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Current Issues on the amendment of the Civil Code (Law of Obligations)

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I. Background

The Working Group on the Civil Code (Law of Obligations) was established in October 2009 by the Legislative Council of the Ministry of Justice to deliberate on extensive amendments to a part of the Civil Code, known as the Law of Obligations. On May 10, 2011, the Working Group released its Interim Report on the Issues on the Amendment of the Civil Code (Law of Obligations) (the "Interim Report") for public comments from June 1, 2011 to August 1, 2011.

The Interim Report covers a wide range of issues, from the introduction of new rules based on existing theories of scholars as well as case laws to the need to reconcile the Civil Code with other laws such as the Consumer Contract Act and the Act on Land and Building Leases. The Interim Report, its supplemental explanation and the minutes of the Legislative Council are available on the website of the Ministry of Justice at http://www.moj.go.jp/shingi1/shingi04900074.html. An English translation of some materials is found at http://www.moj.go.jp/ENGLISH/ccr/CCR_00002.html.

The Interim Report represents the first stage of the amendment process. In the second stage of the process, the Legislative Council will proceed based on the public comments received. The results of the deliberations during the second stage will be compiled into a tentative draft bill, which will be subject to another round of public comments before being formulated into a final draft bill.

The final draft bill was initially scheduled to be submitted to the Diet in 2012, but this schedule could be delayed due to uncertainties in the political arena, the high priority given to the earthquake disaster recovery plans, and opposition from practitioners and scholars who refute the necessity for the reforms. On the other hand, the first stage proceeded at a fast pace, and therefore it is not likely that the process will come to a halt. In fact, some experts foresee that the final draft bill will be submitted to the Diet in 2013 and may come into law in 2015.

II. Contents of the Interim Report

1. Rules on Contract Negotiations and Forming a Contract

(1) Unfairly Breaking Off Contract Negotiations and Duty to Provide Information

The Working Group deliberated on the necessity of providing for the duties of a party not to unfairly break off contract negotiations, and to provide information when forming a contract. (Part XXIII - In this bulletin, references to "Part" correlate to the relevant "Part" of the Interim Report.)

Under the principle of freedom of contract, withdrawal from contract negotiations would not give rise to contract liabilities since the parties may freely decide whether or not to enter into a contract. However, under case laws, if parties unfairly withdraw from the negotiations during the later stages of contract negotiations, they are in certain circumstances held liable for damages that the other side may have incurred based on a reasonable expectation that the contract will be signed.

It is another contract law principle that each of the contract parties should decide whether or not to enter into a contract based on the information that it gathers on its own. However, under case laws, parties having better access to material information are in certain circumstances deemed to owe an obligation to provide information to the other, based on the principle of faith and trust.

The Interim Report suggests further discussions on whether or not to codify these case law rules in the Civil Code. If codification is made, then negotiating parties would have to pay more attention to how they proceed with and close the negotiations.

(2) Standard Form Contract

The Working Group deliberated on the necessity for specific provisions concerning standard form contracts. (Part XXVII) By standard form contracts, the Interim Report means the "whole body of contract terms which are pre-formulated to be used for a large number of contracts." This definition would include uniform terms and conditions typically used for transactions with the general public, such as public transportation or insurance policies, as well as standardized terms used among business entities.

In practice, contracts are often signed without the counterparties (of the drafting party) having sufficient opportunities to read and understand the standard form contracts. On that basis, the Interim Report suggested policing the contracting process by setting forth specific requirements for incorporating standard contract terms into a binding contract, *e.g.*, standard terms must be disclosed to the counterparty before the execution of the contract. Practitioners, however, are concerned that overly

restrictive requirements may negatively affect actual business practice.

The report also mentions that the regulations of unfair terms (discussed below) would apply to the standardized contracts, even when they are used between sophisticated business entities. This is based on the recognition that the counterparties of standard form contracts are not given sufficient opportunities to negotiate the terms.

(3) Regulation of Unfair Terms

The Working Group deliberated on the necessity for specific provisions which deny the binding effect of contracts terms that are one-sidedly and unfairly favorable to one party. This regulation is discussed especially in connection with standard form contracts and consumer contracts. (Part XXXI)

The Interim Report pointed out the need to protect the interests of parties who have less access to or ability to collect information or are in an inferior negotiation position. If this protection will be made to apply to standard form contracts, the regulation of unfair terms may have a major impact on a wide variety of transactions between business entities.

