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The Interim Draft on Proposed Amendments to the Civil Code (Law of Obligations)

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A. Release of the Interim Draft

In October 2009 the Legislative Council of the Ministry of Justice established the Working Group on the Civil Code (Law of Obligations) to deliberate on extensive amendments to a part of the Civil Code known as the Law of Obligations. On March 11, 2013, the Working Group released the interim draft of its proposed amendments to the Civil Code (Law of Obligations) (the “**Interim Draft**”).

Procedures for public comments started on April 16, 2013 and will end on June 17, 2013. According to one newspaper report, the Ministry of Justice aims to submit an amendment bill to the Diet in 2015 at the earliest. This bulletin introduces some of the major issues discussed in the Interim Draft, which may have significant impact on the practice of financing transactions governed by Japanese law.

B. Contents of the Interim Draft

1. Assignment of Claims

(a) Contractual Limitation on Assignment of Claims

One proposal in the Interim Draft will significantly affect contractual restrictions on the assignment of claims. Under the proposal, despite contractual restrictions, contractual claims may be assigned even without the consent of the obligor, but the obligor (a) may refuse to pay the claim to the assignee and (b) instead, may either pay the assignor or set off the claim against the obligor’s claims against the assignor. The rationale for this proposal is that since the obligor may choose the party to whom it will perform its obligation, there is no need to deny the assignment of claims that is made in violation of contractual restrictions.

The Interim Draft, however, has also recommended that contractual restrictions on assignments of claims lose effect in certain cases. For instance, under the Interim Draft, the contractual restrictions on the assignment of claims will cease to have any effect if, after the assignor has perfected the assignment of claims against third parties, either (a) a statutory insolvency proceeding is initiated in respect of the assignor or (b) a creditor of the assignor attaches the assigned claims.

(b) Perfection Requirements for Assignment of Claims

The Working Group deliberated on revising the requirements for perfecting assignments of claims against third parties, and offered two alternative proposals.

The first proposal offers the following perfection methods: (a) in the case of monetary claims, the registration system, and (b) in the case of non-monetary claims, a date-certified assignment agreement. Some practitioners have pointed out that since it is difficult to distinguish between monetary claims and non-monetary claims in certain transactions, parties will tend to satisfy both methods to minimize the risk that the assignment is not perfected.

The other proposal offers either of two perfection methods, namely, (a) a date-certified notice to the obligor and (b) the registration system, for the assignment of monetary and non-monetary claims.

The date-certified consent of the obligor will no longer function as the perfection methods under any of the proposals in the Interim Draft. Some practitioners are critical of this proposition because obtaining the obligor's date-certified consent is convenient and cost-effective for certain kinds of transactions.

(c) Defense of Obligor upon Assignment of Claims

Under the Civil Code, an obligor, who has consented to the assignment of claims without objection, may not assert any ground, which the obligor could assert as a defense against the assignor, as a defense against the assignee. The Interim Draft offers a new rule in which the obligor who expressly waives any defense against the assignor cannot raise that defense against the assignee. Some practitioners have suggested that, under the proposal, it could be more difficult to cause the obligor to waive its defenses.

(d) Assignment of Future Claims

The Civil Code has no provisions on the assignments of future claims, although well-established case laws have upheld those assignments. The Interim Draft seeks to rectify this situation by expressly allowing such assignments.

The Interim Draft also proposes that if a contractual restriction on the assignment of claims is agreed after future claims have been assigned and that assignment has been perfected against the obligor, then the obligor cannot assert that restriction against the assignee.

2. Guarantee

The Working Group is deliberating possible proposals regarding guarantees. Of particular significance is the possible expansion of the protection of guarantors, particularly those who are natural persons.

Under the Interim Draft, natural persons will be prohibited from guaranteeing the debt obligations of business entities, except that a management member may issue a guarantee to creditors of the entity he is managing. Some practitioners, however, have noted the difficulty of defining what a “management member” is.

There are other proposals under the Interim Draft to protect guarantors. These include obligating the beneficiary of a guarantee to give the guarantor sufficient explanation (e.g., explanation regarding the creditworthiness of the principal obligor) when concluding a contract of guarantee. Practitioners, however, are critical of this regulation because the extent of the obligation to explain is unclear.

3. Statutory Interest Rate

The Interim Draft proposes the introduction of a floating interest system. Under the proposed floating interest system, if the Basic Loan Rate (formerly known as the Official Discount Rate) set by the Bank of Japan (the “**Benchmark Interest Rate**”) as of a certain date of a year goes up or down by more than 0.5 percent compared to the Benchmark Interest Rate as of a certain date of the previous year, the statutory interest rate will correspondingly change by 0.5 percent. The Interim Draft also proposes the reduction of the current statutory interest rate from five percent to approximately three percent.

Even under the Interim Draft, the contractually agreed interest rate will apply to contractual claims.

