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# Construction Law 2023

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## **Japan: Trends & Developments**

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Mori Hamada & Matsumoto



# JAPAN

## Trends and Developments

### Contributed by:

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**Mori Hamada & Matsumoto** has a construction practice that extends from traditional to complex transactions involving fund structures with a special-purpose vehicle or a trust, including investment structures for overseas investors, backed by significant experience of real estate transactions. The team's work in this practice primarily includes the following: acquisition of land for construction, advising on construction-related agreements, structuring and fund

formation for construction projects and financing for construction. Recent highlights include advising a US-based data centre developer on the formation of a joint venture for hyperscale data centres, advising on hotel construction and conversion projects in Okinawa, Kyoto and Niseko, and advising on many other construction projects, including Urban Redevelopment Projects.

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Considerations Concerning Real Estate Investments in Data Centres Currently Drawing Attention” (The Finance, October 2020), “An Introduction to Real Estate Financing in the US” (ARES Journal, October 2020) and “Outline of Real Estate Investment Regarding Data Centres” (ARES Journal, December 2019).



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### Overview

#### *Continued strong performance of construction investments*

Construction investment in Japan remains high. According to the Construction Investment Outlook published annually by the Ministry of Land, Infrastructure and Transport (MLIT), construction investment in Japan was expected to increase by 0.6% in FY2022 over the previous year to JPY66.99 trillion. Construction investment in FY2010 was approximately JPY42 trillion, but has been increasing since then, and has remained at a high level of over JPY60 trillion for the past six years despite the COVID-19 pandemic.

The Japanese real estate investment market is active as a whole, especially attracting attention from abroad due to low interest rates and the depreciation of the yen. Both domestic and foreign investors are expanding their Japanese real estate investments, which increases the demand for construction. As discussed below, construction investments are also expanding due to increasing numbers of urban redevelopment projects and increasing demand for housing in certain urban areas; logistics facilities; and data centres.

#### *Urban Redevelopment Projects under the Urban Redevelopment Law*

Large-scale redevelopment projects led by major Japanese real estate developers are being

implemented or planned, mainly in Tokyo, Osaka and other urban areas. Most of these projects are carried out as Urban Redevelopment Projects under the Urban Redevelopment Law. For example, in the Tokiwa-bashi area, which is very close to Tokyo Station, construction of the tallest skyscraper in Japan (a complex of offices, hotels, halls and commercial facilities) is scheduled to be completed in 2027–2028.

The purpose of Urban Redevelopment Projects is to achieve a high level of use of land and renewal of urban infrastructure through demolishing old buildings and other structures in the project area, clearing the land, and constructing new redevelopment buildings along with new roads, parks and other public facilities. Due to the public nature of Urban Redevelopment Projects, administrative procedures, such as approval of redevelopment plans by the local government, are required for Urban Redevelopment Projects. In an Urban Redevelopment Project, the previous right-holders in the project area will obtain a portion of the floor area of the redeveloped building (known as the “allotted floors”), and the floor areas in such redeveloped building that are not allotted to such previous right-holders (known as the “reserved floors”) are sold to the developer and other parties. Profits from the sale are used to repay the project costs of the Urban Redevelopment Project.

## Trends by Property Type

### Offices

From the late 2020s to mid-2030s, a series of high-rise redevelopment office buildings are scheduled to be completed in Tokyo in areas such as Yaesu – Nihon-bashi (including Tokiwa-bashi), Hibiya, Toranomon, Shinagawa, Shibuya and Shinjuku. On the other hand, there has been a move to downsize offices, as teleworking takes hold as a result of the COVID-19 pandemic, and

the office vacancy rate in central Tokyo continues to exceed 5%, which is considered as a benchmark for oversupply. Likewise, in central Osaka, office buildings are being constructed rapidly against the backdrop of office shortages before the COVID-19 pandemic, but the vacancy rate continues to exceed 5%.

In the case of typical office buildings, the holding structure and contractual relationship (eg, tenant lease agreements, building management agreement) are relatively simple. On the other hand, especially in redeveloped buildings in a large-scale redevelopment, right-holders may hold rights in the form of a co-ownership or strata ownership of the building, which tends to make the holding structure and contractual relationship (including agreements among co-owners or strata owners) complex.

