Items to be discussed for the Civil Code (law of obligations) reform (5)

Part I. Payment

1. General discussion

Upon reviewing provisions on payment, first, it is necessary to consider whether the most basic rule that an obligation is extinguished through payment should be stipulated or not (*see,* 2). In addition, it is considered that provisions from the Civil Code Articles 474 to 504 need to be clarified clause-by-clause based on the trend of case law and practice. What kind of points should we need to consider in overall review of provisions on payment?

2. Effects of payment

While it is one of the most basic rules that a claim is extinguished through payment, there is no provision stating that effect. There is a view that such basic rule should be clearly stated in the text of law.

(Related issues)

1 Relationship between payment and performance

As to the relationship between payment and performance, it is theoretically explained by a dominant view that they see the same thing from a different point of view: performance expresses the aspect of realizing content of an obligation from the conduct of the obligor; whereas payment expresses the aspect of extinguishing a claim. There is a view that expression of provisions should be arranged through using the terms of payment and performance separately based on this view.

2 Relationship between satisfaction (dividend) through civil enforcement proceedings

It is pointed that, under the current law, the relationship between satisfaction through civil enforcement proceedings such as dividend (hereinafter “dividend”) and payment is unclear. Accordingly, there is a view that it should be clearly stated in a provision that dividend is also payment.

3. Payment by a third party (CC Art.474)

(1) Relationship between “interest” and “legitimate interest”

Under the current Civil Code, the relationship between the third party with “interest” who can make payment (CC Art.474 (2)) and “a person who has legitimate interest” who can automatically substitute the obligee upon payment (statutory subrogation)(CC Art.500) is unclear. There is a view that it is unnecessary to use

terms differently for qualifications of a third party who can make payment even contrary to the intention of the obligor and of a party who can assert statutory subrogation.

(2) Payment by a third party without interest

Under the current Civil Code, when payment by a third party who has no interest in the obligation conflicts with the intention of the obligor, that payment becomes void (CC Art.474 (2)). However, it is pointed that, respect for the obligor's intention, which is regarded as one of the reason for this provision, is not necessarily inevitable, and the obligee who does not know that the payment is contrary to the obligor's intention may suffer unexpected disadvantage. Accordingly, there is a view that payment by a third party who has no interest in the obligation should be effective with the condition that the payer under such condition should not obtain the right of reimbursement vis-à-vis the obligor.

4. Recovery of a thing delivered to perform obligation (CC Art.478-480)

While provisions of Articles 475 to 477 are the articles about recovery of a thing delivered as payment, there is a view that Article 476 should be deleted because the scope of its application is generally limited to substitute payment and it has little significance.

5. Payment to a third party other than the obligee (CC Art. 478-480)

(1) Effectiveness of payment to a third party without authority to receive payment

While the current Civil Code has a provision about payment to a third party who has no authority to receive payment (CC Art.478-480), there is no provision on when the third party has the authority to receive payment. A view is proposed that a provision should be stipulated on that effect because a practice which one gives a third party the authority to receive payment and let him or her to receive payment (substitute receipt) is broadly used and performs an important function in business.

(2) Payment vis-à-vis a quasi-possessor of a claim (CC Art. 478)

A. Requirement of "quasi-possessor of a claim"

It is pointed that the requirement of "quasi-possessor of a claim" under the Civil Code Article 478 is uneasy to understand in the first place. In addition, another problem is pointed that in substance the purpose of Article 478 is different from the Civil Code Article 205 on quasi-possessor of property rights, and thus it is required to interpret these provisions differently on the point whether so-called an agency of the obligee is included in this term. Accordingly, a view is proposed that the language of "quasi-possessor of a claim" under Article 478 should be reconsidered in order to

clarify the scope of application of this provision.

B. Requirement of without knowledge and negligence

Article 478 of the Civil Code requires that the payer makes payment without knowledge and negligence in order to make payment to a quasi-holder effective. As to this requirement of without knowledge and negligence, the case law considers, about a case of repayment through a method of payment by a bank book machine, not only existence of negligence at the time of repayment but also existence of negligence in installation management of the machine payment system. It is understood that the conclusion of this case law is supported by the theory, too. Accordingly, in order to make such case law theory readable from the text of law, a view is proposed that the language of without knowledge and negligence should be reconsidered.

(Related issues)

Necessity of a ground attributable to the obligee

In reviewing the provision of Article 478, a problem arises as to which of the following views should be adopted on whether a ground attributable to the obligee on appearance of the other party, making it as if it has the authority to receive payment, should be an independent requirement:

[Proposal A] A ground attributable to the obligee should be an independent requirement.

[Proposal B] A ground attributable to the obligee should not be an independent requirement.

(Related issue under (2))

Article 478 of the Civil Code is a provision on payment. However, compared to the time of legislating the Civil Code, financial transactions have become diversified and complex. Accordingly, there are transactions which are similar to payment economically but not exactly payment itself. Then there arises a problem on whether the scope of application of Article 478 should be expanded to conduct other than payment in order to regulate such transactions.

(3) Payment vis-à-vis a bearer of receipt (CC Art. 480)

Article 480 of the Civil Code is a special provision of Article 478 on payment vis-à-vis a bearer of receipt, and imposes the obligee the burden of assertion and proof on subjective requirement (bad faith or existence of negligence). One view is asserted on this provision that it is doubtful if there is a necessity to have a special provision only for payment vis-à-vis a bearer of receipt. Accordingly, a view is proposed that Article 480 should be deleted.

