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OVERVIEW OF A JAPANESE OPERATING LEASE (WITH CALL OPTION) IN THE SHIPPING SECTOR

Demand for Japanese Operating Lease with Call Option or JOLCO as a source of financing in shipping has increased over recent years. In essence, JOLCO financings are similar to conventional sale and leaseback transactions but benefit from tax advantages that allow the shipowner to reduce its cost of financing due to the tax benefits achieved by the Japanese investors. The combination of this attractive overall cost of capital and the availability of 100% funding make it is easy to see why it is an appealing structure to shipowners. On the other hand, the intricacies of the structure will mean that it is not suitable for every transaction. As such having a working understanding of the JOLCO structure is important in order for shipowners to consider it and diversify their sources of capital.

JOLCOs have become very topical of late not only because of their growing popularity in the shipping sector but also because of recent changes to the Japanese special depreciation regime for newbuild vessels and Japanese earnings stripping rules. It is therefore a good time to understand the basics of the structure as well as the key considerations relating to it.

DISTINCTIVE FEATURES OF A JOLCO

While JOLCOs have the same core principles as conventional sale and leasebacks, they also incorporate additional features linked to Japanese tax requirements. In a conventional sale and leaseback, a shipowner sells a vessel to the lessor and simultaneously leases the vessel back from the lessor. The hire under the lease pays off the purchase price of the vessel over the tenor of the lease. The lessor will often fund a portion of the purchase price by obtaining its own financing, which is secured by a mortgage over the vessel and other customary forms of security for ship financings.

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While a typical JOLCO structure is similar to a conventional sale and leaseback, the following are a few of its key differences:

+ First, rather than selling the vessel to and leasing the vessel back from a single entity, a further party is involved, commonly referred to as the "Registered Owner", which will be incorporated in one of the jurisdictions familiar to shipping (in our experience, often the flag of convenience chosen by the original shipowner such as Marshall Islands, Liberia or Panama). This entity purchases the vessel from the shipowner and immediately sells beneficial title to the vessel to one or more Japanese SPVs on an instalment sale basis. The Japanese SPV then charters the vessel back to the shipowner's group. As such, the Registered Owner remains the legal and registered owner of the vessel for the tenor of the transaction, with the beneficial ownership sitting with the Japanese SPV, allowing the latter to claim the required tax benefits.

  This separation of legal title and beneficial ownership does not impact the shipowner and is essentially required to facilitate the vessel registration with a usual shipping flag state such as those mentioned above (which a Japanese company might not be able to do). For JOLCOs involving other asset classes, such as aircraft, this separation of legal title and beneficial ownership is generally not therefore required. If the shipowner requires another flag for chartering purposes then it is possible for the Registered Owner to suspend the primary flag and the shipowner to bareboat charter register the vessel under their preferred flag (provided dual registration is permitted in both the incoming and outgoing ship registries).

+ Secondly, a JOLCO will involve 100% financing for the vessel, paid by the Japanese SPV to the Registered Owner under an instalment sale agreement or a conditional sale agreement and by the Registered Owner to the shipowner under the purchase agreement.

