlook for firms' businesses is the key point. If financial institutions have been advancing initiatives related to promoting "lendings based on customers' business potentials" according to the Financial Services Agency's Financial Monitoring Policy for 2014, we think that the foundation for appropriate use of enterprise value charge has been laid.

We assume that the benefits of evaluating the collateral value (corporate value) of enterprise value charge would arise, and the situation that requires an evaluation arises when business transfer becomes likely, such as at times of foreclosure of the security interest. It may not be easy for branches of financial institutions to evaluate enterprise value, but it is not a completely new field. Methods for evaluating corporate value have been established to some extent through dealings in merger and acquisition activity and investment business. In fact, a certain number of financial institutions have established a section dedicated to handling mergers and acquisitions in order to support business succession and other customer needs. In addition, with the deregulation of the scope of banking business and investment regulations by the amendment to the Banking Act in 2021, a number of banks have established subsidiaries specializing in investment, and have increased the number of secondments to other companies and recruitment to develop employees' skills to carry out investment operations.

As we have seen, banks have been making efforts to promote lending based on evaluation of customers' businesses for many years, so looking at individual banks, within the institution or the entire banking group, personnel that have knowledge and expertise on business evaluation have accumulated. Banks are expected to engage in financing using enterprise value charge through exchanging personnel between departments and affiliated companies.

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Further, the difference between the loan amount and the collateral value can also arise in the case of loans against individual assets, and thus this point is not specific to loans pursuant to enterprise value charge (see also Sato, Masanori. "the benefits and limits of the floating charge and inclusive collateral [part 2]." 2022. *Kinyu Homu Jijou.* No. 2179. p.28). Therefore, we consider concerns about over collateralization not relevant here.

[15] In fact, for example, in the documents provided by the secretariat of the Financial System Council's "working group on a desirable framework for supporting financing practices focusing on companies' businesses" at the first meeting, an image of actual loan practice is provided on page 8, and it says that financial institutions "make loan decisions based on the cash flow of the business," not calculate the collateral value.

Regarding the eligibility of collateral for financial institutions, Toshiaki Nakahara gives the following points in his paper: (i) the collateral can be evaluated objectively; (ii) its value is stable; (iii) the collateral is easy to manage after it is obtained; and (iv) the collateral is easy to dispose of. See "Collateral eligibility from a perspective of financial institutions" included in Tokyo Bar Association, Bankruptcy Division, ed., "Collateral Law and Bankruptcy/Finance Practices and Theory: Issues in Examining Collateral Law," *Supplement Issue of NBL,* No.178, (2021), pp. 56-57. These requirements are relatively easy to meet when real estate is used as collateral, but in the case of enterprise value charge it would be difficult to satisfy because it is not easy to calculate the value of the collateral. However, this does not mean that enterprise value charge is not eligible as collateral. Rather, as pointed out in the text, the role expected of collateral in financing against enterprise value charge is different.

[16] Even in the United States, it is difficult to regard this type of security interests created against the entire property of a business as general collateral when calculating the loan loss reserves for accounting purposes (see page 10 of the materials provided by the secretariat for the first meeting of the Financial Services Agency's study group on financing and rehabilitation practices to support businesses).

### 3.2.2 Monitoring during loan terms

Monitoring of firms' financial conditions is an important operation for financial institutions, and its importance is greater for loans pursuant to enterprise value charge. In the United States, lending against firms' entire asset (enterprise value) is already implemented and lending practice for cash flow-based loans has developed. Such U.S. lending systems and practices will have important implications for the use of enterprise value charge in Japan.

According to a report by the study group on lending practice and business recovery practice for debts against firms' all assets (Japan Institute of Business Law, March 2023), which summarizes the U.S. and U.K. lending systems and practices for loans against the enterprise value and proposes desirable lending practices for Japan when the new collateral system is introduced, notes the importance of financial covenants in cash flow-based lending. The report summarizes the role of loan covenants in the United States as below:

- Financial covenants are also common in SME transactions.
- The purpose of financial covenants is to detect and address financial problems of businesses at an early stage, and they play an important role in communication between financial institutions and businesses.
- In the monitoring of firms' financial conditions, key indicators are firms' financial data and their compliance with financial covenants.
- The number of financial covenants and the frequency of reviews vary depending on the size of the business and the contracts. In the case of SMEs, the number of covenants is only a few and the frequency of reviews is generally once a quarter or a year.
- A breach of financial covenants can be taken as an opportunity for dialogue between financial institutions and businesses. A covenant breach does not mean that the borrower immediately forfeits the benefit of time, and the security interest be foreclosed. Businesses are given time to restore the situation that leads to the loss of benefit of time.

Financial covenants are less common in Japan, particularly in dealings with SMEs. Some financial institutions gave increased monitoring costs as a reason for not establishing financial covenants. However, monitoring of financial conditions is also conducted for general loans, and thus creation of financial covenants does not mean that monitoring costs would increase significantly.