6. Substitute payment (CC Art. 482)

There is theoretical debate on legal nature of substitute payment to the point whether it is a contract requiring a thing or a consensual contract. While it is pointed that case law is consistent with the view of a consensual contract, case law does not clearly decide this point. There is a view that it is desirable to clarify its legal nature and arrange provisions on its requirements and effects, because there are unclear points as to its requirements and effects owing to unclearness of its legal nature. In addition, it is stated that, considering the fact that in practice substitute payment is used in transactions for the purpose of security such as reservation of substitute payment, it is consistent with practice and case law to understand substitute payment as a consensual contract and to recognize the duty to provide a substitute clearly. Accordingly, a view is proposed that a provision on its requirements and effects should be arranged making substitute payment a consensual contract.

(Related issues)

1 Admissibility of demanding performance of the original obligation after agreeing to substitute payment

It is considered that, while an obligation to provide a substitute arises upon an agreement to substitute payment through adopting a view that substitute payment is a consensual contract, the original obligation is not extinguished until provision of the substitute has actually made. There are following views as to admissibility of demanding performance or performing of the original obligation under such condition:

> [Proposal A] Until performance of the duty of providing a substitute has made, the obligee can demand performance of the original obligation and the obligee can extinguish the claim through performing the original obligation.
>
> [Proposal B] After a duty to provide a substitute accrues, the obligor can exercise the right of defense vis-à-vis the obligee who is demands performance of the original obligation, and the obligor himself or herself cannot perform the original obligation.

2 Admissibility of substitute payment by a third party

Article 482 of the Civil Code provides that “the obligor” can make substitute payment but does not clearly state whether a third party other than the obligor can make substitute payment. It is generally considered that Article 474 is applied to substitute payment, and accordingly a third party other than the obligor can also make substitute payment as long as he or she satisfies the requirement under Article 474. Thus, a view is proposed that this effect should be also stated in the text of law.

7. Provisions on content of payment (CC Art. 483-487)

(1) Delivery of specific thing in its existing state (CC Art.483)

While Article 483 of the Civil Code is a provision stipulating that, if an obligation is delivery of a specific thing, such thing should be delivered on “as is” basis of the time when the delivery is due, it is pointed that there is few cases where this provision becomes an issue and its importance is not necessarily high. In addition, this provision is sometimes understood as stipulating the duty of delivering the thing not as of the time of due but as of the time of delivery. Based on this understanding, some consider this provision as a ground for statutory liability theory on warranty against defects (CC Art.570). There is a criticism on such understanding stating that it misunderstands the content of Article 483. Accordingly, a view is proposed that Article 483 should be deleted because it creates harmful effects like this in addition to its little meaning of existence.

(2) Provision on place, time etc. of payment (CC Art. 484)

The current Civil Code only stipulates Article 484 as a provision on the place and time of payment. In the Commercial Code, there is a provision on time on which payment should be made (Article 520, Commercial Code), but the content of this provision is not necessarily special to commercial transactions but generally applicable to civil transactions. Accordingly, a view is proposed that a provision on general civil rule equivalent to Article 520 of the Commercial Code should be stipulated in the Civil Code.

(3) Treatment of receipt and claim instrument (CC Art. 486, 487)

Under the current Civil Code, a person who makes payment is granted the right to demand delivery of receipt and the right to demand return of claim instrument (CC Art. 486, 487). While it is considered that delivery of receipt and performance of the obligation should be performed at the same time, it is interpreted that with the relationship to return of the claim instrument, performance of the obligation should come first. Accordingly, a view is proposed that such interpretation under the current law should be clearly stated in the text of law.

8. Appropriation of performance (CC Art. 488-491)

While there are Articles 488 to 491 on appropriation of performance under the current Civil Code, it is pointed that its content is not necessarily clear from these provisions. For example, while Article 491, which stipulates the order of appropriation where principal, interest, and expenses are to be paid, is understood under case law and the theory that it rejects application of Article 488, which stipulates designation of appropriation, that effect is not necessarily clear from the language of

the provision. In addition, it is debated, about cases where the order of appropriation among expenses, interests, or principals is at issue, whether designation of appropriation is available because Article 492 (2) only applies mutatis mutandis to Article 489 (statutory appropriation) and does not apply to Article 488 (designation of appropriation). Based on these issues, a view is proposed that Articles 488 to 491 should be reviewed in a direction to clarify regulation on appropriation of payment.

(Related issues)

Application of provisions on appropriation of payment of dividend of proceeds in the civil enforcement procedure

There is an issue whether provisions on appropriation of payment are applied when dividend of the proceeds through execution or enforcement of security interests is not enough to extinguish all claims which one obligee possesses. Especially, whether provisions on appropriation based on an agreement or designated appropriation (CC Art. 488) are applicable is debated. Accordingly, one view is proposed that this point should be clarified in the text of law.