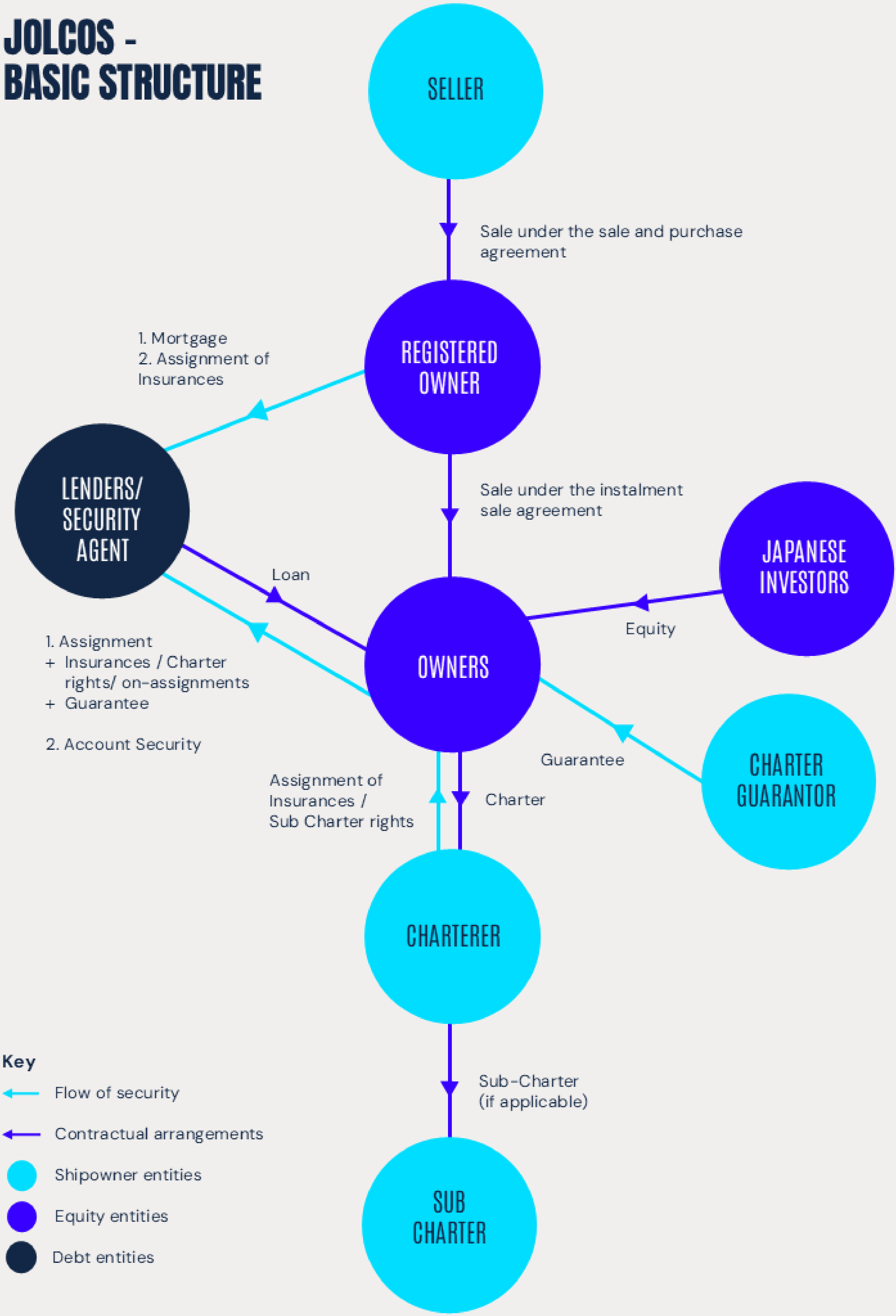
  This is funded through the combination of loan financing obtained by the Japanese SPV and an investment into the Japanese SPV made by Japanese investors. The investors, known as "tokumei kumiai-in", invest through tokumei kumiai or "TK" agreements into what resembles a limited partnership that is transparent for tax purposes, allowing those investors to share in the losses of the Japanese SPV. A conventional sale and leaseback would generally involve a lower financing ratio, with the balance funded by the shipowner often via an advance charterhire.

+ Like any other sale and leasebacks, the vessel will be bareboat chartered back to the shipowner's group simultaneously with the purchase by the Registered Owner and instalment sale to the Japanese SPV, allowing any pre-sale chartering and management arrangements to continue undisturbed. Under a JOLCO structure, the rentals over the term of the bareboat charter will not repay the full capital cost invested by the Japanese SPV so that the Japanese SPV retains a residual value risk in the vessel. The bareboat charter will, however, include one or more purchase options exercisable at predetermined dates which the shipowner group generally exercises to re-purchase the vessel by fully paying out the debt and equity investment.

+ Aside from the predetermined purchase option mentioned above, a JOLCO will generally not include any other voluntary termination rights.

These differences are a product of the Japanese investors' requirement to benefit from depreciation on the vessel which is key to the transaction structure. This aspect flows through into several other distinct features of JOLCO documentation, particularly in relation to the bareboat charter.

