CONTINUING TRANSACTIONS AND PERSISTENT MYTHS: CONTRACTS IN CONTEMPORARY JAPAN

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[*For twenty years, many Australian lawyers have accepted a paradigmatic view that law is largely irrelevant to Japanese contracts, that the business relationship is paramount, that the Japanese favour unwritten agreements, and that they do not consider themselves to be bound by contracts. This article suggests that such static representations of 'Japanese' contracting norms are both false and misleading. The author argues that a dynamic combination of commercial custom, legislative reform and case law fashion contract law and practice in Japan. New contract forms, such as franchises and distributorships, pose new social problems, sometimes resolved through judicial intervention and the rubric of 'good faith'. The article concludes that comparative studies which analyse the market characteristics of different contract types in Japan are needed, and that sweeping comparisons of Japanese contracting with law and practice in 'the West' have outlived their utility.*]

INTRODUCTION

The trade relationship between Australia and Japan has been marked by relatively few public legal disputes between trading partners. Those that have attracted publicity (such as the C.S.R. Sugar Dispute of the mid-1970s)[1] or have been litigated (such as the failed real property deals of the 1980s) have tended to be infrequent and atypical. More usually, Australia-Japan trade disputes have been resolved before they have become caught up in the processes of a public legal forum. Mid-transaction disputes, such as the following are more typical than litigated outcomes:

> A solicitor from a medium-sized law firm in a large city rang for advice late in 1993. Back in 1976, his client had become the State distributor for a Japanese product, and then took over the distribution network for that State. When the original time period had run, the contract was renewed annually by oral agreement. With the fall in the Australian dollar, the product had become much harder to sell locally, but in 1992 the client had been offered $18 million for the distributorship by a prospective third-party purchaser. The Japanese manufacturer refused to consent to the assignment of the distributorship, on the basis that it intended to take over distribution of the product in that territory itself. The law governing the original contract was Japanese law. A delegation from the Japanese company was arriving on Monday (it was now Friday). 'What would you advise?'[2]

Nevertheless, if the client in this problem is to 'bargain in the shadow of the law',[3] they will need to be advised about where the shadow falls.

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1 Described in March, R.M., *The Japanese Negotiator* (1988) 97-110. For a thorough legal analysis of the dispute which draws on interviews with the executives of the Japanese trading companies involved and chronicles strategic mistakes made by both the Japanese and Australian parties see Fazio, M., *The Long-Term Sugar Contract Dispute* (1982) Unpublished Honours Dissertation, Department of Japanese Studies, Monash University.

2 June 1993. Transcript of interview held by author. Company details kept confidential by agreement.

3 See *e.g.* Galanter, M., 'Reading the Landscape of Disputes: What We Know and Don't Know (and Think We Know) About Our Allegedly Contentious and Litigious Society' (1983) 31 *U.C.L.A. Law Review* 4; Ramsayer, J.M., 'Reluctant Litigant Revisited: Rationality and Disputes in Japan' (1988) 14 *Journal of Japanese Studies* 111.

Problems such as this one crystallise a dilemma for Australian trade lawyers in the 1990s. For the last twenty years, many Australian lawyers have used two touchstones when describing Japanese contract law and practice: the C.S.R. Sugar Dispute, and the thesis advanced by Professor Kawashima about Japanese attitudes to contracts.[4] The story about Japanese contracting that emerges from each of these sources is that law is largely irrelevant. Instead, the business relationship is paramount, and the Japanese favour unwritten, or very brief agreements; do not regard themselves bound by the letter of such agreements but rely on the notion of 'changed circumstances' to seek renegotiation; and, in the case of a dispute, will seldom, if ever, allow the matter to proceed to court.[5]

This received wisdom is remarkably resilient and Japanese businesspeople have been astute enough to recognise this.[6] It is not surprising, therefore, to find the story reiterated in countless Australian and Japanese business settings and adopted in writings on Japanese business and law.[7] Some Australian commentators, however, doubt that this contract story furnishes us with enough information, and suspect that the legal and cultural stereotypes it presents are no longer accurate (if they ever were).[8]

Neither culture nor legal systems remain static. As contract practice and doctrine have been reshaped in the common law world in the last twenty years, so too, Japanese discourse and practice regarding contracts has changed dramatically. Though the 'cultural' contract story of the 1970s is comfortingly familiar, it is at best inaccurate and more often quite misleading. Worst of all from a legal perspective, it offers no 'value-added' advice to the client. Failure to become familiar with the 'new' Japanese contract law[9] will simply deliver to clients something that, 'on the surface, is sentimental nonsense. Deep down it is sentimental nonsense too.'[10]

4 Kawashima, T., *Nihonjin no hōishiki (The Legal Consciousness of the Japanese)* (1967); partially translated by Charles R. Stevens as 'Contract Consciousness of the Japanese' (1974) 7 *Law in Japan* 1.