9. Rendering of performance (CC Art. 492-493)

In cases where the obligee does not receive payment even though the obligor renders it (delay of acceptance), case law and the theory understand that there arises various effects such as extinguishment of the obligee's defense of simultaneous performance, reduction of the duty of care in delivery of a specific thing, imposition of increased costs on the obligee, transfer of risks when the subject matter is extinguished. However, the current Civil Code merely provides, as an effect of delay of acceptance, that "the relevant obligor shall be responsible for the delay on and after the time of the tender of the performance," whereas it provides, as an effect of tender of performance, that "the relevant obligor shall be relieved from any and all responsibilities which may arise from the nonperformance of the obligation." Accordingly, it is pointed that concretes effect of the tender of a performance and the delay of acceptance of such performance are unclear from the text of law. Therefore, a view is proposed that, based on such suggestions, concrete effects of the tender of a performance should be clearly stated in the text of law with maintaining consistency of the provisions on delay of acceptance.

(Related issues)

Clarification of cases where even an oral tender is not necessary

Article 493 of the Civil Code provides that there are two methods of tendering a performance; an actual tender and an oral tender. However, case law acknowledges that even an oral tender is unnecessary when the obligee manifests an intention of rejection such

as by denying the existence of the contract itself. Accordingly, there is a view that this idea under the case law should be clearly stated in the text of law.

10. Deposit of subject matter of payment (deposit of performance) (CC Art. 494-498)

(1) Clarification of requirements and effects of deposit of performance

It is pointed that the requirements and effects of deposit of performance under the current Civil Code is unclear. For example, while Article 494 of the Civil Code provides the ground for such deposit, case law requires deposit of performance by the obligor for the deposit caused by rejection of receipt by the obligee. However, such requirement is not clearly stated in the provision. In addition, there is a debate over legal relations during the performer once deposits a property and his or her right to recover the property is extinguished because it is provided that the performer can recover the deposited property as long as the obligee does not accept the deposit, or the judgment which pronounces that the deposit is effective does not become final even though deposit has an effect to extinguish the claim concerned. Further, it is pointed that, while deposit has an effect that the obligee obtains the claim to refund the deposited property, such basic legal relation of deposit is not necessarily clear from the text of law. Based on such suggested points, there is a view that provisions on deposit should be reformed in the direction to clarify the requirements and effects of deposit of performance.

(2) Expansion of requirements of self-help buyout

Under the current Civil Code, when the subject of performance (1) is not suitable for deposit, (2) is likely to suffer any loss or damages, or (3) requires excessive expenses for the preservation, the performer may obtain permission of court to sell such property at public auction and deposit the proceeds of such sales (CC Art.497). It is understood that the requirement under (1) is satisfied when the subject of performance is a thing other than money or negotiable instruments and there is no prospect to appoint an appropriate custodian in reality. There is a problem, however, that, in order to meet such condition, it takes a long time. Accordingly, it is considered that, in cases of deposit of a thing, it is desirable to admit deposit of the dividends through self-help buyout because there is low potential to obtain appointment of appropriate custodian in reality.

(Related issues)

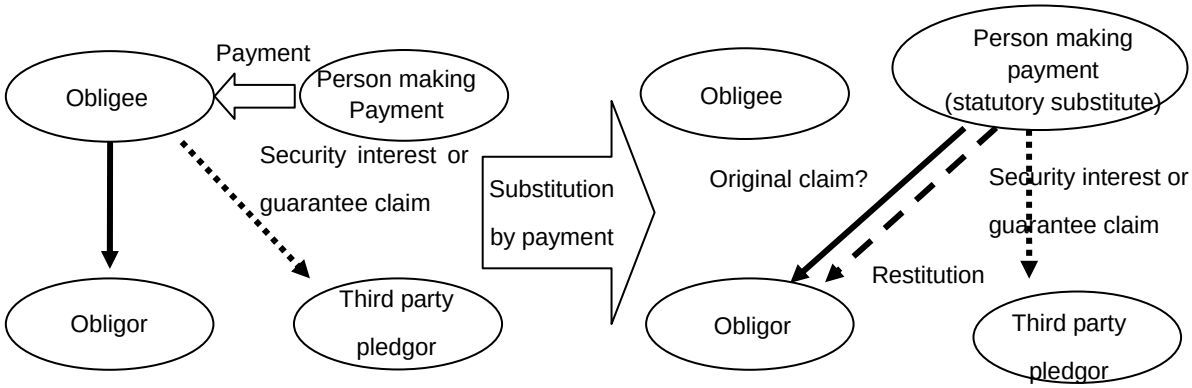
Necessity to reconsider “likely to suffer any loss or damage”

Article 497 of the Civil Code admits deposit of the proceeds of public auction through self-help buyout when the subject of performance is “likely to suffer any loss or damage.” It

is, however, pointed that self-help buyout should be admitted to things of which the market price actively changes and the value collapses if left untreated, even when the value of the substance itself is not deteriorated.

Accordingly, a view is proposed that the requirements for self-help buyout should be reconsidered so that it is admitted even in the occasions stated above.

11. Subrogation through payment (CC Art. 499-504)



(1) Review of voluntary subrogation

Under the current Civil Code, when a person other than those who are granted statutory subrogation makes a payment, such person can subrogates to the claim of the obligee by acquiring the acknowledgment of the obligee for the purpose of promoting payments through third parties. (Art.499) There are some criticisms on this system of voluntary subrogation such as that it is not consistent with the Civil Code Article 474 (2) which restricts payment by a third party, and that requiring an acknowledgment of the obligee would result in a situation where the obligee receives a payment but the payer could not subrogate the obligee if the obligee does not agree with the subrogation. In addition, it is also pointed out that this system may be used for the purpose of escaping the regulation by a special provision prohibiting transfer of the claim because the effect of such special provision does not reach the payer who exercises the original claim, understanding in a way that the payer can exercise the original claim upon voluntary subrogation.