By sharing specific figures in the financial covenants between financial institutions and businesses, this would facilitate communication between them and increase the effectiveness of monitoring. As such, enterprise value charge and financial covenants are both important tools that contribute to banks' "partnered support" of business. Especially when enterprise value charge is used, better lending practices can be developed with the use of financial covenants.

## 3.3 Refinancing and Additional Financing

It is difficult to assess the value of a business or the future prospects of a business by one measure decidedly. Even after thorough discussion between businesses and financial institutions, there may be cases where their views do not converge on the necessity or the amount of additional financing. In such cases, businesses may look for a different financial institution that would agree to their views about future business prospects, and obtain additional loans from that institution, or refinance the existing loans.

From the perspective of businesses on financing, it is important to develop a legal

environment that facilitates businesses to obtain additional financing and refinancing.[17] To this end, the Act on the Promotion of Cash Flow-based Lending explicitly provides for the following points to ensure such an environment: debtors' request to set a maximum value of loans (Article 9, paragraph 2); public notification of security interests by commercial registry (Article 15); allowance for setting a junior security interest in enterprise value charge (Article 16, Article 22, Article 27 paragraph 2, etc.); and borrowers' request to fix the value of loan principal (Article 28, paragraph 1).

In the case of refinancing, after the loan principal is fixed, the existing debt to the financial institution (specified secured claims) will be repaid in full and the enterprise value charge will be extinguished (Article 30 of the Act). Therefore, even if collateral for security interests (security interests in individual assets or enterprise value charge) is provided to the new financial institution, no complexity would arise. It should be noted that, at this point, foreclosure has not taken place, and since the debtors are a going concern, the provisions about the retained value of unspecified secured claims do not apply. On the other hand, when a business obtains additional financing from a new financial institution, if the financial institution requests creation of an enterprise value charge or a security interest in individual assets, there may be conflicts of interest with the existing enterprise value charge. In practice, creditors' interests would likely be adjusted through dialogue and agreed. However, establishing a security interest in the additional loan without obtaining the consent of the holder of the enterprise value charge may be controversial in relation to the debtor's right of disposal.[18] We believe that this is acceptable from the viewpoint of ensuring diversity of financing by businesses.[19]

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[17] See remarks by Inoue in page 44 of an article on a panel discussion participated by Ohkita et al. (see footnote 11), which points out that this point is also important so as not to create the so-called "lender liability" problem.

[18] First of all, the debtor has the right to dispose of the collateral property in principle, even if an enterprise value charge is being created. However, when disposal of assets beyond the scope of normal business activities is made, the debtor shall obtain the consent of the enterprise value charge holder, and disposal conducted without such consent is invalid in principle (Article 20 of the Act).

Article 20, paragraph 2 (i) of the Act lists acts of disposal that are beyond the scope of ordinary business activities, and one of it is "disposal of important assets." The same phrase is also used in Article 362, paragraph 4 (i) of the Companies Act, where the creation of a security interest is interpreted as "disposal of important assets" provided for in the article. Assuming that Article 20, paragraph 2 (i) of the Act is to be interpreted in the same way, a debtor would not be able to provide collateral to a new financial institution without the consent of the enterprise value charge holder. How should we consider this point.

The purpose of requiring consent of the enterprise value charge holder for the "disposal of important assets" in this Act is to prevent damage to the value of the collateral as a result of losing important assets. On the other hand, the reason why "disposal of important assets" is made a matter to be decided exclusively by the board of directors under the Companies Act is to demand cautious decisions on important management issues and to prevent arbitrary actions by representative directors (see Ochiai, Seiichi, eds., *Eighth Volume of Commentary on the Companies Act: Institutions (2),* Shoji Homu, 2009, p. 222 [Seiichi Ochiai]). As such, although this Act and the Companies Act use the same phrase "disposal of important assets," the element and the objective of the provisions differ. Article 20, paragraph 2 (i) of the Act should be interpreted only from the viewpoint of whether or not the collateral value would be damaged.

[19] Based on the understanding of the previous footnote, we first examine a case where an enterprise value charge that is junior in priority is established. The possibility that a junior enterprise value charge may hinder a non-mandatory business transfer cannot be denied, but it cannot be judged that the existing enterprise value charge is damaged by the establishment of a junior status enterprise value charge, in light of the facts that the senior enterprise value charge precedes over the junior enterprise value charge in foreclosure, and that the junior enterprise value charge holder cannot file a petition for commencement of the foreclosure procedure (Article 83, paragraph 2 of the Act). Therefore, it is possible to interpret that the establishment of an enterprise value charge with junior status does not mean "disposal of important assets" (Article 20, paragraph 2 (i) of the Act).

