

JAPAN'S CIVIL CODE REFORM: KEY IMPLICATIONS FOR YOUR BUSINESS

A reform to the Civil Code of Japan (the Reform) becomes effective on 1 April 2020 (the Effective Date). We have picked out three key areas which foreign investors and corporates need to be aware of: defect liability (non-latent defects may need to be compensated for; buyers may request completion or a reduction in the purchase price), guarantees (guarantees for a category of unspecified obligations by individuals must have a cap on the guaranteed amount) and assignment of receivables (restricted claims may be more easily tradable). Commercial parties need to make sure that agreements entered into on or after the Effective Date reflect these changes.

BACKGROUND

The Reform was enacted in May 2017. This is the first comprehensive set of reforms since the enactment of the Civil Code in 1896.

Although the Reform covers numerous topics, we have selected three key areas as being those most likely to be of interest to international clients, namely defect liability, guarantees and assignment of receivables.

DEFECT LIABILITY

Impact on your business

Sale and purchase agreements should provide details of criteria by which the acceptability of the asset to be sold should be assessed. This should include a detailed expected description of the asset. They should also reflect the parties' agreement on liability for completion (e.g., repair or provision of alternative assets) or reduction of the purchase price if the asset does not conform to those criteria.

Existing and new rules

Before the Reform, if a buyer found a latent defect, the buyer could claim for damages arising from the defect and/or terminate the agreement.

On or after the Effective Date of the Reform, the term "latent defect" will be deleted from the Civil Code. Instead, the seller may be liable if it provides an asset "which does not conform to the agreement". This means that even if a defect in the asset is known to the buyer, there is a possibility that the buyer may claim damages or terminate the agreement if the asset does not conform

Key issues

- Defect liability: The criteria by which the acceptability of the asset to be sold should be assessed should be provided in sale and purchase agreements.
- Guarantees: Guarantees by individuals for a category of unspecified obligations must have a cap on the guaranteed amount.
- Assignment of receivables: Assignments of restricted claims are in principle legally valid, which may enhance the tradability of receivables.

to the criteria agreed by the seller and the buyer, unless the parties agree otherwise in the agreement.

In addition, on or after the Effective Date of the Reform, the buyer may claim completion of the seller's performance (e.g., repair or provision of alternative assets) or a reduction in the purchase price, again, unless the parties agree otherwise.

Practical implications

Parties should clearly state the criteria that the asset being sold should satisfy so that conformity with these can be determined. In addition, parties should also clearly indicate in the agreement who should bear the costs if defects become apparent. From the seller's point of view, any known defects must be expressly stated in the agreement so that the asset will be transferred with the existing defect as is. From the buyer's point of view, it is important to state in the agreement that the target asset must not contain any defects and include the criteria by which the existence of any defect will be determined.

Another notable issue is how to treat representations and warranties made by the seller which respect to the asset being sold. If the seller does not want to owe an obligation for completion or reduction of the purchase price that can be triggered by law, the agreement must clearly disclaim these as remedies for breach of representations and warranties.

GUARANTEE

Impact on your business

Under the reformed Civil Code, a personal guarantee where the guaranteed obligations are a category of unspecified obligations (a Revolving Personal Guarantee) is required to set a cap on the guaranteed amount, otherwise the relevant guarantee will be void. This requirement does not apply to any guarantee provided by a corporation.

Personal guarantees are often used in residential property leasing - such as where a relative of a tenant provides a guarantee to the landlord when the tenant enters into a residential lease agreement. Therefore, this new requirement will directly affect businesses in the real estate sector. In particular, investors in residential buildings in Japan need to pay extra attention to whether the underlying lease agreements contain any personal guarantees, and if so, whether the relevant guarantees duly specify a cap, during any due diligence process conducted on or after the Effective Date of the Reform.

Existing and new rules

There is no restriction on the amount guaranteed under the current Civil Code, which means that the guarantor could be required to cover *any* obligations owed by the principal debtor to the extent required under the relevant guarantee contract. However, under the reformed Civil Code, a Revolving Personal Guarantee needs to specify the upper limit of the guarantee to be provided by a natural person, and any obligations owed by the principal debtor exceeding such limit may not be claimed from the personal guarantor.

In principle, any Revolving Personal Guarantee agreed on or after the Effective Date must comply with the new requirements under the reformed Civil Code. However, any existing Revolving Personal Guarantee executed before the Effective Date will remain effective and in full force without any cap.

In the case of a residential lease agreement, it is common for the lease agreement to be renewed between the landlord and tenant upon the expiry of the lease term with the existing guarantee given by the guarantor at the time of execution of the original lease agreement covering the tenant's obligations for the renewed lease term without any notification to or consent from the guarantor under Japanese law.

According to the Ministry of Justice's opinion on this point, any such guarantee executed before the Effective Date will be valid without a capped amount - even if the residential lease agreement is renewed between the landlord and the tenant on or after the Effective Date. On the other hand, if a new guarantee contract is agreed with the guarantor (i.e., the guarantor signs a new guarantee contract or a renewed lease agreement as guarantor) on or after the Effective Date, the new requirement under the reformed Civil Code will then apply and require the new guarantee contract for the lease to include a cap.