Considering these criticisms, there is a view that the system of voluntary subrogation itself should be reconsidered. There are the following proposals as a way of reviewing the system concretely.

[Proposal A] The system of voluntary subrogation should be abolished.

[Proposal B] The requirement of acquiring acknowledgment from the obligee

should be omitted.

(2) Clarification of effects of subrogation through payment

A. The consequence of the original claim when the payer subrogates the obligee

Under the current Civil Code, a person who subrogated to the claim of the obligee through payment can exercise the original claim and its security interest within the scope of the reimbursement right (Art.501). Case law explains about the consequence of the original claim in such a case that the original claim is transferred to the payer. Although not small number of people support this view of case law, it is pointed out that a complex legal relationship arises because two rights – i.e., the original claim and the reimbursement right – belongs to the payer and further issues arise such as the appropriation relationship between the two claims and whether the effect of interruption of prescription regarding one claim reaches the other claim. Based on such indication, one view is proposed that the idea that the original claim is transferred to the payer should be changed and the original claim should be regarded as having been extinguished through payment even when the payer subrogates the obligee.

B. Clarification of provisions on the relationship among statutory substitutes.

Article 501 of the Civil Code stipulates provisions on the relationship among statutory substitutes in item 1 to 5. There are, however, ambiguities about the following relationships: (1) the relationship between a guarantor and a third acquire (occasions where additional registration is required in order for the guarantor to subrogate the obligee against the third party); (2) regulation among guarantors when there are multiple guarantors; (3) the relationship between a third party pledgor and a third party who is transferred the subject matter of security interest; (4) treatment of a person who is a guarantor as well as the third party pledgor; and (5) treatment of a person who acquired the subject matter of security interest from a third party pledgor. Case law and theories have supplemented such ambiguities. Accordingly, a view is proposed that these ambiguities should be clarified as much as possible in the text of law.

(Related issues)

1. Effect of an agreement to alter proportion of subrogation

There is an occasion where a special provision is formed among statutory substitutes to the effect that proportion of subrogation under Article 501 is altered. Case law states that such a special provision can be asserted against a lower-rank mortgagee. Accordingly, there is a view that this understanding of case law should be clearly mentioned in the text of law.

2. Relationship between a third party pledgor and a lower-rank mortgagee

When a joint mortgage is set on immovable property X which a third party pledgor owns and immovable property Y which the obligor owns, and a lower-rank mortgage is set on the immovable property X, if X is auctioned through exercise of the mortgage on immovable property X and the proceeds from the sale fully covers a prioritized secured claim, the third party pledgor who becomes to make payment of an obligation of others through such a proceeds can exercise the mortgage on immovable property Y by subrogation through payment. However, a lower-rank mortgagee of immovable property X suffers disadvantage in such a case if the third party pledgor is able to receive prioritized payment through exercising the mortgage on immovable property Y based on subrogation, compared to a case where immovable property X and Y are auctioned at the same time (it is considered that the proceeds of sales from immovable property Y is first appropriated to the secured claim of the joint mortgage). Accordingly, there is a problem whether the lower-rank mortgagee or the third party pledgor can receive prioritized payment from the mortgage on immovable property Y. Case law decides on this issue that the lower-rank mortgagee receives prioritized payment, and therefore there is a view that this case law theory should be clearly stated in the text of law.

(3) Review of the requirement of subrogation through partial payment

Under the current Civil Code, if any performance by subrogation occurs with respect to a part of a claim, the substitute can “exercise his or her right together with the obligee” (Art. 502 (1)). There is a debate whether the substitute can exercise security interest by oneself. While there is an old case which admits the substitute exercising security interest alone, there is a strong criticism against the conclusion of this case decision such as that it deviates from the purpose of the subrogation system – i.e., protection of the right of reimbursement – and imposes disadvantage on the obligee. Accordingly, a view is proposed that, in case of subrogation through partial payment, it should be clearly stated in the text of law that the substitute cannot exercise security interest without joint exercise of such right by the obligee.

(Related issues)

Availability of exercising a right by the obligee alone

Article 502 (1) of the Civil Code merely stipulates that the substitute can exercise a right “together with the obligee.” Thus, it is unclear whether, in case of subrogation through partial payment, the obligee can still exercise a right such as security interest. A view is proposed on this point that a provision stating the obligee can exercise a right alone should be stipulated.

(4) Review of the effect of subrogation through partial payment

While a substitute through partial payment can “exercise his or her right together with the obligee in proportion to the value of his/her performance” (Art. 502 (1)), it is unclear from the language of the law whether the obligee or the substitute receives prioritized payment from the dividend of secured real property. Case law states that the obligee is prioritized, and the theory also supports this conclusion. Accordingly, a view is proposed that this case law theory should be clearly stated in the text of law.