Next, we consider a case when a security interest is established in individual assets. The reason why enterprise value charge that is senior in priority precedes over a security interest set later in individual assets (the rights are perfected) is the same as the case where an enterprise value charge that is junior in priority is set. However, a security interest in individual assets, which subordinates to an enterprise value charge, can be foreclosed unlike a subordinated enterprise value charge. In addition, in foreclosure procedure of a security interest in individual assets, enterprise value charge

### 3.4 Treatment of Creditors in Non-mandatory Business Transfer

When a borrower transfers its business, first of all, labor receivables and receivables of business counterparts are basically paid to the relevant persons or succeeded to the transferee (see section 2.3.1 "Phase before foreclosure of enterprise value charge" for the process up to a non-mandatory transfer of business). After that, the borrower pays a certain amount of consideration to the specified secured creditor after the procedure to fix the loan principal of the specified secured claims (Article 28 of the Act and other provisions). If the entire value of the specified secured claim is paid, the enterprise value charge is extinguished (Article 30 of the Act). However, if this is not the case (and we will discuss such a case from here), enterprise value charge is often extinguished by debt waiver or debt relief when specified secured creditors waiver the remaining value of their claims.

Since the security interest is extinguished outside foreclosure processing, the provisions regarding retained fund for unspecified secured claims and its distribution do not apply here. That is, as we looked in section 2.3.2 "Priority given to labor claims and trade receivables in foreclosure of security interests and retained value for unspecified secured claims," in the foreclosure processing, the amount allocated for specified secured claims to be distributed to security interest holders of enterprise value charge is limited to the amount remaining after deducting the retained value for unspecified secured claims (Article 166, paragraph 2 and Article 8, paragraph 2 (i)(c) of the Act); Unspecified secured claims are identified and the details determined in liquidation or bankruptcy proceedings, and distribution is made to unspecified secured creditors from the above retained value in these

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holders are not entitled to distribution. An objection to foreclosure may be made by an enterprise charge holder if that would impede continuation of the debtor's business, (Article 19, paragraph 1 of the Act), but the holder shall bear the procedural costs to do so. If foreclosure of a security interest in individual assets would not impede the continuation of the debtor's business, the enterprise charge holders shall not make an objection. Given that an enterprise value charge recognizes the value of the business (the higher of the business value or the liquidation value), if the business value exceeds the liquidation value, the collateral value of the enterprise value charge is not undermined, but when the business value falls below the liquidation value, the collateral value of the enterprise value charge is undermined. Taking these into consideration, it seems reasonable to construe that, unlike the establishment of an enterprise value charge junior in priority, the establishment of a security interest in individual assets falls under the "disposition of important assets" (Article 20, paragraph 2 (i) of the Act). However, enterprise value charge holders are in a position to bear similar disadvantages as above, in the least, as a result of compulsory execution by general creditors. Given that the disadvantages caused by establishment of a security interest in individual assets do not exceed those as a result of compulsory execution by general creditors, we consider that enterprise value charge holders should also accept establishment of a security interest in individual assets. If that is the case, it is possible to interpret that the establishment of a security interest in individual assets does not mean "disposition of important assets" (Article 20, paragraph 2 (i) of the Act).

Assuming that creation of a security interest that is junior in priority does not mean "disposition of an important assets," it is possible that a senior enterprise value charge holder specifies establishment of a security interest that is junior in priority as an event that requires advance notice or an event that results in acceleration (forfeiture of the benefit of time). Provisions explicitly indicating such causes may be included in a contract for a syndicated loan (see also Article 21, paragraph 2 of the model contract on commitment line (JSLA2019 version) published by the Japan Syndication and Loan-trading Association). In addition, to prevent an emergence of a subordinated individual security interest holder, creditors may establish a security interest in individual assets as necessary; which is pointed out as one way of preventing. It is understood that "foreclosure" of a security interest is prohibited (Article 11 of the Act), but "establishment" is not prohibited. See Koyasu, op. cit. p.24 (footnote 11), Sato, Yamamoto, op. cit. p.26 (footnote 11), and Taguchi, Yuki, and Miyazawa Tetsu: "Feasibility of enterprise value charge in LBO finance," p. 25, *Ginko Homu 21 (Banking Law Journal 21)*, No. 920, 2024, p. 31. This approach would not prevent creation of a junior security right per se, but it would prevent foreclosure of a security interest that is junior in priority through "no-surplus cancellation." However, in cases where the exercise of an individual security interest would impede the debtor's continuation of business, the enterprise value charge holder may make an objection (Article 19, paragraph 1 of the Act), and therefore, the necessity of establishing an individual security interest should be examined in light of such viewpoints (Saito, Mizui, op. cit. p.42. (see footnote 11) points out that establishment of an individual security interest should be carefully determined depending on the situation).

proceedings (Article 62, paragraphs 1 and 2, and Article 6, paragraph 2 of the Act). As such, provisions regarding distribution stipulate that distribution for unspecified secured claims are to be made in liquidation or bankruptcy proceeding after the foreclosure of the enterprise value charge. Therefore, based on such flow of process, if a non-mandatory business transfer takes place, and the corresponding payment for the business transfer is made to specified secured creditors outside the foreclosure process, and subsequently the enterprise value charge is extinguished, these provisions would not apply, and so it may not be necessary to have retained value for unspecified secured claims. However, unlike cases of "refinancing" described above, if a borrower does not plan to continue its business after business transfer, we need to be careful about how to treat retained value for unspecified secured claims, which we will discuss below.