As to regulating unfair terms, the Interim Report considers the possibility of defining two categories of unfair terms, one called the “black list” (contract terms definitely deemed unfair and thus void), and the other one called the “gray list” (contract terms presumed to be unfair and thus void unless the reasonableness of the terms are otherwise proved), the details of which are still to be discussed.

(4) Misrepresentation

The Working Group deliberated on the possible expansion of the grounds for rescission of contract, particularly including misrepresentation. (Part XXVII)

Under the current Civil Code, a contract can be void on the grounds of mistake, fraud or duress. The Working Group proposes to expand those grounds to include misrepresentation, modeling on common-law contract principle. This proposal may impact the practice of providing for contractual “representations and warranties.” Under shares or business purchase agreements in certain types of M&A transactions, the typical contractual remedy for misrepresentation is compensation for damages but not contract termination after closing has occurred. Practitioners are concerned, however, that if the Civil Code is amended to provide for the rule of misrepresentation and the parties are not allowed to “contract-out” the applicability of such rule, then the buyer may have the chance to legally rescind the agreement after the closing even though such rescission is expressly forbidden in the agreement in case of the seller’s misrepresentation.

2. Change and Expansion of Contractual Relationship

(1) Perfection Requirements for Assignment of Claims

The Working Group deliberated on revising the requirements for perfecting assignments of claims against third parties (*i.e.*, parties other than the obligors of the claims). The report offered several alternative proposals, one of which is to use the registration system as the sole perfection method. (Part XIII)

Two perfection methods are available under the current Civil Code, namely, (a) a date-certified notice to or consent of the obligor and (b) the registration system. Some practitiones, however, are critical of the proposal to only use registration considering that the date-certified notice or consent is convenient and cost-effective method for certain kinds of transactions.

(2) Contractual Limitation on Claims Assignment; Assignment of Future Claims

The Working Group deliberated on possible exceptions to the enforceability of contractual provisions that prohibit the assignment of claims without the consent of the obligor, as well as provisions regarding assignments of future claims. (Part XIII)

Under the Civil Code, an obligor may validly restrict the assignability of a claim against it. The Working Group discussed the need to limit the validity of this kind of contractual restriction, with the aim of enhancing financing transactions that utilitze valuable receivables as collateral or securitized assets. The Interim Report mentions a proposal to introduce a rule that claims become assignable when a statutory insolvency proceeding has been initiated in respect of the assignor. The rationale behind this proposal is that the free assignability of claims should be prioritized over the protection of the obligor once the assignor has become bankrupt. Practitioners, however, doubt whether this proposal will actually enhance financing transactions.

As for future claims, there are no Civil Code provisions that specifically address assignments of future claims, although well-established case laws have basically upheld such assignments. Thus, the Working Group proposed to expressly allow such assignments, subject to certain limitations. In this connection, the Interim Report has not touched on the effects of an assignment of future claims in cases where, after the assignment, the assignor becomes insolvent and a bankruptcy trustee is appointed. The extent to which the assignee may assert the assignment of future claims against the bankruptcy trustee remains a practical concern especially for certain types of financing transactions.

(3) Guarantee

The Working Group deliberated on the introduction of legal protections for guarantors, the grant of a guarantee by agreement between the obligor and the guarantor, and clarifications of the rules on revolving guarantees.

First, based on the observation that there are a number of cases where guarantors (especially natural persons) with burdensome guarantee obligations have become financially distressed, the Interim Report has introduced several proposals to protect guarantors. Such proposals include an obligation of the beneficiary of a guarantee to give the guarantor sufficient explanation to enable the guarantor to understand the scope of the guarantee. Some practitioners, however, pointed out that these regulations should not be applicable to all types of guarantees used in practice.

Second, under the Civil Code, a guarantee is granted through the agreement between the beneficiary of the guarantee and the guarantor. The Working Group's deliberations, however, expanded the grounds for forming a guarantee to include the agreement between the guarantor and the principal obligor.