(Related issues)

Relationship between the original claim of the obligee and the reimbursement right of the guarantor when a guarantee obligation is partially performed

The guarantor acquires, through performing a part of a guarantee obligation, the right to reimbursement as well as becomes able to exercise the original claim and its security interest by subrogation through partial performance (hereinafter, “the reimbursement rights” for the right of reimbursement and the original claim and its security interest acquired from subrogation). In such a case, while there is no provision regulating the relationship between the reimbursement rights which the guarantor acquires and the original claim which the obligee holds, a view is asserted that the reimbursement rights is subordinated to the original claim, and the guarantor cannot exercise the reimbursement rights until the obligee receives full amount of performance for the original claim.

(5) Obligation of the obligee

The current Civil Code states obligations of the obligee relating to subrogation through payment such as an obligation to deliver the claim instrument and security interest of the obligee who receives full payment, and an obligation to enter subrogation into the claim instrument of the obligee who receives partial payment (Art.503). In addition, it is understood that there is an obligation to cooperate with entering subrogation into registration when there is a mortgage, and that Article 504 is a provision stipulating the obligation to preserve security. Accordingly, a view is proposed that these obligations which are acknowledged by construction should be clearly stated in the text of law.

(Related issues)

1. How the provision on the obligation to preserve security interests should be

It is pointed out, especially from the stance of bank practice, that the content of Article 504 is not reasonable. Based on such indication, a view is proposed that the provision should be reviewed in a direction that the obligee is discharged from the responsibility of violating the obligation to preserve security interest when there is a reasonable ground such as by stipulating, for example, that when security interest is lost or reduced “without a reasonable

ground in the course of ordinary trade with intent or negligence," the statutory substitute is discharged.

2. Scope of the effect of exclusion of liability by violation of the obligation to preserve security interests

It is unclear from the text of law whether a third party who transferred mortgaged immovable property from a third party pledgor or a third party acquirer after the obligee loses security interest violating the duty to preserve security can assert against the obligee the effect of discharge based on violation of the duty to preserve security. Case law decides on this point that, when the obligee intentionally or negligently loses or reduces security interest, all or part of the responsibility imposed on mortgaged immovable property is automatically extinguished to the extent that the obligee becomes unable to receive reimbursement through such loss or reduction based on Article 504, and the effect of extinguishment of the responsibility is not affected by transfer of immovable property to a third party. Accordingly, a view is proposed that this case law theory should be clearly stated in the text of law.

Part II. Set-off

1. General discussion

On reviewing provisions of set-off, it is necessary to clarify provisions based on case law theories and to consider availability of set-off by a third party (*See,* 2.) as well as appropriateness of the scope of which set-off is prohibited (*See,* 4.). It is also necessary to consider whether retroactive effect should be granted to the effect of set-off (*See,* 3.). Furthermore, it is necessary to discuss issues such as the relationship between statutory set-off and attachment with regard to adjusting interests between a person who has the right to set-off and expectation about the function of set-off as security and other claim holders (*See,* 5 and 6.).

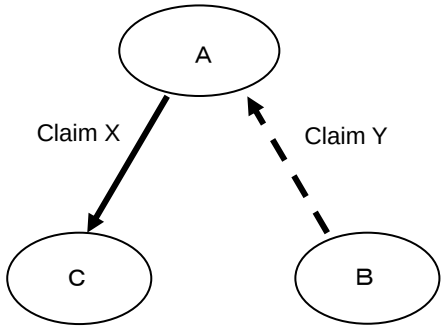
2. Requirements for set-off (CC Art.505)

(1) Clarification of requirements for set-off

While Article 505 (1) of the Civil Code states as a requirement of set-off "both obligations are due," case law admits set-off even when the due date for a claim for set-off is not matured and thus formal language of the law and case law are inconsistent. In addition, both case law and the theory agree that set-off is not admitted when a defense right of the other party is attached to the claim of set-off, but this is not clearly mentioned in the text. Accordingly, there is a view that these requirements which are admitted in construction as a requirement for set-off should be clearly stated in the text of law.

(2) Availability of set-off by a third party

Article 505 (1) of the Civil Code states as a requirement of set-off existence of opposing claims between two parties. However, there is an opinion that when a person "has legitimate interest in making payment", set-off which extinguishes an obligation of others with own claim (in the following figure, B seeks set-off of Claim Y for Claim X) should also be admitted. From such stance, a view is proposed that a clear provision stating that set-off by a third party is admissible should be stipulated.



(3) Manifestation of intention to prohibit set-off

Article 505 (2) states that a party cannot make set-off if the other party manifests an intention to the contrary, and that such an intention cannot assert against a third party "without knowledge." There is a view that it is appropriate to consider a third party as with knowledge when the third party did not know manifestation of intention to prohibit set-off owing to serious negligence, and that, therefore, that effect should be clearly stated in the text of law.

3. Method and effects of set-off (CC Art. 506)

The current Civil Code requires manifestation of intention of one party as a requirement of set-off (Art.506(1)), and states that the manifestation of intention will take effect retroactively as of the time when the obligations of both parties became due and suitable for set-off (Art.506 (2)). The reason for this is that granting a retroactive effect to set-off meets with parties' expectation that the claim and the obligation are liquidated at the time suitable for set-off and thus it is fair. However, the necessity to protect above-stated parties' expectation is not necessarily high because it is pointed out that in practice a special provision which allows balance calculation at the time of manifestation of intention for set-off is stipulated in order to avoid complex treatment of late charges which have been paid. In addition, it is also pointed out that an idea which grants a retroactive effect of set-off does not necessarily harmonize with the idea requiring manifestation of intention as a requirement of set-off. Accordingly, a view is proposed that the current provision should be modified and the effect of set-off should become effective at the time of manifestation of intention of set-off because giving a retroactive effect to set-off is not necessarily reasonable.

