

Japan: Civil Code reform and how it affects securitisation transactions

by Hajime Ueno, Nishimura & Asahi

PERHAPS THE BIGGEST UPDATE IN THE JAPANESE BUSINESS LAW LANDSCAPE IN 2017 IS THAT CONGRESS PASSED A BILL AMENDING JAPAN'S CIVIL CODE. THE AMENDMENT WILL BE MADE EFFECTIVE BY AN EXECUTIVE ORDER WITHIN THREE YEARS FROM THE PUBLICATION OF THE BILL (WHICH WAS JUNE 2, 2017; THE CIVIL CODE AS AMENDED THEREBY, HEREINAFTER THE "AMENDMENT").

The Amendment deals with all provisions of the Civil Code relating to contracts and claims, ranging from statutes of limitation, guarantee, power of attorney, the statutory interest rate, contractual remedies upon breaches including terminations and rescissions, transfer of claims/receivables and set-off to provisions on certain types of contracts (loan, lease, sale and purchase, sub-contract and partnership, etc.). This will be the first fundamental amendment to these provisions since the Civil Code's enactment in 1896.

This article introduces some of the amendments that have relevance to securitisation transactions.

Fraudulent transfers

Under the legal landscape of Japan, a fraudulent transfer of assets or receivables can be rescinded, voided or nullified primarily under two sets of rules: (i) a rescission of a fraudulent act under the Civil Code; and (ii) an avoidance of a fraudulent transfer under the insolvency statutes of Japan.

Under the pre-amendment Civil Code, due to historical and other various reasons, the two rules were not necessarily aligned and consistent; for example, in the case of the

avoidance regime under the insolvency statutes, there are extra sets of requirements to avoid a transfer for which adequate consideration was provided to the debtor (making it more difficult than not to avoid a transfer with adequate consideration); whilst in the case of a rescission of a fraudulent act under the pre-amendment Civil Code, there is no express provision providing for an exception even if a transfer was made with adequate consideration, giving rise to the possibility of a situation where a



Hajime Ueno, Partner
Nishimura & Asahi

tel: +81 3 6250 6275

email: h_ueno@jurists.co.jp

rescission under the pre-amendment Civil Code would be allowed when an avoidance under the insolvency statutes would not. The Amendment addresses these inconsistencies by expressly providing for certain exceptional requirements.

Transfer with adequate consideration

For a transfer of an asset for which the debtor received adequate consideration to be rescinded under the Amendment, the following additional requirements would need to be satisfied:

- (i) such act actually gives rise to a threat of a concealment, giving away (for no consideration or inadequate consideration) or other disposition harmful to the debtor's creditors by liquidation into cash or other conversion of class or type of asset;
- (ii) the debtor had the intent to conceal, give away or otherwise dispose of the asset in a manner harmful to its creditors; and
- (iii) the counterparty to the transfer, at the time of the transfer, knew the debtor's intent described in (ii).

These requirements were basically transplanted from the insolvency statutes so that the two sets of rules would be more aligned and consistent.

In the context of securitisation transactions, this feature of the Amendment should result in there being less risk in terms of fraudulent transfers, providing more stability to securitisation transactions, as long as adequate consideration is paid or otherwise given to the relevant originator.

Grant of security interest

Under the pre-amendment Civil Code, there is no express reference to a rescission of a grant of a security interest, leaving the issue, for example, of whether or not a new grant of a security interest can be rescinded, and if yes, what are the requirements to rescind the grant, open to interpretation by the judicial system; to clarify, there have been judicial interpretations allowing rescissions of newly granted security interests.

Now, not only does the Amendment expressly recognise a

grant of security interest as one type of act that can be subject to rescission, it also provides for a set of additional requirements for the rescission. The additional requirements are:

- (i) such act being done within 30 days before the day when the debtor became insolvent; and
- (ii) such act being done with the beneficiary of the act and the debtor conspiring to harm other creditors of the debtor.

Because the Amendment both follows the long-standing judicial precedent on the issue, on the one hand, and transplants the line of thinking behind the requirements under the insolvency statutes, the requirements for rescission under the Amendment are now more stringent (i.e. less easy to rescind) than the insolvency statutes.

In the context of securitisation transactions, this feature of the Amendment should result in there being less risk in terms of fraudulent transfers, allowing more stability to securitisation transactions, as long as there is no conspiracy between the debtor (i.e. the relevant originator) and the beneficiary (i.e. the relevant secured creditor who was granted the security interest) to harm the other creditors.