Third, the Working Group proposed to further discuss the rules addressing the issue of whether or not a beneficiary of a guarantee can enforce a revolving guarantee before the crystallization of the guaranteed obligations, and whether or not a revolving guarantee can be automatically assigned together with the assignment of the principal claim.

(4) Changes in Circumstances; Defense of Prospective Non-Performance

The Working Group deliberated on the need for provisions on changes in circumstances and on potential non-performance.

One theory under case laws states that a contract party is exempted from performing a contract by reason of a change in the circumstances which formed the basis of the parties in entering into the contract, although the applicability of such theory is fairly limited in practice. The requirements for the exemption include the condition that the changes in circumstances could not have been foreseen by either of the parties at the time of the execution of the contract and are beyond the control of the parties, and that the changes in circumstances create a significant inequality in the interests of the parties.

Case laws also acknowledge that if the credit condition of a creditor has worsened and the obligor has a claim against the creditor which is not yet due, the obligor can refuse the performance of its obligation subject to certain requirements, because of the potential non-performance by the creditor in the future.

The Working Group proposed to expressly stipulate these rules under case law into the Civil Code. Practitioners have raised concern that these amendments might increase the likelihood of parties refusing the performance solely on the basis of these principles.

3. Rule on Contract Performance and Claim Collection

(1) Default and Compensation for Damages

The Working Group deliberated on the issues regarding claims for damage as a remedy for the non-performance of a contract by the debtor. (Part III)

Under the Civil Code, the prevailing notion is that a creditor may seek compensation for damages resulting from a debtor's non-performance of a contract by intent or negligence. The Working Group discussed whether or not to replace the concept of "by intent or negligence" with another requirement. One of the proposals is to provide that the obligor is liable for its non-performance unless such non-performance is attributable to "reasons outside the scope of liability that the obligor agreed to under the contract" or a "force majeure event." This discussion is based on theoretical or academic concerns. As the discussion is quite academic in nature, it is difficult to predict at this stage what the amendments will be and if and in what way these amendments will eventually affect practice.

Under the Civil Code, the scope and amount of compensation for damages are determined based on what may be foreseen as the consequence of the non-performance, but the Civil Code does not explicitly provide from whose point of view those foreseeable damages should be determined, or how exactly to calculate the amount of the damages to be compensated. The Interim Report proposes to further discuss these issues, as a consensus on these issues had not yet been reached.

(2) Termination

The Working Group deliberated on establishing the rule that a party cannot terminate a contract unless the other party has committed a material breach of the contract. (Part V)

Under the Civil Code, termination of a contract by one party as a remedy for non-performance is possible only where the breach of the contract by the other was committed by intent or negligence. Some scholars opine that the termination of the contract is not a sanction against the defaulting party but a remedy of the non-defaulting party to release it from the binding effect of the contract. On this basis, the Interim Report suggested removing the requirement of "by intent or negligence" in cases of termination by reason of non-performance of the other party. On the other hand, the Interim Report

proposes to introduce the concept of material breach of a contract as a requirement of termination. Although the concept of material breach is used in contract laws in other jurisdictions or international conventions such as the Vienna Sales Convention, it is new to Japanese domestic legislation, and therefore practitioners argue that the Working Group should further clarify the specific requirements under which the termination of a contract is permitted.

(3) Set-offs

The Working Group deliberated on the enforceability of set-off declared by one of the creditors of an insolvent debtor in relation to another creditor who took judicial steps to attach the insolvent debtor's claims against the creditor exercising its set-off rights. (Part XVIII)

The Civil Code provides that a creditor cannot set off its claim if the counterparty's claim is subject to an attachment by a third party and that creditor's claim arises or is acquired after the attachment has become effective. On the basis of this provision, the courts have allowed a creditor to set off its claims as long as the creditor's claim has arisen or was acquired before the attachment, despite some scholars' argument that a set-off should not be allowed if the attached claims become due prior to the due date of the creditor's claim. Under current court ruling, set-off has played a significant role as a security measure in favor of creditors that owe certain financial indebtedness to the debtor, typically banks who have lending exposure to its depositors. The Interim Report suggested further discussions on whether or not to propose the legislative adoption of the scholars' dissenting position to such current court ruling, but practitioners are concerned that this proposal may decrease the effectiveness of set-offs.