4. Set-offs

In cases where a debtor’s claim has been attached, courts have allowed a creditor to set off its claims against the attached debtor’s claim as long as the creditor’s claim arose, or the creditor acquired its claim, before the attachment. The Interim Draft proposes to include this case law into the Civil Code. In addition, the Interim Draft allows a creditor to set off its claims against the attached debtor’s claim as long as the ground for the creditor’s claim arose before the attachment.

5. Misrepresentation

The Interim Draft proposes (a) to enact into law the well-accepted rule under case law that a person who enters into a contract by mistake because the contract does not reflect his motive for entering into that contract, may assert, in certain circumstances, the nullity of the contract, as it does not reflect his motive, and (b) that that mistake may be due to misrepresentation by the other party (among other things). The proposal, however, seems to expand case law, in that it allows a party to nullify a contract due to “a mistake in motive” as a result of the misrepresentation of the counterparty, even if that party’s motive for entering into the contract cannot be seen or assumed from the contract itself.

Practitioners are concerned that the foregoing proposal will expand the grounds for rescission of contract and adversely affect certain types of transactions. For example, under shares or business purchase agreements in certain M&A transactions, the typical contractual remedy for misrepresentation is compensation for damages but not contract termination after closing has occurred. Practitioners are concerned that if the proposal becomes law, the buyer may be able to legally rescind the agreement after closing even though that rescission is not contractually allowed in the case of the seller’s misrepresentation.

6. Unfairly Breaking Off Contract Negotiations and Duty to Provide Information

The Interim Draft proposes to codify case law rules on unfairly breaking off contract negotiations and on the duty to provide information. The proposals are:

- (a) If a party unfairly withdraws during the later stages of contract negotiations, then, under certain circumstances, he will be held liable for damages that the other side may have incurred based on a reasonable expectation that the contract will be signed.
- (b) Under certain circumstances, a party who has better access to material information will be deemed to owe an obligation to provide that information to the other side.

7. Standard Form Contract and Regulation of Unfair Terms

(a) Definition

The Interim Draft proposes to introduce specific provisions concerning standard form contracts, which the Interim Draft defines as the “whole body of contract terms which are pre-formulated to conclude contracts with a large number of counterparties, and which are used to uniformly specify the contents of the contracts.”

(b) Requirements for Incorporation of Standard Contract Terms

The Interim Draft proposes the following requirements for incorporating standard contract terms into a binding contract without having separate discussions on each contract term:

- (a) the contracting parties agree to use a standard form contract; and
- (b) the party who formulated the form gives the counterparty the opportunity to take reasonable steps to know the content of that form before the signing of the contract.

(c) Revision of Standard Contract Terms

The Interim Draft proposes the following requirements for the revision of standard contract terms:

- (a) there is a reasonable need to uniformly revise the contents of the standard contract terms;
- (b) there are a large number of contracts that use such standard contract terms, and it is difficult to get all the counterparties to agree to the revision of those standard contract terms;
- (c) the content of the revision is reasonable, and the scope and extent of the revision are appropriate in light of the necessity mentioned in item (a) above; and
- (d) where the content of the revision is adverse to the interest of the counterparties, the appropriate countermeasures are prepared.

(d) Regulations of Surprising Terms and Unfair Terms

The Interim Draft proposes that a term in a standard form contract which the counterparty could not reasonably be expected to find in that standard form contract, taking into account other terms of that contract, the explanation of the party who formulated that contract, the knowledge and experience of the counterparty, and all other factors surrounding the contract, will not be effective, even if the requirements for incorporating standard contract terms into a binding contract are satisfied.

The Interim Draft also proposes that standard contract terms that are incorporated into a binding contract will not be effective if those terms (a) restrict the rights of the counterparty, or (b) add duties on the counterparty which would not have been imposed without those standard contract terms, and which excessively impair the interest of the counterparty, all in light of the contents of the restrictive or expansive terms, the overall contents of the contract, the situation under which the contract was concluded, and all other relevant circumstances.

Some practitioners, however, strongly oppose these proposals because these proposals may result in less predictability of the effectiveness of contract terms in standard forms.

News

- Chambers Global & Asia 2013

Mori Hamada & Matsumoto and many of its lawyers have been recognized by Chambers Global & Asia 2013.



- Best Lawyers in the fourth edition of "The Best Lawyers in Japan"

55 lawyers from our firm were selected for "The Best Lawyers in Japan" by the Best Lawyers survey.



- ALB Japan Law Awards 2013

Deals by Mori Hamada & Matsumoto in 2012 earned awards at the ALB Japan Law Awards 2013.

Publications

- Article "The "Interim Draft Proposal" on the Amendment of the Civil Code - Detailed Explanation of 36 Important Topics Related to Corporate Legal Affairs"
(Business Houmu, June 2013)
Authors: Hiroki Aoyama, Itaru Adachi, Yoshinori Tatsuno, Yuki Matsuda, Kei Shirakawa
- Article "Corporate Legal Affairs: Explanation of the Interim Draft Proposal for the Reform of the Civil Code (Law of Obligations)"
(Accounting & Auditing Journal, June 2013)
Authors: Hiroki Aoyama, Yuki Matsuda