5 These are the components of 'traditional' contract consciousness identified by legal sociologist Kawashima Takeyoshi in *Nihonjin no Hōishiki*, *ibid.*, and 'Dispute Resolution in Contemporary Japan' in von Mehren, A.T. (ed.), *Law in Japan: The Legal Order in a Changing Society* (1963) 41. At a popular level the ideas have been taken up by writers such as March, *op. cit.* n.1, and more thoughtfully by Van Wolferen, K., *The Enigma Of Japanese Power* (1989).

6 For the most recent in a long tradition of such utterances by Australian lawyers and businesspeople, see: Craig, J., 'Legal Traps in Signing Deals with Japanese' in Survey Japan, *Australian Financial Review*, 25 October 1993.

7 See for example, Robert March:

> One of the least understood and most exasperating aspects of the Japanese is their attitude to contracts and the law. For instance, the Japanese will conduct million-dollar transactions based on no more than oral agreements . . . A Japanese court compels a purchasing firm to comply with an oral commitment to accept delivery of soy beans at the original price despite a drastic fall in the market price. And one of Japan's foremost oil refineries does not demand written contracts merely because its customers dislike such documents of agreement. How does such behavior — irrational and perplexing, if not infuriating, to Western observers — come about?: March, *op. cit.* n.1, 111.

8 For an early, robust dismissal of 'the myth that the Japanese don't use or believe in contracts' see Smith, M., 'Comment on Some Legal Aspects of Japanese Involvement in the Australian Mining Industry' (1980) 2 *Australian Mining and Petroleum Law Journal* 192-3.

9 Following Macneil, I.R., *The New Social Contract: An Inquiry Into Modern Contractual Relations* (1980) and Uchida, T., *Keiyaku no saisei* (The Rebirth of Contract) (1990). For a discussion of the shift away from classical contract in New Zealand see McLauchlan, D.W., 'The ''New'' Law of Contract in New Zealand' [1992] *New Zealand Recent Law Review* 436.

10 Ian Buruma, referring to more general assertions about the organic uniqueness of Japanese

False assumptions permeate Australian perceptions about contracts in Japan, yet positive law and the impact of 'new' contracts, such as franchises and distributorships, on classical contract doctrine are significant components of Japanese contracting. The growth of these transaction types has strengthened the view among Japanese lawyers that the the paradigm contract in Japan is not the 'one-shot deal' contemplated by classical contract law, but a long-term, relational contract. Economists, too, have concluded that a preference for dealing flexibly on a long-term basis with people one likes is not a cultural idiosyncracy, but a rational risk-minimisation strategy, which underpins both Japanese corporate organisation and the wider economy.[11] This article discusses a number of atypical, but interesting, relational transactions that break down and are eventually litigated. These cases illustrate the way in which commercial custom and commercial expections both inform, and are informed by, judicial decision-making in Japan.[12] Examination of reported cases and academic commentary on Japanese contract law is, of course, an imperfect guide to the 'law in action'.[13] However, because they form a significant part of the legal mosaic, the cases cited are discussed in detail.

The re-examination of Japanese contract law and practice has important implications for Australian lawyers. At a theoretical level, it corresponds to the transformation of Australian contract law evident in the regeneration of doctrines such as unconscionability,[14] and suggests that, in the field of continuing contracts, the differences between the Japanese and Australian legal systems may be fewer than imagined. For practitioners, some insight into this field of contract law creates an opportunity to deliver to the client both legal knowledge and some degree of legal leverage in negotiations.

culture in 'The Identity Business', Unpublished Paper delivered at *Stirrup, Sail and Plough: Continental and Maritime Influences on Japanese Identity*, International Conference, The Australian National University, Canberra, 20-23 September 1993, 4.

11 Itoh, M., 'Organisational Transactions and Access to the Japanese Import Market' in Sheard, P. (ed.), *International Adjustment and the Japanese Firm* (1992) 50 and Sheard, P., 'Introduction', in Sheard, P., *supra*. 5. Professor Itoh cites with approval the work of economist Oliver Williamson in Williamson, O., *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (1985).