### Hotels

Even though hotel occupancy rates have not yet returned to pre-COVID-19 pandemic levels (ie, around 80%), they are on the road to recovery (being above 70% as of February 2023) as the number of tourists, including inbound travellers, is increasing. Many hotels are being built for opening in 2023 to 2024 in anticipation of post-COVID-19 pandemic recovery. In particular, Okinawa, one of the leading resort destinations in Japan, sees recovery in demand for tourism, and is enjoying a construction boom, with many brand new hotels developed by international hotel operators. Similarly, even during the COVID-19 pandemic, much development of resort facilities in Niseko, Hokkaido has continued, with a number of luxury hotels and condotels being operated by international hotel operators.

In the development and operation of hotels, which are typical operational assets, structuring is highly important. There are many legal issues

typical to hotels, for example: (i) whether to execute agreements with hotel operators in the form of (a) a lease agreement (in this case, whether to use gross operating profit-linked variable rent or fixed rent) or (b) a management contract or franchise agreement; (ii) who holds the FF&Es (Furniture Fixture & Equipment); and (iii) which entity will obtain permits and licences under the Hotel Business Law, the Liquor Tax Law, and other laws. The development and operation of condotels shall be also subject to some unique laws and regulations, such as Act on Building Unit Ownership, etc. Careful consideration is required from the preliminary stages of hotel development projects.

## *Residential*

Demand for condominiums in central Tokyo has remained high against the backdrop of long-term low interest rates and an increase in dual-income households; thus, prices for the sale of new condominium units remain high. Many high-rise condominiums are being built, with most of them in the bay area, which is close to the central business districts in Tokyo. In Tokyo and other metropolitan areas such as Osaka, construction of small to medium-sized rental apartments continues, and many of them are on the market targeted by institutional investors, including foreign investors.

When developing and selling new housing, the construction contractor and seller are liable for defects in the major structural components of the housing for ten years after delivery under the Law Concerning the Promotion of Securing Housing Quality. In addition, for property owners who want to operate rental apartments, the Law regarding Appropriate Management of Rental Housing applies and was fully enforced from 15 June 2021; such law provides for (i) measures to ensure the appropriateness of lease contracts

between sublessors (master lessees) and owners; and (ii) a registration system for the rental apartment management business.

## *Logistics facilities*

The development of advanced logistics facilities has been active in recent years, with continued strong demand, especially in the three major metropolitan areas of Tokyo, Nagoya and Osaka. One of the unique features of these advanced logistics facilities is that the developers of such facilities are actively working to improve operational efficiency and convenience through the introduction of robotics and AI technology. In addition, many of these facilities are usually equipped with solar power generation facilities on their roofs or on their premises. With fuel prices rising and expected to continue rising, efforts to ensure a stable supply of electricity derived from renewable energy sources are also gaining momentum.

“Build-to-suit” arrangements are sometimes used in the development of logistics facilities. In this arrangement, tenants, such as shippers and third-party logistics companies, are identified at the pre-development stage, and property owners build the logistics facilities to suit the needs of such tenants. For this purpose, it is common to execute a certain agreement to confirm the specifications of the buildings as well as the outline of the expected long-term, fixed-term building lease agreement between the property owner and the tenants; thus the terms and conditions of such agreement are highly important. In addition, investment vehicles incorporated under special laws (eg, TMKs or REITs) are not allowed to sell electricity; hence, when such investment vehicles acquire logistics facilities equipped with solar power generation facilities, special measures, such as roof leases to a third party, are considered.



## *Data centres*

Demand for data centres, as a new growth area alongside logistics facilities, is expanding due to the growing use of cloud services. Major Japanese real estate developers are increasing their investments in developing data centres, and new foreign data centre operators are entering the Japanese market. The expansion of the data centre market is also one of the Japanese government's national strategies; concerned that about 60% of data centres are concentrated in the Tokyo area (Tokyo, Saitama, Chiba, and Kanagawa prefectures), the Japanese government published the fundamental policy on 7 June 2022 that it aims to develop a dozen or more regional data centre locations around Japan in about five years in order to decentralise data centres to rural areas, and to handle the rapid increase of digital requirements and data traffic.