JOLCOS - BASIC STRUCTURE



EQUITY INVESTORS - KEY PLAYERS

The finance structure of a JOLCO usually consists of 70-75% debt and 25-30% "equity", where equity comprises the funds provided by the Japanese investors. An equity arranger will generally set up the Japanese SPV, create the equity structure and own these entities for the transaction's duration. The equity arranger will often also fund the initial equity investment before selling down to the Japanese investors.

The Japanese investors benefit from sharing the losses realised by the Japanese SPV due to the asset's depreciation and other deductible costs, such as interest payments on the loan. These create substantial tax losses which are shared with the equity investors and, indirectly, with the shipowner through a lower blended cost of funding.

A number of features linked to the transaction documentation are crucial in order to maintain this tax position for the Japanese investors. Most importantly the Japanese SPV needs to be seen as the economic owner of the vessel from a Japanese tax perspective. As stated above, the hire payments will not therefore fully pay out the equity element of the funding and, unless the purchase option is exercised (which is the expected outcome), the shipowner has the right to return the vessel at the end of the bareboat charter tenor such that the Japanese SPV becomes the charter free owner.

Typically, only the equity parties obtain Japanese tax advice as the Japanese tax risk sits with them. It is important nevertheless for the other parties to have a good understanding of this tax position and how it feeds into the documentation, in order to understand the relevant provisions and their scope for negotiation amongst the relevant parties. This is also important so that the other parties can ensure that the tax risk is appropriately allocated under the documentation.

KEY DOCUMENTS

Loan Agreement

The loan agreement will generally follow the usual LMA form with most of the commercial provisions being dealt with under the bareboat charter. The loan agreement is also limited recourse, meaning the obligations of the Japanese SPV are limited to the amounts they receive and rights they have under the bareboat charter and other transaction documents. Given their limited involvement after the transaction closes, and given that the shipowner will remain in possession and operational control of the vessel, the Japanese SPV and the equity generally will not take on any risk beyond its control.

One key difference versus a traditional vessel mortgage loan agreement is that there is no loan-to-value clause in the loan agreement or the charter, since the Japanese SPV is treated as the economic owner of the vessel.

The loan is amortised in full over the charter period with typical tenors ranging from 6 to 8 years. Repayment profiles are generally equal in amount (like an annuity) and must match the rates of hire under the charter. There is no option for a voluntary prepayment as the prepayment provisions align to those under the bareboat charter.

Charter

The charter is an operating lease in the sense that there is a genuine right to return the vessel at the end of the charter period. Therefore, the Japanese SPV takes the residual value risk in the vessel. It will, however, include one or more purchase or call options (as reflected in the name - being the "CO" part of the "JOLCO") in favour of the charterer which it is incentivised to exercise from an economic perspective and, as with any sale and leaseback, to allow the charterer to repurchase the vessel at the conclusion of the transaction. Irrespective of the exercise of the purchase option, the charter hire will be sufficient to repay the debt financing by the scheduled expiry of the charter.

The bareboat charter is generally the most negotiated document since (as noted above) it will include the majority of the commercial provisions and the operational and maintenance provisions for the vessel. Where applicable, these may be based on existing financing documents of the shipowner group, particularly with regard to financial covenants. Hire is differentiated under the charter to reflect the underlying obligations (debt or equity) to which it relates.

The charter includes various termination events (such as the charterer's default, total loss, a change in the Japanese tax law, etc.) which, if triggered, will give rise to a termination payment. Typically, the termination payment consists of either (i) the stipulated loss value, which is equal to the outstanding loan plus the equity invested and the return on the equity or (ii) the termination value which also fully covers the outstanding loan but involves a reduced equity payment. It is possible to have additional termination payment amounts, such as a mid-termination sum. The applicability of different termination payment amounts will be a question for negotiation among the parties but will relate to the underlying causation and the party to which such risk is allocated, or the party responsible.