12 As is common with Japanese reported cases, the parties are usually individuals, or small to medium-sized companies. The absence of 'large corporate names' in the reports is sometimes alluded to as evidence of a preference for avoiding litigation, or the financial capacity and negotiating experience which make an out-of-court settlement possible. In this selection of cases, however, my hypothesis is that the parties are fairly typical of the smaller companies and individuals involved in distribution chains and franchising in Japan.

13 As Macneil correctly points out,

> [t]he trouble focus, inherent in most of the law school curriculum, projects a distorted view of life. If you wish to understand contract you must remember that appellate cases show mainly the pathological, not the healthy performance of contracts. Most contracts are performed to the reasonable satisfaction of the parties, who iron out such troubles as occur. Remembering this is extraordinarily difficult while living on an exclusive diet of appellate cases — most being but post-mortem reviews of defunct relations.

Macneil, I., *Contracts, Exchange Transactions and Relations* (1978) 55-6.

14 The leading case in Australia on unconscionability is *Commercial Bank of Australia Ltd v. Amadio* (1983) 151 C.L.R. 447 For a concise exposition see Starke, J.G., Seddon, N.C., and Ellinghaus, M.P., *Cheshire and Fifoot's Law of Contract* (6th ed. 1992) 422-35. On the question of whether one (or more) High Court cases really signal a system shift, see Drahos, P. and Parker, S., 'Critical Contract Law in Australia' (1990) 3 *Journal of Contract Law* 30, who suggest that such perceptions often lack a firm basis. On the reformation of the common law during the 1980s generally, see Finn, P., 'Statutes and the Common Law' (1992) 22 *University of Western Australia Law Review* 7.

1. *WHAT WE THINK WE KNOW ABOUT JAPANESE CONTRACTS*

Most of what we think we know about Japanese attitudes to contracts can be traced to the important work by legal sociologist Kawashima Takeyoshi, *Legal Consciousness of the Japanese.*[15] In his chapter on 'contract consciousness',[16] Kawashima explores the gulf between the normative meaning of Japan's formal rules of contract law and the ordinary person's conception of 'contracts' and contractual rights and duties.[17] Kawashima's focus is the individual: 'the psychology of each person as distinguished from the normative meaning of national law'.[18]

Reliance on Kawashima as a canon on Japanese contracting, however, is unwise. There is a tendency to read him ahistorically, whereas Kawashima himself was careful to limit his discussion to a description of 'traditional' attitudes to contracts in Japan which, in line with modernisation theory, he believed would become 'Westernised' over time.[19] He is also universally (and mistakenly) cited for the proposition that Japanese contracting behaviour is unique, and can be explained by Japanese culture. Rather than accepting the notion of Japanese 'culture' as an organic, unchanging entity, it is more useful to focus on how dominant values within a culture are manifested in the institutional and economic influences which shape attitudes toward, and regulation of, contracts within that legal system. The generalist assumptions on which Kawashima's contracting story is based can be critiqued in this light.

1.1 *Japanese Contracting Behaviour is Unique*

In his essay, Kawashima emphasises the relational nature of Japanese contracting, in comparison with the formality and detatchment of transactions in the West (for which we can probably read the United States). Even the most thoughtful non-Japanese commentators often refrain from challenging the validity of Kawashima's construction of this legalistic 'West', despite the evidence to the contrary and the limited selection of Kawashima's own examples.[20]

[15] Kawashima, *op. cit.* n.4.

[16] Kawashima, T., *Waga kuni ni okeru keiyaku no hōishiki* (Contract Consciousness of the Japanese) in Stephens, C.R., *op. cit.* n.4, 1.

[17] Some of Macaulay's work exploring the same theme in an American context had been published earlier: Macauley, S., 'Non-Contractual Relations in Business: A Preliminary Study' (1963) 28 *American Sociological Review* 55 and Macaulay, S., 'The Use and Non-Use of Contracts in the Manufacturing Industry' (1963) 9 *Practical Lawyer* 13. Macaulay's work is cited by Hoshino in his 1966 treatise, but not by Kawashima: see Hoshino, E., *Gendai ni okeru keiyaku* (The Contemporary Contract) (1966) 8 *Gendaihō* (Contemporary Law) 206, translated by Haley, J.O., in (1972) 5 *Law in Japan* 1.

[18] Kawashima, *op. cit.* n.4, 2. A threshold problem is that Kawashima's ideas are usually extrapolated and misread as being equally applicable to corporations, merchants and society at large.

[19] The translation of Kawashima's *Legal Consciousness of the Japanese* was for many years probably the most widely-read work on Japanese law in English. For a description of the current state of empirical legal research in Japan and what Kawashima meant by 'legal consciousness', see Miyazawa, S., 'Taking Kawashima Seriously: A Review of Japanese Research On Japanese Legal Consciousness and Disputing Behaviour' (1987) 21 *Law and Society Review* 219.