(Related issues)

1 Necessity to review set-off of a claim which as been extinguished by prescription (Art.508)

It is pointed out that, in case of reviewing Article 508 of the Civil Code, with protecting parties' expectation that claims and obligations which are suitable for set-off are liquidated, such expectation should be restricted to the extent reasonable, and it is important to secure an opportunity to invoke prescription for the obligor of an obligation which has been extinguished by prescription. Based on such point of view, the following ideas are indicated: (1) the obligee A can manifest intention of set-off of a claim which has been extinguished by prescription before the obligor B invokes prescription; but (2) the obligor B is able to invoke prescription within certain period of time after A's manifestation of intention of set-off.

2 Necessity to review regulation on allocation (Art.512)

(1) Regulation on allocation of set-off under the current law

When there are multiple claims for or of which set-off is sought, and either party does not designate the order of set-off, there arises a problem on how to decide the order of set-off among multiple principals of claims. Case law follows the purpose of Articles 512 and 489, balances multiple principals of claims out based on the order of the time when the claim becomes suitable for set-off, and, among the principals of claims which become suitable for set-off at the same time and among the principal claim and its interests and expenses, allocates set-off applying Articles 489 and 491. If current regulation which grants a retroactive effect to set-off is maintained, it may be necessary to discuss whether the above-stated order should be clearly stated in the text of law.

(2) Necessity to review in a case where the retroactive effect of set-off is not granted

If a view which does not grant a retroactive effect to set-off is adopted, the above-mentioned case law theories about the order of allocation become inapplicable. In such a case, under the current law, when claims are suitable for set-off, it is possible to apply item 2 of Article 489 as an occasion of all obligations are due. Under item 2, "the applicable performance shall be allocated in the order of the obligations which shall result in more benefit to the obligor when performed." However, in case of set-off, both parties are the obligors and thus there is a problem that which party should be prioritized in deciding the order of allocation. There is a proposal on this point that the interest of a party who takes a major role in extinguishing claims and obligations through manifesting intention of set-off should be protected and thus set-off should be allocated in the order of the obligations which shall result in more benefit to the party who makes manifestation of intention of set-off.

4. Set-off for a claim from tort (CC Art.509)

Article 509 of the Civil Code prohibits set-off for a claim having arisen from tort. The reasons for such prohibition are: (1) protection of victims by actually compensating damages of the victim; and (2) prevention of inducing tort actions. However, it is pointed out that these grounds do not explain the necessity to prohibit all set-off for a claim arising from tortious acts and an easy settlement through set-off is excessively restricted. Accordingly, a view is proposed that the scope in which set-off for a tort claim is prohibited should be limited to the scope in which the above-stated grounds are applicable. Based on such view, the following proposals are suggested as to occasions where set-off for a tort claim is granted or prohibited:

[Proposal A] Maintaining provision of Article 509, set-off should be admitted only when both parties' property rights are infringed by the same accident which has arisen from both parties' negligence.

[Proposal B] Deleting Article 509, only set-off for the following either claim is prohibited.

(1) a claim for damages based on a tortious act of the obligor who intended to harm the obligee;
(2) a claim for damages based on non-performance of an obligation of the obligor who intended to harm the obligee; or
(3) a claim for damages based on injury of life or body (excluding (1) and (2)).

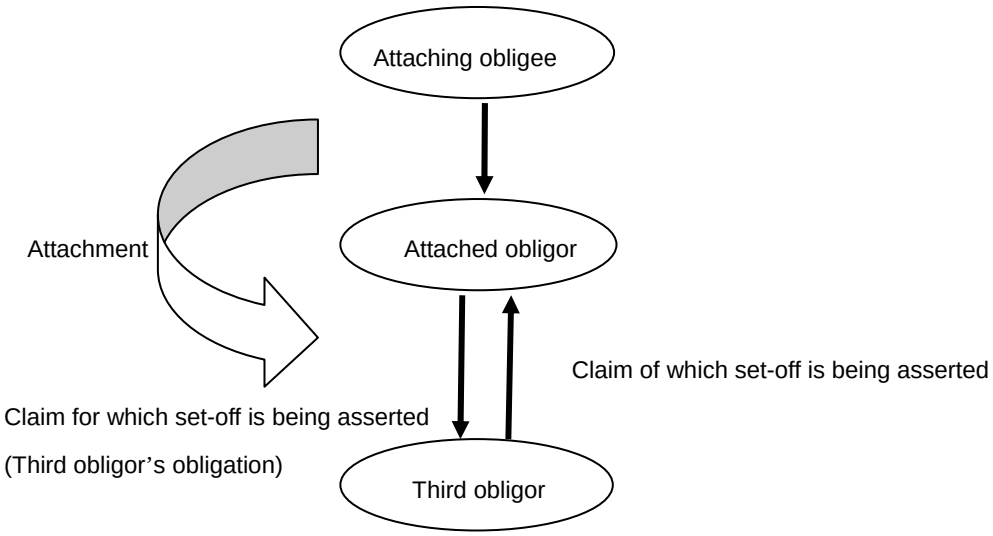
5. Prohibition of set-off for a claim subject to injunction (CC Art.511)

(Note) In this section 5, the following definitions are applied:

"Attaching obligee" : a person who has attached the claim which the attached obligor obtains.