First, since business transfer by the borrower is an act of disposition "beyond the scope of ordinary business activities," it needs to have the consent of the enterprise value charge holder in order to make the transfer effective (Article 20, paragraph 2 (ii) of the Act). If an enterprise value charge holder gives consent to business transfer and the borrower transfers its business, repayment to specified secured creditors are made and subsequently the enterprise value charge is extinguished; essentially this has the same effect as foreclosure of enterprise value charge. Therefore, it is considered that the right of specified secured creditors to receive preferential payment is limited, especially in cases like this, to the amount remaining after the retained value for unspecified secured claim is deducted (see Article 166 paragraph 2 and Article 8, paragraph 2(i)(c) of the Act).[20]

Further, in a case where the debtor's all assets (those with positive value) are realized, through for example a business transfer, and a certain amount is paid to specified secured creditors with senior priority from that money, bankruptcy proceedings should be commenced upon filing of a petition by the debtor, in the same way as bankruptcy proceedings are commenced at some point after foreclosure processing of enterprise value charge is commenced (see Article 196 of the Act). In such a case, foreclosure processing has not taken place formally, but the situation can be regarded the same as, substantially, when bankruptcy proceedings began after foreclosure processing. Therefore, if some amounts of the retained value for unspecified secured credits remain as the debtor's assets, distribution of that amount could have been possible to the bankruptcy creditor in bankruptcy proceedings (Article 62, paragraphs 1 and 2, and Article 6, paragraph 2 of the Act); Yet, if that remaining fund is paid out even to specified secured creditors, and so distribution of funds is no longer possible to unspecified secured creditors, such repayment would be considered as partiality (or favored treatment) and shall be subject to powers of avoidance.

As we have seen above, in a case where specified secured creditors receive voluntary payment from the debtor after a non-mandatory business transfer and the debtor subsequently goes bankrupt, considerations should be made to keep aside funds equivalent to the retained value for unspecified secured creditors at the debtor and that the specified secured creditors do not receive the retained value. It would be desirable, at least, to have in place practices that expenses necessary for filing a petition for commencement of bankruptcy proceedings or liquidation proceedings are retained by the debtor. In addition, considering the risk that the debtor might conceal and/or use the retained funds, it may be one idea for the holder of enterprise value charge to manage the amount of funds equivalent to the retained value for unspecified secured claims until the commencement of bankruptcy

[20] See Mizutani, Tomio. et al. "The Act on the Promotion of Cash Flow-based Lending: Focusing on rules on enterprise value charge and related trust operations," *Shintaku*, No. 300, 2024, p. 47. In addition, it is pointed out that until a decision to commence liquidation proceedings or bankruptcy proceedings is made, "beneficial interest in unspecified secured claims is borne, but it is in a floating state with no attributable party (unspecified secured creditors who are beneficiaries are not specified or do not exist)" (Mizutani et al., ibid. p.8; footnote 2).

proceedings. However, the obligation to manage the amount equivalent to the retained value for unspecified secured claims by the enterprise value charge holder arises only when foreclosure processing is taken place formally (see Article 8, paragraph 2(i)(c) of the Act). If such obligation is imposed on an enterprise value charge holder after non-mandatory business transfer, it may impose an administrative burden beyond what is legally prescribed. Therefore, it would be appropriate for the debtor to manage the retained value for unspecified secured claims.

# 4. Relationship between Foreclosure Proceedings and Three Types of Bankruptcy Proceedings

## 4.1 Relationship between Foreclosure Proceedings and Bankruptcy Proceedings

### 4.1.1 Cases where a foreclosure proceeding commences first

As we have noted repeatedly, the bankruptcy proceedings that this Act typically envisages are those that commence after foreclosure processing. In foreclosure processing, specified secured creditors are repaid through the enterprise value charge holder, and following the completion of foreclosure, bankruptcy proceedings are commenced and repayment to unspecified secured creditors are made.

Bankruptcy proceedings could commence while foreclosure is being carried out (Article 196 of the Act).[21] However, an enterprise value charge is regarded as a mortgage under the bankruptcy law (Article 227 of the Act), and is treated as a "right of separate satisfaction." Therefore, the foreclosure of security interests basically has priority (see articles 195 to 207 of the Act as special provisions governing such a situation).