Practical implications

Consequently, landlords will be required to amend the guarantee provisions in their residential lease agreement forms, so that they specify a capped amount on or after the Effective Date. In addition, market participants generally expect that, in practice, an existing individual guarantor should not be included as a party to a renewed residential lease agreement if the landlord wishes to avoid the application of the new requirement under the reformed Civil Code.

Investors in real properties in Japan should be aware of the new guarantee regime in order to properly assess the value of target properties, especially in the case of acquisition of residential buildings.

ASSIGNMENT OF RESTRICTED CLAIMS – VALID OR INVALID?

Impact on your business

For the banking and finance sector, the Reform changes the rules surrounding the assignment of claims. The current Civil Code provides that an assignment of claims is in principle legally invalid if assignment is contractually prohibited. This has been considered an obstacle to securitisation or off-balance sheet financing activities. The Reform may therefore improve the liquidity of receivables. The Reform will be applicable if an assignment agreement is entered into on or after the Effective Date.

Existing and New Rules

Under the current Civil Code, an assignment of claims which are contractually prohibited from assignment (Restricted Claims) is in principle legally invalid. By exception, however, an assignment of Restricted Claims is valid vis-a-vis an assignee who did not know of the restriction and was not grossly negligent.

The reformed Civil Code has made a 180-degree turn on the principle above, to the effect that the assignment of Restricted Claims is in principle legally valid. Consequently, this reform opens the door to trading in Restricted Claims by means of assignment, pledge (*shichi-ken*) and/or security assignment (*joto-tanpo*). Nevertheless, even under the Reform, there is a risk that an assignee who knew or was grossly negligent in not knowing of a contractual restriction (an Assignee With Knowledge) may not be able to benefit fully from the assigned Restricted Claims. The reformed Civil Code allows an obligor to refuse to pay directly to an Assignee With Knowledge and to perform its obligations towards the assignor. This will not be applicable if the obligor has

not paid to the assignor for a "reasonable period of time" after the first demand made to the obligor for payment to the assignor by the Assignee With Knowledge. Therefore, the Assignee With Knowledge may not be paid in a timely manner by the obligor after the assignment and, if the obligor pays to the assignor, the Assignee with Knowledge will be exposed to the credit risk of the assignor.

Practical Implications

Assignment of Restricted Claims

Due to the risks referred to above, in practice, a prudent assignee may still wish to obtain certainty as to its title to a Restricted Claim. This is normally done by obtaining a consent letter (a Consent Letter) from the obligor on the date of assignment of a Restricted Claim addressed to the assignor and assignee providing (a) express consent to the assignment and (b) an express comprehensive waiver of all rights and counterclaims then held by the obligor in respect of the assigned claims. The Consent Letter would (i) cure a contractual breach by the assignor; (ii) perfect assignment against the obligor; and (iii) prevent the obligor from exercising against the assignee its rights / counterclaims. Regarding item (iii), a comprehensive waiver addressed to an assignee can (A) divest the obligor of its rights against that Assignee With Knowledge and (B) prevent the obligor from exercising against that assignee the rights (including set-off rights) and counterclaims it has against the assignor. Although the form of the Consent Letter is expected to be similar in function to that currently used under the current Civil Code, item (iii) has to be expressly provided for as the Reform abolishes the rule under the current Civil Code under which an obligor who consents to an assignment by not specifically asserting its counterclaim cannot exercise against the assignee any counterclaim; and therefore an express waiver is required.

Securitisation of Claims

Under the reformed Civil Code where the assignment of Restricted Claims is legally valid, Restricted Claims can be the subject of securitisation. Nevertheless, in practice, most securitisation parties may wish not to notify the obligor of securitisation and therefore would not obtain a Consent Letter from the obligor. Since an assignment of Restricted Claims without a Consent Letter constitutes a contractual breach by the assignor, parties may still want to exclude Restricted Claims from the subject of securitisation. In this sense, the Reform does not introduce dramatic favourable changes to securitisation. In an attempt to overcome this obstacle, in its commentary on the Reform, the Ministry of Justice has stated that an assignment of Restricted Claims without consent may not constitute a contractual breach, although this is dependent on the obligor's intention in restricting the assignment. The commentary also states that, even if an assignment of Restricted Claims does constitute a contractual breach, the obligor may not be entitled to terminate the underlying contract as any purported termination may constitute an abuse of rights by the obligor. While the Ministry of Justice's desire to encourage the securitisation of receivables is to be welcomed, whether this view will give sufficient certainty to market participants to allow significant expansion of the securitisation of receivables remains to be seen.

In the meantime, prudent assignees are likely to continue to seek either a representation from the assignor in the assignment agreement that the receivables being assigned do not include Restricted Claims or a Consent Letter.

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