"Attached obligor": a person who is attached his or her claim.

"Third obligor": an obligor of a claim which is attached by the attaching obligee.



(1) Statutory set-off and attachment

While a third party obligor who has been enjoined from making payment cannot assert set-off of any after-acquired claim against the relevant attaching obligee (Art. 511), it is unclear from the text of law that, in case where a claim for which set-off is being asserted is attached, whether both claims for and of which set-off is being asserted need to be due at the time of attachment or, even if they are not necessary to be due, whether the order for each claim becomes due is an issue in order for the third party obligor to assert set-off. Case law decides on this point that set-off is available regardless of the order of the due dates for the claims when a claim of which set-off is being asserted is acquired before the claim for which set-off is being asserted is attached. However, there is a strongly supported theory that, in cases where both claims are not due at the time of attachment, the third party obligor should be able to assert set-off only of a claim of which the due date comes earlier than the due date of

the claim for which set-off is being asserted. The differences between the above case law and the above theory are: (1) whether it is necessary to protect expectation of the third party obligor about set-off when the due date of a claim of which set-off is being asserted comes later; and (2) whether it is appropriate to admit prioritized collection by the parson who has a right to set-off respecting the security function of set-off.

It is pointed out that the order of merit between statutory set-off and attachment is especially important in financing practice such as bank trades and thus the standard for such order should be clearly stated in the text of law. Based on such indication, the following proposals are possible as to the order of merit between statutory set-off and attachment.

[Proposal A] As long as the third party obligor acquires the claim of which set-off is being asserted prior to attachment of the claim for which set-off is being asserted, the third party obligor can assert set-off regardless of the order of the due dates of the claims. (Unrestricted theory)

[Proposal B] When the due dates for both claims have not yet come at the time of attachment, the third party obligor can assert set-off only when the third party obligor acquires the claim of which set-off is being asserted before attachment of the claim for which set-off is being asserted, and the due date for the claim of which set-off is being asserted comes first. (Restricted theory)

(Related issues)

1 Transfer of claims and defense of set-off

As an issue similar to the relationship between statutory set-off and attachment, there is a debate about the requirement for the obligor to assert defense of set-off against a person who is transferred the claim. It is also pointed out that this point also should be clarified in the text of law. There are following proposals in concrete:

[Proposal A] A provision should be stipulated.

[Proposal A-1] The following provision should be stipulated: Set-off is granted regardless of the due dates of the claims if the obligor obtains the claim against the transferor before defense is disconnected.

[Proposal A-2] The following provision should be stipulated: When the obligor obtains the claim against the transferor before defense is disconnected and both claims are not yet matured for set-off, set-off is granted only if the due date for the claim of which set-off is being asserted comes prior to the due date for the claim for which set-off is being asserted.

[Proposal A-3] The following provision should be stipulated: Set-off is granted only if the obligor obtains the claim against the transferor before defense is disconnected and at that

time both claims have matured for set-off.

[Proposal B] No provision is necessary and this issue should be left to construction.

2 Necessity to limit set-off by the time when the claim of which set-off is being asserted is obtained

While Article 511 of the current Civil Code prohibits set-off of any claims which are acquired after attaching claims for which set-off is being asserted, there is no other provision which restricts effects of set-off based on the time of acquiring claims of which set-off is being asserted. It is, however, fair to say that if a third-party obligor who knows that attachment has been filed over his or her obligation vis-à-vis X tries to assert set-off against X before the attachment order is served, such an action simply deviates the restriction on Article 511. Accordingly, a view is proposed that a new provision should be established to deny effect of set-off for such occasions.

(2) Effect of precontracts for set-off

In practice, there are occasions where parties make an agreement that the parties lose the benefit of time period or the effect of set-off arises without manifestation of intention if an order or interim order of attachment is issued. (Hereinafter, such agreements are called “precontracts for set-off.”) There is a debate whether the effect of these precontracts for set-off can be asserted against a third-party attaching obligee, in relation to the discussion on “5 (1) Statutory set-off and attachment.” Case law takes the position that the effect of precontracts for set-off can be asserted against the attaching obligee without special restriction. In the theory, however, a view is claimed that the effect of precontracts for should be limited to a reasonable scope because such precontracts are formed in order to avoid collection of claims through attachment.

Considering the fact that precontracts for set-off takes an important role as a method of collecting claims in financial trade, a view is proposed that a clear provision should be stipulated as to its availability to assert against attaching obligees. In concrete, the following views are possible:

[Proposal A] The effect of precontracts for set-off can be uniformly asserted against attaching obligees.

[Proposal B] The effect of precontracts for set-off can be asserted only when both claims for the set-off has a relationship in which a standardized character that both parties provide credits mutually is socially recognized.

[Proposal C] The effect of precontracts for set-off can be asserted only when the due date of the claim of which set-off is being asserted comes prior to the due date of the claim for which set-off is being asserted.