Another issue on set-off is the enforceability of acceleration provisions, typically found in loan agreements, in the context of a set-off. Although the courts widely recognize the effect of acceleration provisions and allow the creditors to set-off their exposure before the due date of the subject claims, the Interim Report suggested further discussions on whether or not to limit the enforceability of the set-off brought about by virtue of acceleration provisions. Practitioners are also concerned about this proposal.

(4) Extinctive Prescription

On this issue, the Working Group deliberated on the length of the prescription periods, when such periods should start, and whether or not the prescription periods or the time of commencement can be changed by agreement. (Part XXXVI)

Under the Civil Code, the prescription period for a claim, in principle, expires in 10 years, save that the

actual periods can differ for some categories of claims. One of the Working Group's proposals is to reduce that period to either 3 years or 5 years.

4. Specific Types of Contracts

(1) Deposit and Statutory Interest Rate

The Working Group considered the need for specific provisions on bank deposits as the Civil Code has no such provision (Part LII). In this regard, it is expected that these provisions may help clarify the question on the validity of security interest created over liquid deposits, which are the subject of debate under current laws.

The Working Group also tackled the criticism of having a statutory interest rate which is a fixed rate, at 5% under the Civil Code (and 6% under the Commercial Act) and is not reasonable considering market movements, and discussed whether to introduce variable interest. (Part I) Although the Working Group has not proposed any concrete base rate, several indices that were discussed include (i) the short-term target interest rate of the Bank of Japan, (ii) the interest rate of short-term government bonds, (iii) the average short-term prime rate of commercial banks, and (iv) the Basic Discount Rate and Basic Loan Rate set by the Bank of Japan.

(2) Real Property Leases

The Working Group deliberated on the need for provisions to address the legal relationships that arise when a leased real property is sold to a third party. (Part XLV)

Under case laws, the status of the lessor and its obligation to return lease deposits are automatically transferred to the transferee of the real estate, though most practitioners believe that the transferor is discharged from the obligation to return the deposit upon the transfer of the real estate, with the transferee being automatically liable for the deposit instead. If the future Civil Code provisions on this issue adopt the rule that the transferor, in addition to the transferee, remains liable for the return of lease deposits, then a transferor will have to make sufficient preparations to minimize its liability.

(3) Finance Leases

The Working Group deliberated on the need for and extent of basic legal rules on finance lease contracts. (Part XLVI)

The Civil Code has no provision on finance leases, but in practice a typical finance lease contract

covers the parties' rights and obligations in detail. If any new statutory provisions on finance lease are non-mandatory in nature, then they are expected to have little impact on current practice.

(4) Contracts for Rendering Services

The Working Group deliberated on the need to revise the whole framework for contracts for rendering services, based on the viewpoint that current rules do not address new types of services. (Part XLVII and L)

A contract for rendering services refers to a contract pursuant to which the obligor agrees to provide services. The Civil Code provides for only four categories of contracts for rendering services: contracts for work, mandates, bailment and employment. It has, however, been pointed out that new types of services (such as medical care, education and travel) are difficult to categorize under any of those four categories. In this regard, the Working Group stated in the Interim Report two approaches to the possible revision of the entire legal framework on contracts for rendering services. The first approach is to add the contracts on these new services to the list of contracts covered by the Civil Code. The other approach is to establish extensive general rules which cover all of the contracts for rendering services.

(5) Long-Term Contracts

The Working Group deliberated on whether or not to provide for long-term contracts, particularly regarding the termination of such contracts. (Part LX)

A long-term contract refers to a contract where the parties are required to continuously perform their obligations over a certain period of time. Case laws have restricted the right to terminate or to refuse the renewal of long-term contracts based on the principle of good faith. The Working Group's deliberations focused on whether to codify these case law rules in the Civil Code.

News

- Firm receives awards at ALB Japan Law Awards 2011
  "M&A Deal of the Year" - Morgan Stanley - MUFG Joint Venture
  "Westlaw Japan Award TMT Deal of the Year"
  - Symantec-VeriSign Acquisition
  The firm also earned the following awards: "Best China Practice of the Year", "Japanese Deal Firm of the Year"

Publications

"Highlights of Proposed Amendment of Contract Law - Analysis of the Interim Report"
Publisher Business Houmu Vol. 11 No. 8
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