### 4.1.2 Cases where a bankruptcy proceeding commences first

There are, of course, cases where debtors file for bankruptcy before foreclosure. Such a case would be, for example, when debtor's business value has been damaged already and so the security interest holder has lost its incentive considerably to file a petition for foreclosure, or the case where, while the debtor wishes to close the business at an early stage, the security interest holder hesitates to exercise the security interest in a timely and appropriate manner and so business value has declined as it was carried on. Before reaching such a phase, the feasibility of a business transfer is normally considered. When bankruptcy proceedings commenced nevertheless, usually the assets of the debtor are disposed of and the business liquidated. (see 2.3.1 "Phase before foreclosure of enterprise value charge"). However, if the bankruptcy trustee determines that there remains a possibility of a business transfer that would contribute to improving the bankruptcy estate, there may be another attempt to seek the transfer of business. In such a case, the court's permission is only needed (Article 78, paragraph 2 (iii) of the Bankruptcy Act), and the consent of the enterprise value charge holder is deemed unnecessary.[22]

### 4.1.3 Agreement on the right of separate satisfaction and unspecified secured claims in bankruptcy proceedings

Money obtained by the bankruptcy trustee through procedures for realizing debtor's assets as described above are, used for payment to the specified secured creditors first, after concluding an

[21] For interpretation issues pointed out regarding Article 196, see comments by Yusuke Shimizu and Inoue on p.51 of the article by Ohkita et al. (footnote 11).

[22] Regarding this point, see Yamamoto, Kazuhiko, "Overview of a New Collateral Scheme: Relationship with Insolvency Proceedings," *NBL,* No.1277, 2024, p.26.

agreement on right of separate satisfaction with the enterprise value charge holder.[23]

Next, with regard to payment to unspecified secured creditors, since foreclosure procedure of enterprise value charge has not been conducted, there are no legal provisions governing such a case, and thus questions may arise about the necessity of making payment (i.e., payment may not be needed). However, as discussed in "3.4 Treatment of general creditors in non-mandatory business transfer," the amount equivalent to the retained value for unspecified secured claims should be set aside considering the objective of this Act. From such a standpoint, it is deemed that foreclosure of the enterprise value charge has taken place in effect when the consent of the enterprise value charge holder to the extinguishment of the security interest is obtained in concluding the agreement on separate satisfaction right mentioned above. Based on this understanding, a retained value for unspecified secured creditors shall be set aside (see Article 8, paragraph 2(i)(c) of the Act), and specified secured creditors are repaid up to the amount remaining after deducting the retained value (see Article 166, paragraphs 1 and 2 of the Act). Since bankruptcy proceedings have already commenced, the payment need not be made to the enterprise value charge holder (see Article 166, paragraph 3 of the Act). Instead, it will be managed by the bankruptcy trustee (see Article 62 paragraph 1(iv) of the Act), and distribution will be made after investigation and confirmation of claims regarding specified secured creditors.

## 4.2 Relationship between Foreclosure Proceedings and Rehabilitation Proceedings

### 4.2.1 Where a foreclosure proceeding commences first: the significance of the rehabilitation proceeding as a countermeasure to foreclosure

The enterprise value charge holder would file a petition for a foreclosure proceeding when he thinks the transfer of business to a third party would be an appropriate way to realize the collateral property of its security interest, but the debtor does not cooperate. In such a case, if the debtor considers it would be most appropriate to restructure on its own, the debtor will propose its own reconstruction plan to the trustee who is appointed by the court in foreclosure proceeding, and the trustee will fairly compare the proposed plan with other options and make decision on how to proceed. This would be sufficient on the side of the trustee; that is, this would not be construed as undermining the protection of the debtor. Therefore, the debtor would not need to file a petition for rehabilitation proceedings in this case.

However, if the debtor wishes to be involved more, such as taking initiative in selecting sponsors, the debtor would need to consider countermeasures against foreclosure of the security interest. As countermeasures, the Act allows the following action according to Article 212, paragraph 2: refinancing by a new sponsor, which in fact means, repayment of specified secured claims in full and withdrawal of the foreclosure proceeding by the enterprise value charge holder (Article 86 of the Act); a judicial order to stay foreclosure proceding in civil rehabilitation proceedings (Article 31 of the Civil Rehabilitation Act), and a petition for permission to extinguish the security interest in civil rehabilitation proceedings and the corresponding judicial permission (Article 148 of the Civil

[23] It is unlikely for the enterprise value charge holder to not accept conclusion of agreement on the right of separate satisfaction, but if the holder is reluctant, the bankruptcy trustee will aim to conclude the agreement using provisions in Article 206, paragraphs 1 and 2 of the Act for negotiations. The article stipulates that, since foreclosure of enterprise value charge would have a significant impact on the bankruptcy proceedings, the court may specify, upon petition by the bankruptcy trustee, a period during which the enterprise value charge holder shall foreclose the enterprise value charge. The article also stipulates that foreclosure cannot be made if the enterprise value charge holder does not exercise the security interests within the specified period. There would not be much meaning to carry out foreclosure procedure of enterprise value charge at this phase (it is reasonable to leave the proceeding to the bankruptcy trustee), so in most cases, agreements on the right of separate satisfaction are concluded.