Many of the points to be considered for the development and operation of logistics facilities also apply to data centres, but careful consideration is required on how to structure the operational aspects unique to data centres. For example, the development and operation of data centres need to consider whether or not licences (registration or notification) are required under the Telecommunications Business Act, depending on the degree of involvement of the property owner. Generally, if the property owner only leases real property with major facilities, such as power supply equipment, to a data centre operator, the property owner is not required to have a licence under the Telecommunications Business Act. On the other hand, if the property owner provides operational services (eg, providing functions that enable communication with third parties such as enabling individuals to send and receive email via a server), the property owner may be considered a "Telecommu-

nications Carrier" and will be required to obtain a licence (registration or notification) under the Telecommunications Business Act.

## *Integrated resort*

In July 2018, the Act on Development of Specified Integrated Resort Districts (the "IR Act") was enacted. The purpose of the IR Act is to achieve attractive stay-and-go tourism with high international competitiveness by having private operators fund and conceptualise "Specified Integrated Resort" facilities (the "IR Facilities") using profits from casino facilities.

The local governments of Osaka Prefecture and Osaka City, and Nagasaki Prefecture submitted applications to be selected for the first sites for IR Facilities. Osaka Prefecture and Osaka City have officially been selected, while Nagasaki Prefecture's application is still under review by the relevant authorities.

Under the IR Act, IR Facilities are defined as a group of facilities integrating a casino with the following facilities: (i) MICE (Meeting, Incentive tour, Convention, Exhibition) facilities; (ii) facilities that promote Japanese traditions, culture, arts and other attractions; (iii) facilities that provide appropriate information on sightseeing in various regions of Japan, and that arrange transportation, accommodation and other services necessary for sightseeing trips to each region in an integrated manner; and (iv) accommodation facilities. Operators must develop and operate the foregoing facilities as integrated facilities.

## *Renewable energy power plant*

Under the feed-in tariff (FIT) system for renewable energy launched in 2012, which currently is being gradually replaced with the feed-in premium (FIP) system, renewable energy has been recognised as an investment with the poten-

tial for stable returns, and significant progress has been made in Japan in the introduction of solar power plants, including mega solar power plants. In addition, the Japanese government decided that maximum efforts would be made to expand the introduction of renewable energy as the main source of power, with the goal of steadily achieving a 36–38% share of renewable energy in the power source composition in 2030.

In recent years, offshore wind power has been seriously considered to serve as a sustainable energy source in Japan, which is surrounded by the sea on all sides. The Japanese government set a target for the introduction of 10 million kW offshore wind power generation in total by 2030 in its “Offshore Wind Industry Vision” released on 15 December 2020, and is proceeding to designate “Promotion Areas” under the Act on the Promotion of Utilisation of the Sea Area for the Development of Offshore Renewable Energy Power Facilities. Operators of Promotion Areas, who will be selected through public bidding, will be granted a licence to occupy the area for a maximum of 30 years, and will be required to implement an offshore wind power generation project in accordance with the plan submitted by the operator. Through the first round of the public bidding, the operators for the first four Promotion Areas were selected in 2021; the second round of the public bidding for other four Promotion Areas is now underway, with results scheduled to be announced in March 2024.

## PPP/PFI

Since the enactment of the Act on Promotion of Private Finance Initiatives (the “PFI Act”) in 2009, Japan has seen the spread of PPP (public private partnership)/PFI (private finance initiative) projects under the strong promotion of the government. On 3 June 2022, the Cabinet Office, Government of Japan, decided on the

“PPP/PFI Promotion Action Plan (2022 revised version)” at the 18th meeting of the Council for the Promotion of the Private Finance Initiatives, which sets a target project scale of JPY30 trillion for the next ten years.