6. Abuse of the right of set-off

The case law and theories deny set-off by the principle of abuse of rights when granting set-off is against the principle of fairness in relation to general obligees even when such set-off does not violate individual provisions on prohibition of set-off (Abuse of the right to set-off). Based on such occasions and conditions, there is a view that clear provision should be stipulated for such occasions.

Part III. Novation

1. General discussion

In reviewing provisions on novation, it is considered that it is necessary to clarify the contents of provision (*see,* 2 and 4), as well as to discuss necessity to have a provision on novation through substitution of the obligee or obligor, which overlaps with the provisions on transfer of claims and exemptory assumption of claims and thereby its meaning of existence comes under question. What else, if any, should we consider in reviewing overall system of novation?

2. Clarification of requirements for novation (CC Art.513)

(1) Clarification of "element of obligation" and intention of novation

It is considered that "changing any element of an obligation" which is a requirement of novation under Article 513 means substitution of the obligor or the obligee, or alternation of the purpose of the obligation. Among them, substitution of parties is discussed later. It is pointed out that it is unclear from the text of law what kind of occasions other than substitution of parties form novation.

In addition, while novation involves an important effects of extinguishing the old obligation and accompanying security interest and defense right, it is difficult to decide whether novation is established or not only with the objective requirement of "element of an obligation." Accordingly, case law suggests that unless the intention of novation is especially clear, it should be considered that novation is not established, and the dominant theory also supports this case law.

Accordingly, a view is proposed that concrete content of "element of an obligation" should be clearly stated as much as possible and parties' intention of novation (especially the intention of extinguishing an old obligation) should be clearly stated as a requirement of establishing novation in the text of law.

(2) Existence of an old obligation and formation of a new obligation

As a requirement to effectuate novation, it is considered that it is necessary that an old obligation exists and a new obligation is established. A view is proposed that that effect should be clearly stated in the provision of novation.

3. Necessity of provisions on novation by substitution of parties (CC Art. 514-516)

The current Civil Code has provisions on novation through substitution of the obligee and substitution of the obligor. While substitution of parties through novation had taken a significant role in days when assumption of claims or transfer of claims were not admissible, it is pointed out that today transfer of claims are available under the statute and thus the meaning of such provisions is decreasing. In addition,

although effects of novation by substitution of parties is different from transfer of claims or exemptive assumption of obligations in a point that novation by substitution of parties extinguishes defenses through extinguishing old claims but can maintain security rights, transfer of claims or exemptive assumption of obligations can bring the same results through acceptance without an objection or a mutual agreement.

Accordingly, a view is proposed that provisions on novation through substitution of parties should be deleted recognizing that an agreement to substitute a party is not included in novation. In addition, when such a view is taken, in order to avoid confusion in practice, another provision is proposed that it should be regarded as an agreement of transfer of claims is formed when there is an agreement equivalent to novation through substitution of the obligee, and an agreement of exemptive assumption of obligations is formed when there is an agreement equivalent to novation through substitution of the obligor.

4. Clarification of provisions when the old obligation is not extinguished (CC Art. 517)

It is pointed out that Article 517 of the Civil Code, which stipulates cases where the old obligation is not extinguished, has ambiguous language and it is difficult to read its requirements directly from the article. For example, the following issues are pointed out: whether “reasons unknown to the parties” are limited to reasons unknown to the obligee only; whether “when any obligation arises from novation … is rescinded,” means when a new obligation is rescinded, or when a novation contract is rescinded; whether the language “reasons unknown to the parties” is taken by only the term “is not established” or but also the term “is rescinded.” Accordingly, a view is proposed that this provision should be clarified.

Part IV. Release and Merger

1. General discussion

While it is considered that, as to the provision on release, it is necessary to discuss whether the point that release is a solo action of the obligee should be revised (*see,* 2), there seems no concrete proposals for revision as to the provision on merger to date. When we review overall regulation on release and merger, what kind of point should we consider?

2. Review of the provision on release (CC Art. 519)

Under the current Civil Code, release creates the effect of extinguishing a claim without participation of the obligor upon one-side manifestation of intention by the obligee. However, as to the current regulation, which admits release even when the obligee has a contrary intention, it is pointed out that, if the obligor has an interest in performing the obligation, the interest of the obligor can be deprived one-sidedly when release is granted without participation of the obligor. In addition, it is criticized that the regulation under the current law, which admits release through one-sided manifestation of intention by the obligee, is not consistent with other regulations under the current law such as payment by a third party (Art.474 (2)) and substitution of the obligee through novation (proviso of Art.514), which respect intention of the obligor even though the obligee receives a benefit. Accordingly, a view is proposed that the provision of release should be revised for the direction that release is not admitted when the obligor has contrary intention.

Part V. Necessity to correspond to sophisticated and complex situation of means of settlement (About the issue on settlement among multiple parties)

In practice, there is an occasion where settlement of obligations and claims among multiple parties is processed through the central counter party (CCP). While, in the process of this settlement, the claim between A and B who participate in the CCP is replaced by A's claim vis-à-vis the CCP and the CCP's claim vis-à-vis B (*See,* figure below), there is no legal concept under the current law which sufficiently explains the legal relationship regarding this replacement. Accordingly, a view is proposed that a legal concept which clearly explains such legal relationship should be established in the Civil Code for the purpose of enhancing stability of settlement.