SECURITY

The security structure is similar to that of a typical sale and leaseback transaction. The loan agreement is secured by, amongst other things, (i) a mortgage executed by the Registered Owner (a third-party mortgage), (ii) assignments of all insurances from all parties, (iii) assignment of the rights of the Japanese SPV under the charter and related security (as there is generally no direct security between the lenders and the charterer), (iv) account charges, and (v) quiet enjoyment and subordination letters. Due to the limited recourse nature, the equity arranger (which is the parent of the Japanese SPV and Registered Owner) does not provide any guarantees or security over shares but does provide comfort letters (in relation to the ownership and management of the Japanese SPV and Registered Owner) to the financing banks and the shipowner.

BENEFITS OF JOLCO TRANSACTIONS TO SHIPOWNERS

The economic benefits to a shipowner in using JOLCOs are clear. The combination of 100% financing with an attractive overall cost of capital is the principal reason for JOLCO's popularity across a variety of asset financing classes. The lack of a loan-to-value covenant may also be a benefit to the shipowner. However, as a result, the corporate credit of the shipowner group will be an important consideration for both the financing banks and the Japanese investors.

Using JOLCO transactions as part of a wider fleet financing strategy may also allow a shipping group to diversify financing structures, unlock additional sources of capital and to free up equity for other investments.

JOLCOS MAY NOT BE SUITABLE FOR EVERY VESSEL OR TRANSACTION

Given the particular structural requirements to access the requisite tax benefits, there are certain aspects of JOLCO documentation which are less flexible than some other financing structures. Generally, the lack of voluntary termination rights outside the predetermined purchase option(s) will be the main aspect that determines whether a JOLCO transaction works for a particular vessel and shipowner. In the aviation market, where asset values are less volatile and opportunistic sale and purchase is less common, this is less of an issue but will clearly be a point of consideration for shipowners who anticipate selling portions of their fleet as the market moves.

Certain vessels will also be unsuitable due to their type (and the appetite from Japanese investors for, for example, crude/product tankers and offshore vessels) or the underlying charter's tenor. Nor is a JOLCO a structure all lenders can offer, as it generally requires the debt financing to be booked in Japan and the lender to be licensed in Japan.

RECENT LEGAL DEVELOPMENTS

There exists a tax regime in Japan by which special depreciation could be claimed on newbuild vessels. The ability to combine this special depreciation on newbuild vessels with the regular depreciation to generate greater tax losses at the level of the Japanese SPV makes newbuild vessel JOLCOs attractive to Japanese investors and allows for improved overall rates to be offered to the shipowner.

However since 2023, only vessels which meet specific environmental and technological requirements and for which approval has been granted by the Japanese Minister of Land, Infrastructure, Transport and Tourism (MLIT) can benefit from special depreciation rates of 18-30%. Whether a vessel can benefit from these rates will therefore not only depend on its characteristics but also on satisfying the procedural requirements in Japan.

Another less recent development is the change to the deductibility of interest at the Japanese SPV level. This was implemented in 2020 and, in essence, capped the deductibility of interest where the interest payments are being made to a lender outside Japan. For practical purposes this severely limited the ability of banks not able to book their participation in the loan from within Japan from participating in JOLCOs as booking their participation from outside of Japan would have the effect of reducing the losses created by the Japanese SPV and, as such, impacting the overall economic benefits of the structure.

The above are examples illustrating how Japanese legal developments may affect the way JOLCOs are structured to maximise the economic advantages of a JOLCO for the parties involved.

POINTS TO TAKEAWAY

Shipowners have a variety of possible sources of capital to consider, and understanding each of these will be important to allow a shipowner to determine which is best suited for their fleet. JOLCOs have significant economic advantages but will not be appropriate for all vessels or financings and, as such, weighing these economic advantages against the required level of flexibility will be an important consideration.

Stephenson Harwood LLP has a long track record of advising on JOLCO transactions in the shipping sector, for all the different parties involved and across the globe. The volume of transactions on which we advise, as well as the range and complexity of these transactions (whether that be ECA-backed JOLCOs, certain green or sustainability-linked JOLCOs or other variations on the conventional JOLCO structure) mean that we are uniquely placed to provide legal advice to all parties involved. This includes the structuring aspect as well as the documentation and implementation of JOLCO transactions for vessels.

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