Rehabilitation Act). So, we examine whether these procedures do function as measures against foreclosure proceeding.

To start, the assumptions are that an enterprise value charge is deemed to be a mortgage in rehabilitation proceedings (Article 228 of the Act), and thus its rights can be exercised as separate satisfaction and the foreclosure proceeding will continue, even if rehabilitation proceedings have commenced. In addition, when decision to commence foreclosure of security interests is made, the rehabilitation proceedings are suspended until the foreclosure proceeding is completed or terminated (Article 212, paragraph 1 of the Act). Under such circumstances, orders to stay foreclosure and petition for extinguishment of security interests described above are permitted as countermeasures to foreclosure proceedings as an exception.[24]

For the debtor to counter foreclosure of security interests, the debtor will aim at concluding an agreement on the rights of separate satisfaction after the commencement of rehabilitation proceedings. The enterprise value charge holder may agree to conclude separate satisfaction agreement, if the holder considers that the rehabilitation plan prepared by the debtor is more likely to succeed, or if the enterprise value charge holder determines that an adequate amount of funds would be collected through separate satisfaction. However, in general, it is presumed that, prior to the commencement of foreclosure procedure of security interests, consultations have been made to decide either to choose a rehabilitation plan proposed by the debtor or to leave it to the trustee's decision upon foreclosure (section 2.3.1 "Procedures up to foreclosure of enterprise value charge"). Despite such a process, when enterprise value charge holders file for commencement of foreclosure proceedings, many such cases imply that holders had rejected the debtors' proposals. Therefore, in practice, when a debtor files a request for rehabilitation proceedings after the commencement of foreclosure of security interests, the court hears from the enterprise value charge holder, and when the holder is unlikely to conclude agreement on separate satisfaction or give permission to the extinguishment of the security interests, it would be desirable for the court to dismiss the petition for commencement of rehabilitation proceedings on the grounds that the situation corresponds to "if it is obvious that a proposed rehabilitation plan is unlikely to be prepared or approved or a rehabilitation plan is unlikely to be confirmed" (Article 25 (iii) of the Civil Rehabilitation Act).

If rehabilitation proceedings have commenced, an order to stay foreclosure must be issued first to counter foreclosure of enterprise value charge. To do so, the fulfillment of the requirement "the stay conforms to the common interest of creditors in rehabilitation proceedings and is not likely to cause undue damage to the auction applicant" is necessary, but meeting this requirement is difficult in general. Furthermore, if an agreement on separate satisfaction right is not concluded, the debtor would need to consider filing a petition to the court for extinguishment of the security interest (provided that the value of the specified secured claims is higher than the collateral value). For the extinguishment of security interests, money equivalent to the value of the collateral property must be paid in a lump sum. Enterprise value charge has a collateral value equal to the higher of the corporate value or liquidation value, which is expected to be a considerably large value. Therefore, it is understood that debtors often find it difficult to make a lump sum payment, and cases where petition for extinguishment of security interests are used are fairly limited.[25]

As we have examined, we can say that the rehabilitation proceeding functions little as a means to counter foreclosure procedure. Therefore, in practice, debtors who would file for

[24] In addition, procedures concerning the commencement and termination of rehabilitation proceedings are provided as exceptions.
[25] Yamamoto, ibid. (footnote 22) p. 25 also points this out.

commencement of rehabilitation proceedings to counter foreclosure of security interests would likely to be limited.

### 4.2.2 Where a rehabilitation proceeding commences first

In some cases, debtors may file for rehabilitation proceedings in advance.[26] Even in such a case, if the right of enterprise value charge is later exercised, the rehabilitation proceedings shall be suspended and it would be difficult to rehabilitate the business through the rehabilitation proceedings, as explained above. Therefore, in order to avoid the foreclosure of the enterprise value charge, the debtor would aim for payment of the entire amount of the specified secured claims and the conclusion of a right of separate satisfaction agreement. If the agreement cannot be concluded, the debtor would consider filing a petition for extinguishment of the security interest.

However, regarding the conclusion of an agreement on separate satisfaction right or filing of a petition for the extinguishment of a security interest, the same problem arises as in the case where foreclosure proceedings of a security interest precedes, and rehabilitation proceedings may not proceed depending on the intent of the enterprise value charge holder. Specifically, if an enterprise value charge holder chooses to exercise its security interest, the rehabilitation proceedings that have already been carried out may become meaningless, and merely impose unnecessary procedural burden. Therefore, the intent of the corporate value security interest holder is important.[27] Consequently, if the enterprise value charge holder is unlikely to conclude a separate satisfaction right agreement or permit extinguishment of security interests, rehabilitation proceedings would not need to be commenced in the first place.

