

Client Alert

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Civil Code amendments affecting real estate transactions

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Civil Code amendments affecting real estate transactions - Volume One

Overview

The Civil Code of Japan, one of the major Japanese codes covering real estate, contract and tort law, family law and inheritance law, is due to undergo significant amendment in 2020.

The amendments to the Civil Code, which are due to come into effect on April 1 next year, are of a magnitude not seen since the Civil Code was first enacted 120 years ago.

The majority of the amendments are intended to codify case law principles which the courts have adopted since enactment and are expected to help modernize the Civil Code. However, a few amendments vary or update existing case law principles.

The amendments are also intended to update the language and terminology of the Civil Code in order to make the Code more accessible to non-lawyers.

This client alert is the first in a series in which we outline the key amendments to the Civil Code which will have an impact both broadly and specifically on real estate investments and transactions. In this alert, we provide an overview of the key changes and in subsequent alerts, we examine in greater detail amendments affecting specific real estate transactions including:

- real estate purchase and sale agreements,
- real estate lease agreements, and
- construction agreements.

This alert also provides an overview of amendments to general provisions of the Civil Code such as the statute of limitations, statutory interest rate, termination rights, and transitional measures (grandfathering). In this alert and subsequent alerts in this series, the Civil Code, as amended, is referred to as "the Amended Civil Code".

Real Estate Purchase and Sale Agreements

The most important change introduced by the Amended Civil Code affecting the sale and purchase of real estate is the change to the warranty against defects.

Under the current Civil Code, if there is any "latent defect" in the subject property, a buyer under a contract for the purchase and sale of real estate is entitled to demand that the seller compensate it for loss or damage (excluding lost profit) as a result of the defect, and to terminate the purchase and sale agreement.



Under the Amended Civil Code, a property defect no longer has to be "latent" for the buyer to be able to claim compensation. The seller is responsible for any defect (referred to as "non-conformity" under the Amended Civil Code) even if the buyer knew of the defect at the time it entered into the purchase and sale agreement. In addition, the buyer can seek the following remedies for breach of this warranty:

- to demand performance so that the property conforms to the applicable contractual term, such as the repair of the property;
- to demand damages;
- to terminate the contract; and
- to demand a reduction of the purchase price.

Volume 2 of this alert series examines this and other changes impacting purchase and sale agreements in further detail.

Real Estate Lease Agreements

Under the Amended Civil Code, to facilitate sale and lease-back transactions, the consent of existing tenants is no longer required in order to change their "direct leases" into "sub-leases."

In addition, the Amended Civil Code contains new provisions regarding (i) the extent of the lessee's obligation to restore or "make good" the premises at the end of lease term, and (ii) the lessor's obligation to refund the security deposit.

Volume 3 of this alert series examines these and other changes impacting lease agreements in further detail.

Construction Agreements

The Amended Civil Code contains a "liability for non-conformity" provision applicable to construction agreements that is similar to the liability for non-conformity provision applicable to purchase and sale agreements.

In addition, the Amended Civil Code contains new provisions regarding (i) the contractor's right to receive partial payment for the contract price in the event of termination of a construction agreement, and (ii) the owner's right to terminate a contract for building construction.

Volume 4 of this alert series examines these and other changes impacting construction agreements in further detail.

General Provisions

Statute of Limitation (*shoumetsu jikou*)

Limitation Period. Under the current Civil Code, the limitation period varies depending on the type of claim or cause of action. For example, the limitation period for a claim that arises from a commercial transaction is five (5) years from the due date for performance while the general limitation period is ten (10) years except for certain claims, such as a claim in relation to the contract



price under a construction agreement (the limitation period for this type of claim being three (3) years).

Under the Amended Civil Code, the limitation period for any contract claim is the earlier of (i) five (5) years from the day on which the claimant becomes aware that it has a claim, or (ii) ten (10) years from the day on which the claim becomes payable. There is a separate limitation period for tort claims.

Statutory Interest Rate

New Statutory Interest Rate. The statutory interest rate under the current Civil Code is generally five percent (5%) and six percent (6%) if the claim arises from a commercial transaction. The statutory interest rate will apply, for example, to a loan transaction as the default interest rate unless otherwise agreed by the parties.

The statutory interest rate has significantly deviated from the market interest rate in Japan over the last several decades.

However, under the Amended Civil Code, the statutory interest rate is reduced to three percent (3%).

Review and Further Amendment of Statutory Interest Rate. The statutory interest rate will be reviewed every three years and if the statutory interest rate varies 1% or more from the market interest rate calculated based on the average market interest rate for short-term loans for the preceding five years, the statutory interest rate will be amended (but without retroactive effect for existing claims).

Termination Right

Termination for reasons not attributable to the non-performing party. Under the current Civil Code, a party cannot terminate a contract for delay in performance or failure to perform unless such delay or failure is attributable to the counterparty to the contract.

For example, if a manufacturing plant is destroyed by a natural disaster or similar event and the manufacturer/supplier is unable to fulfill its delivery obligations under a purchase and sale contract for an extended or indefinite period, the purchaser cannot terminate the agreement unless the manufacturer/supplier agrees to the termination.

Under the Amended Civil Code, however, a party (the purchaser in the example above) can terminate the contract even if the failure to perform is not attributable to the other party.

Transitional Measures

Contracts. In general, the current Civil Code will continue to apply to contracts entered into on or before March 31, 2020 until the contract expires. The Amended Civil Code will apply to all contracts entered into on or after April 1, 2020.

However, it is not clear whether a contract entered into before April 1, 2020 but renewed after that date will be subject to the Amended Civil Code. The Japanese Ministry of Justice has published its view on several specific cases.



For example, if a building lease agreement is entered into in December 2019, and expires in December of 2021 and a dispute arises between the parties with respect to the refund of security deposit, the current Civil Code will apply to any interpretation of the relevant contract provisions and resolution of the dispute. However, if a contract, such as a lease agreement or a guarantee agreement, is executed prior to April 1, and then renewed after that date by mutual agreement, the Amended Civil Code will apply to the renewed contract.

Limitation Period. For any claim made prior to April 1, 2020, the limitation period will be the limitation period provided under the current Civil Code. For example, if a construction agreement is executed in December 2019, the short limitation period, i.e., three years, will apply to any claim for the contract price. However, this excludes any claim based on tort which is subject to different rules.