Effect of rescission

Under the letter and the interpretation of the pre-amendment Civil Code, the effect of a rescission is construed as not extending to the debtor; the effect of rescission is recognised only between the party who exercised the right of rescission of the fraudulent act and the beneficiary of the act. As a result, the beneficiary is regarded as not having a statutory right to the consideration it provided to the debtor even if the beneficiary returned the subject matter/asset or paid the amount equivalent to the subject matter/asset.

The Amendment now expressly provides that the beneficiary will have the right to claim for the return of the consideration it paid or delivered to the debtor in exchange for the subject matter/asset affected by the rescission.

Transfers of claims/receivables

Ban on contractual restriction/prohibition

Different from the regime under the pre-amendment Civil Code, the Amendment will provide that, irrespective of any contractual provision that prohibits or restricts a transfer of a right, receivable or claim thereunder, a transfer of a right, receivable and/or claim will be valid and effective.

The residual exception from the pre-amendment Civil Code, however, remains with respect to bank deposits; namely, as with the rule under the pre-amendment Civil Code, a bank, i.e. an obligor to a bank deposit refund claim, will be able to assert against any transferee who is aware, or who failed to become aware due to gross negligence, of the contractual prohibition/restriction, that the relevant transfer of the bank deposit refund claim is invalid and thus that no effective transfer took place.

In terms of securitisation transactions, therefore, where the transaction structure calls for a transfer of or collateralisation of a bank deposit, the relevant obligor bank's consent to the transfer/collateralisation of the deposit will remain a necessary factor. Just to be clear, in Japan, except for transferable deposit claims, virtually all bank deposits' terms and conditions contain restrictions/prohibitions on transfer.

Protections available to obligors and transferees – balancing the interests

Notwithstanding the ban on contractual restrictions/prohibitions of transfer as described above, in order to allow the obligors' interest in not allowing any new party to become the counterparty to the contract, the Amendment now provides certain protections for the obligors. That is, if the transferee is aware, or failed to become aware due to gross negligence, of the contractual prohibition/restriction, then:

- (i) the obligor is allowed to decline to payment to the transferee; and
- (ii) the obligor may also assert defences that work to discharge the transferred right, receivable or claim.

To counter-balance the interests of transferees against the

protection made available to obligors as noted above, there are two notable protections made available to transferees (who were aware, or who failed to become aware due to gross negligence, of the contractual prohibition/restriction of transfer):

- (i) the first such protection is the rule that once the obligor fails to abide by its obligation after the transferee demands performance of the obligation with an adequate term to perform, the obligor will lose its ability to assert its defenses described above; and,
- (ii) the other protection made available is the right to demand the obligor to make a deposit with a competent governmental agency (namely a legal affairs bureau) in the amount that satisfies the relevant claim upon the bankruptcy (*hasan*) of the relevant transferor, thus, protecting the transferee from the bankruptcy risk of the transferor.

Note, however, that the second protection is extended to transferees only when the relevant transferor becomes subjected to bankruptcy (*hasan*), which is a liquidation-type insolvency proceeding in Japan, and not when the relevant transferor becomes subjected to other types of insolvency proceedings such as corporate reorganisation (*kaisha kosei*) proceedings or civil rehabilitation (*minji saisei*) proceedings, which are reorganisation-type insolvency proceedings.

The ban on contractual restrictions and prohibitions on the transfer of claims/rights/receivables under the Amendment is introduced with an aim to allow more transfers of claims/rights/receivables to be made in business transactions, including financing with claims/rights/ receivables transferred as collateral. However, practitioners are somewhat sceptical in terms of the impact the Amendment would have on the business arena, due mainly to the fact that there remain protections made available to the obligors and that the protections made available to the transferees might not be sufficient to lure transaction parties to deal with claims/rights/receivables that are subject to contractual restrictions/prohibitions of transfer.

NISHIMURA & ASAHI



Nishimura & Asahi provides efficient legal services with high added value, particularly for projects that require an ability to traverse multiple specialized areas, cutting-edge projects that require a high level of expertise, and projects that require immediate action.

TOKYO
NAGOYA
OSAKA
FUKUOKA
BANGKOK
BEIJING
SHANGHAI
DUBAI
HANOI
HO CHI MINH CITY
JAKARTA*1
SINGAPORE
YANGON
HONG KONG*2

*1 ASSOCIATE OFFICE

*2 AFFILIATE OFFICE

WWW.JURISTS.CO.JP

Abandoning the “deemed waiver” regime

Under the pre-amendment Civil Code, if an obligor consents to a transfer of a claim/right/receivable (whether or not the transfer was contractually restricted/prohibited) without noting an objection, or citing, asserting or referring to its defences, then the obligor will no longer be able to assert any of its defences or claims that it had or would have had against the transferor (had there not been any transfer). Therefore, in short, under the pre-amendment Civil Code, obligors are deemed to have waived all of the defences and claims that it had or would have had against the transferor upon consenting to the transfer unless the obligor expressly reserves its defense and/or claim against the transferor.