In practice, therefore, the court would hear from the enterprise value charge holder when a petition to commence rehabilitation proceedings is filed by the debtor. An enterprise value charge holder would respond upon considering various factors including benefits of commencing rehabilitation proceedings, the extent of damage to the business value caused by the commencement of rehabilitation, and advantages and disadvantages of having the rehabilitation debtor take the initiative in considering a reconstruction method. Benefits of rehabilitation proceedings for an enterprise value charge holder would include: (i) the holder would not need to take action itself or make prepayment of expenses, unlike in foreclosure procedures; (ii) when rehabilitation proceedings begin, provisions restricting “set-offs of claims” are applied and “right of avoidance” would be admitted; and (iii) rescheduling of debts become possible with other financial creditors and this would contribute to the rehabilitation of debtor’s business. As for advantages and disadvantages of taking the initiative in reconstruction, an enterprise value charge holder may consider waiting and seeing the commencement of rehabilitation proceedings when the agent of the rehabilitation debtor is deemed a reliable bankruptcy attorney,[28] or it may respond to accept the commencement of rehabilitation proceedings if the debtor does not continue its business operations and a trustee is appointed by the

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[26] Debtors can reschedule their debts by devising a rehabilitation plan and presenting it to specified secured creditors without commencing rehabilitation proceedings. Here, a case in which there is a rationale to commence rehabilitation proceedings and aim for conclusion of an agreement on separate satisfaction would be when there are multiple financial creditors besides specified secured creditors. However, such a case would be limited because the scheme assumes the main bank to provide cash flow-based lending when an enterprise value charge is established.

[27] Legally, rehabilitation proceedings are carried out until foreclosure of enterprise value charge, so depending on the timing of the foreclosure, some actions are expected to be taken such as public notices of commencement of rehabilitation proceedings, notification to known rehabilitation creditors (Article 35, paragraphs 1 and 3 of the Civil Rehabilitation Act), supervision orders (Article 54, paragraph 1 of the Civil Rehabilitation Act) and administration orders (Article 64, paragraph 1 of the Civil Rehabilitation Act), and related duties performed by supervisors and a trustees.

[28] See remarks by Shimizu in p.51 of Ohkita et al. ibid. (footnote 11).

court to take over the business. Depending on the response of the enterprise value charge holder, there may be cases where the petition for commencement of rehabilitation proceedings is dismissed on the grounds that "it is obvious that a proposed rehabilitation plan is unlikely to be prepared or approved or a rehabilitation plan is unlikely to be confirmed" (Article 25 (iii) of the Civil Rehabilitation Act).

When rehabilitation proceedings are commenced after these procedures were followed, and the proceedings are carried out appropriately, then an agreement on separate satisfaction right would be concluded between the rehabilitation debtor and the enterprise value charge holder.[29]

### 4.2.3 Agreements on the right of separate satisfaction and unspecified secured claims in rehabilitation proceedings

As we have seen, in general term, there can be cases where agreements on the right of separate satisfaction is concluded in rehabilitation proceedings. If an agreement on separate satisfaction right is concluded, typically a certain amount of the specified secured claims would be repaid to the enterprise value charge holder in installments.

Even in such a case, the same problems may arise as in "3.4 Treatment of creditors in non-mandatory business transfer" and "4.1.3 Agreement on the right of separate satisfaction and unspecified secured claims in bankruptcy proceedings." That is, since unspecified secured claims are determined and distributions are made in liquidation proceedings or bankruptcy proceedings after the foreclosure of security interests, in a case where only rehabilitation proceedings had taken place, the presence and details of unspecified secured claims cannot be determined, according to the legal provisions. Therefore, whether the retained value for unspecified secured claims is needed or not becomes an issue, and as we have seen before, we should consider it from the objective of the Act, and so it would be natural to conclude that the amount equivalent to the retained value for unspecified secured claims is necessary.

First of all, unspecified secured claims are considered to be claims equivalent to rehabilitation claims, and such rehabilitation claims are determined in the rehabilitation proceedings and repaid based on a rehabilitation (substantially liquidation) plan. (If taking votes on the rehabilitation plan is deemed complicated, "consequential bankruptcy (i.e., bankruptcy by order of the court upon closing rehabilitation proceedings)" can be one option to consider.) And in the rehabilitation proceedings, it is necessary to observe the "principle of guarantee of liquidation value," which is a principle that a value to be distributed in rehabilitation proceedings shall not be smaller than an estimated distribution value in a case of bankruptcy. Therefore, if a proposed rehabilitation plan is a plan that does not make payment of an amount equivalent to the retained value for unspecified secured claims to rehabilitation creditors, the rehabilitation plan may be rejected, or even if the plan is approved, if there is opposition from rehabilitation creditors whose liquidation value is not guaranteed, the rehabilitation plan may not be approved because it does not satisfy the requirements set forth in "if the resolution on the rehabilitation plan is contrary to the common interests of creditors in rehabilitation proceedings" (Article 174, paragraph 2 (iv) of the Civil Rehabilitation Act).