Typically, in traditional PFI projects in Japan, the private sector establishes a special purpose vehicle (SPV) for each project, procures funds through the SPV, and handles the design, construction, maintenance, management and operation of public facilities, while the national or local governments pay the SPV a certain service purchase fee for its services. On the other hand, independently profitable projects, in which the private sectors’ costs are recovered through usage fees from the users of public facilities, were rarely seen in Japanese PPP/PFI. However, the amendment of the PFI Act in 2011 introduced the Japanese version of the concession: a scheme where the government gives right to operate public facilities to the private sector, which is intended to be used primarily for the operation of independently profitable projects. The government has strongly been promoting this concession scheme with a target project scale of JPY7 trillion in the PPP/PFI Promotion Action Plan, as mentioned above.

## ESG Real Estate Investment

### Overview

As the concept of ESG (environmental, social and governance) is spreading globally, there is a growing trend towards emphasising ESG responses in the context of real estate development, management and investment (“ESG Real Estate Investment”).

ESG Real Estate Investment is expected to be one of the measures to cope with global warming and climate change, as well as problems specifically affecting Japan, such as its decreas-

ing birth rate and ageing population, and disaster prevention and mitigation. The MLIT established the “Study Group on ESG Real Estate Investment” for the purpose of studying how ESG Real Estate investments should be made and how ESG Real Estate Investment initiatives should be promoted. The Study Group released an “Interim Summary” on 3 July 2019, providing guidelines for promoting ESG Real Estate investment. The MLIT also established the “ESG-TCFD Practitioner Working Group for the Real Estate Sector” to study how information related to ESG including TCFD (Task Force on Climate-related Financial Disclosures) should be disclosed, and “Study Group on Promotion of ESG Investments to Address Social Issues in the Real Estate Sector” to organise evaluation items, basic ideas, and methods for assessing social impact for efforts to address social issues in the real estate sector. These study groups published the “TCFD Guidance for the Real Estate Sector” on 3 March 2021 and “Practical Guidance on Social Impact Real Estate” on 24 March 2023, respectively.

## *Environmental*

One of the efforts recently being promoted is the construction of ZEBs (Zero-Energy Buildings), which achieve zero energy balance by drastically reducing energy consumption and generating solar power on the rooftop of the building. In addition, tools for evaluating environmental performance, including energy conservation, such as CASBEE (Comprehensive Assessment System for Built Environment Efficiency), DBJ Green Building Certification and BELS (Building-Housing Energy-Efficiency Labelling System) have been developed and applied. An analysis shows that new achievable rent for office buildings with an environmental certification tends to be higher than office buildings without such certification.

Under the revision of the Law Concerning the Improvement of Building Energy Consumption Performance (the “Energy Conservation Law”) enforced on 1 April 2021, the obligation to comply with building energy consumption performance standards (the “Energy Conservation Standards”), which had previously been limited to large-scale, non-residential buildings, has been extended to mid-scale non-residential buildings with a floor area of 300 square meters or more. When constructing, remodelling or making additions to a large or mid-scale, non-residential building, the owner (ie, a person who orders construction work from a general contractor) is required to submit a “Building Energy Consumption Performance Plan” to the relevant authorities, who will determine if the building complies with the Energy Conservation Standards. If the building does not meet the Energy Conservation Standards, the owner cannot obtain a “Building Confirmation Certificate”, which is necessary to start the construction, remodelling or making additions to the building. Under the revised Energy Conservation Law, promulgated on 17 June 2022, and scheduled to take effect from April 2025, the above-mentioned obligation to comply with the Energy Conservation Standards will apply in principle to all new residential and non-residential buildings.

On the other hand, the owner can consider applying for a certification for a “Building Energy Consumption Performance Improving Plan” to construct, extend, renovate or repair the building. If the owner obtains this certification, the owner can obtain certain relaxations in floor area ratio, which determines the total size of the building in relation to the land size, etc.

## *Social*

Regarding the social aspect of ESG, ESG Real Estate Investments are expected to address



social problems specifically affecting Japan. For example, it is expected that preparation for natural disasters will be achieved by ensuring that buildings are earthquake-resistant, and that increasing investments in healthcare properties may be one of the solutions to the decreasing birth rate and ageing population.

In addition, since the construction phase is labour intensive and may involve workers who are vulnerable, such as short-term workers, temporary workers and foreign workers, it is necessary to pay attention to human rights risks affecting these workers. Recently, contracts with clauses that take human rights risks into account are gradually increasing.

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