Answering the criticism that the pre-amendment Civil Code places too much emphasis on protecting transferees at the cost of the obligors, the Amendment abandons the deemed waiver regime and requires the obligors’ express waiver of their defences and claims in order for the obligors to lose their ability to assert against the transferees their defences or claims that they had or would have had against the transferors.

How this change under the Amendment will affect or impact securitisation transactions remains to be seen, but similar to the concern that some practitioners have of the potential chilling effect that this change may have on claims/rights/receivables transfer transactions in general, the underlying obligors’ psychological hurdle could be higher to expressly waive its defences and/or claims and it could be high enough to result in having a chilling effect on securitisation transaction structures that would have been successfully concluded if the “deemed waiver” regime was intact.

Transfer of future receivables

Unlike the pre-amendment Civil Code, the Amendment will expressly provide that transfers of future receivables are permissible; under the pre-amendment Civil Code, the issue was left to the interpretation of the statute and there were judicial precedents recognising transfers of future receivables. However, this is only taken into account provided that under the Amendment issues, such as which transfer of a future receivable or business transfer

transaction would take priority or what would happen when the transferor enters into bankruptcy after it effected a transfer of future receivables, would be left to the interpretation of the statute.

One issue that will be expressly provided for under the Amendment is, what happens when a contractual restriction/prohibition of transfer is effected subsequent to a transfer of a future receivable: the Amendment provides that, if the obligor and the transferor effects a contractual restriction/prohibition of transfer after the transfer but before the perfection against third parties in terms of when the transfer is obtained, then the transferee (and other third parties) will be statutorily deemed as being aware of the contractual restriction/prohibition, thereby allowing the protections made available to the obligor, as described above, to kick in.

Transfer of contracts

Under the pre-amendment Civil Code, there is no statutory recognition of a transfer or assumption of a contract. In various fields of business practice in Japan, however, there have been numerous transactions that involve the transfer/assumption of a contract where a party to the contract transfers the contract to a third party with the consent(s) of the other party (or parties) to the contract.

To recognise long-standing practices in the business field, the Amendment now recognises transfers/assumptions of contracts. And, expectedly, the Amendment provides that a transfer/assumption of a contract would require the remaining party to the contract to consent to the transfer for the transfer to become effective.

However, nothing else is provided for even under the Amendment.

Statutes of limitation

General rule

Under the pre-amendment Civil Code, unless a claim falls in any of the classes of claims for which exceptions are provided for, it will be subject to the general statute of

limitation, which is 10 years from the time the claim can be exercised. The Amendment will adopt a two-prong approach. The general statute of limitation will now be:

- (i) *subjective standard*: five years from the time the claimant became aware of the fact that the claim can be exercised; and
- (ii) *objective standard*: 10 years from the time the claim can be exercised.

Exceptions

With respect to the exceptions under the pre-amendment Civil Code providing for shorter periods for statutes of limitation than the general class of claims, the Amendment will abolish those exceptions. However, not all classes of claims will be subject to the general statute of limitation because:

- (i) tort claims will be subject to a separate statute of limitation; and
- (ii) a new exception involving personal injury and death claims as well as pension claims and certain other periodic payment claims will be subject to a longer period of statute of limitation.

Standstill agreement

Under the Amendment, there now will be a statutory ground to temporarily halt the running of the period

for the statute of limitation if the claimant and the debtor enter into a standstill agreement. This will allow claimants not to file for “just-in-case precautionary” lawsuits when discussions and negotiations are on-going with the standstill agreement in place. Under the pre-amendment Civil Code, because there is no statutory ground for a temporary halt, occasionally, claimants would have to file for “just-in-case precautionary” lawsuits despite continued discussions and negotiations, which are expected to become unnecessary so long as parties succeed in entering into standstill agreements.

This would allow, for example, servicers of securitised assets to more effectively utilise standstill agreements without commencing “just-in-case lawsuits” as a precautionary measure.

Contact us:

Nishimura & Asahi

Otemon Tower, 1-1-2 Otemachi, Chiyoda-ku

Tokyo 100-8124, Japan

tel: +81 3 6250 6200

web: www.jurists.co.jp/en/