Based on the above considerations, in the conclusion of agreement on separate satisfaction right, the amount equivalent to the retained value for unspecified secured claims (calculated based on the total repayment value for specified secured creditors according to the agreement on separate satisfaction right) should not be distributed to specified secured creditors with priority and the

[29] Taro Awataguchi also notes the same point in his paper, "Precautionary management and attentive support and business management and business revitalization based on enterprise value charge," *Ginko Homu 21 (Banking Law Journal 21)*, No. 916, 2024, p. 28.

enterprise value charge holder should agree to this arrangement.

## 4.3 Relationship between Foreclosure Proceedings and Corporate Reorganization Proceedings

### 4.3.1 Where a foreclosure proceeding commences first (the significance of the corporate reorganization proceeding as a countermeasure to foreclosure)

Since enterprise value charge is regarded as a mortgage in corporate reorganization proceedings as in rehabilitation proceedings, a specified secured creditor of the enterprise value charge is treated as a secured reorganization creditor (Article 229, paragraphs 1 and 3 of the Act); to be precise, credits here means the amount remaining after deducting the amount equivalent to the retained value for unspecified secured claims from the market value of the collateral property for the enterprise value charge at the time of commencement of reorganization proceedings. Given that a foreclosure proceeding is suspended upon commencement of reorganization proceedings, reorganization proceedings seem to function as a counter measure to foreclosure, unlike in a rehabilitation proceeding.[30] When reorganization proceedings commences, if a reorganization trustee devises a reasonable reorganization plan or makes a business transfer, this would create the same situation as when a trustee commences a foreclosure proceeding and carries out business transfer. In addition, the commencement of reorganization proceedings may provide benefits such as "prohibition of a set-off" and "exercise of right of avoidance." If so, it may not be so rationale for the enterprise value charge holder to place priority on the foreclosure of security interests and not agree to the commencement of reorganization proceedings. However, given that there are various procedures during the process between the commencement of reorganization proceedings to the finalization of the reorganization plan−such as public notices of the commencement of reorganization proceedings, notification to known rehabilitation creditors, investigation and finalization of reorganization claims by trustees, management of the assets of the reorganization company, and execution of business−considerable expenses could be incurred in addition to the expenses already paid in the foreclosure procedures. The enterprise value charge holder could oppose to the commencement of reorganization proceedings when foreclosure procedure of the enterprise value charge has advanced considerably, and such additional expenditure is not rationale. In such cases, the situation could be regarded as relevant to a case for not commencing proceedings, which is "when the petition to commence reorganization is filed for an unjustifiable purpose or it is not filed in good faith" (Article 41, paragraph 1 (iv) of the Corporate Reorganization Act).[31]

It is understood that unspecified secured claims are treated not as secured reorganization claims but as reorganization claims in corporate reorganization proceedings (the opposite interpretation of Article 229, Paragraph 1 of the Act). In addition, the Act stipulates that an amount equivalent to the retained value for unspecified secured claims is to be set aside to secure necessary funds for repayment based on the reorganization plan (Paragraph 3 of Article 229). Therefore, distribution of funds to reorganization creditors (i.e., unspecified secured creditors) would be realized in the reorganization plan that is duly approved.

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[30] However, when a foreclosure proceeding has commenced beforehand, cases where a debtor (business operator) would file a petition for commencement of reorganization proceedings are limited because a change in business operator is assumed in principle in reorganization proceedings.

[31] This point is also noted by Ito, Makoto, "Four Committee Symposium: 'Bankruptcy and the New Collateral Law,' from confrontation to tense coexistence, focusing on enterprise value charge," *NBL.* No. 1279. See p. 54.

### 4.3.2 Where a reorganization proceeding commences first

Just as rehabilitation proceedings can precede foreclosure procedures, there are cases where reorganization proceedings precede foreclosure procedures. In such a case, the enterprise value charge holder cannot exercise the security interest, and so the process followed would be a different one from rehabilitation proceedings. In other words, specified and unspecified secured creditors receive distribution of funds in reorganization proceedings.

Does an enterprise value charge holder need to prevent commencement of reorganization proceedings? If reorganization proceedings commence and a reorganization trustee devises reasonable reorganization plans or consummates the transfer of business, the situation will be the same as when foreclosure of security interests is commenced and a trustee consummates the transfer of business. If so, it would not be reasonable at all to foreclose the enterprise value charge by making prepayment of expenses for the procedure, and express disagreement to the commencement of reorganization proceedings. Therefore, unless an enterprise value charge holder files an objection that says a bankruptcy proceeding is to be commenced rather than a reorganization proceeding, the reorganization proceedings would commence without delay.[32]

## 5. Conclusion

Over six months have passed (original report was published in January 2025) since the enactment of the Act on the Promotion of Cash Flow-based Lending, and many papers outlining the structure of the Act and discussing practical use of it have been published. We hope this report will also contribute to a better understanding of the Act, in terms of the purpose and elements of the law.

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[32] Awataguchi, ibid. (footnote 29) p.27 also points this out.

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