[20] Note, however, that Kawashima's argument has been criticized in Japan. See *e.g.* Michida, S., *Keiyaku Shakai: Amerika to Nihon no Chigai o Miru* (Contract Societies: America and Japan Contrasted) (1987) in Taylor, V.L. (trans.), (1992) 1 *Pacific Rim Law and Policy Journal* 199. Hiroshi Wagatsuma and Arthur Rosett observe that the absence of reliable data is problematic and the

Part of the appeal of Kawashima's approach was undoubtedly its consonance with the theory of Japan's social uniqueness which was popular in both Japan and the West during the 1960s and 70s.[21] We are now aware that Japanese contracting behaviour is not unique. Cultural norms are important, but no more so than in other legal systems. The relational nature of contracts, emphasised in descriptions of Japan,[22] is also a feature of transactions in the United States,[23] Britain,[24] Australia,[25] France[26] and possibly China.[27]

In his essay Kawashima argues that the relationship, rather than formalities or potential legal sanctions, traditionally gave the contract its binding force in Japan. The same inclination towards contractual informality and flexibility was observed by Stewart Macaulay among Wisconsin businessmen in the 1950s. Manufacturers and suppliers in his study routinely used oral agreements and order forms, rather than formal written contracts. They modified the agreement as circumstances changed. They also had a strong desire to avoid lawyers and litigation.[28] The relational contract theories developed by Macaulay, Macneil and others recognise that businesspeople value preserving their business relationships over a strict application of contract 'rules'. For this reason, disparity between contract rules developed by lawyers and 'relational' contract practice developed by businesspeople is characteristic of many legal systems.

overgeneralizations about the contractual attitudes and practices of 'the Japanese' and 'Westerners' or 'Americans' are inaccurate. They hypothesize that company size and international experience will be more telling variables in future: Wagatsuma, H., and Rosett, A., 'Cultural Attitudes Towards Contract Law: Japan and the United States Compared' (1983) 2 *U.C.L.A. Pacific Basin Law Journal* 76, 78. Compare this with spirited rebuttals of another of Kawashima's influential theories: Kawashima, T., 'Dispute Resolution in Contemporary Japan' in von Mehren, A.T. (ed.), *Law in Japan: The Legal Order in a Changing Society* (1963) 41, critiqued in Haley, J.O., 'The Myth of the Reluctant Litigant' (1978) 4 *Journal of Japanese Studies* 359 and Ramsayer, J.M., 'The Costs of the Consensual Myth: Antitrust Enforcement and Institutional Barriers to Litigation in Japan' (1985) 94 *Yale Law Journal* 604.

21 For a thoughtful discussion of the evolution of Japanology, *nihonjinron* (theories of Japanese uniqueness developed by and for the Japanese), and critical, empirically based Japanese studies, see Mouer, R. and Sugimoto, Y. (eds), *Images of Japanese Society* (1986).

22 See, *e.g.* Foote, D., 'Evolution in the Concept of Contracts' in Kusuda-Smick (ed.), *U.S./Japan Commercial Law and Trade* (1990) 689; Kinoshita, T., 'The Relational Contracting' in Kusuda-Smick, *supra* 679; and Kawakami, M., *'Keiyaku no seiritsu o megutte'* (Concerning Formation of Contract), (1988) 655 *Hanrei Taimuzu*; (1988) 657 *Hanrei Taimuzu* 14.

23 The scholarship in this area is now voluminous. A sampling includes Charny, D., 'Non-legal Sanctions in Commercial Relationships' (1990) 104 *Harvard Law Review* 373; Crystal, N.M., 'An Empirical View of Relational Contracts - Article Two of the Uniform Commercial Code' in *1988 Annual Survey of American Law* (1990) 293; Hadfield, G.K., 'Problematic Relations: Franchising and the Law of Incomplete Contracts' (1990) 42 *Stanford Law Review* 927; Linzer, P., 'Uncontracts: Context, Contorts and the Relational Approach' in *1988 Annual Survey of American Law* (1990) 139; Macaulay, S., 'The Reliance Interest and the World Outside the Law School's Doors' [1991] *Wisconsin Law Review* 248; Macaulay. S., *An Empirical View of Contract*, Working Paper 1984-8, Disputes Processing Research Program, University of Wisconsin-Madison Law School (undated); Macneil, I., *Contracts, Exchange Transactions and Relations: Cases and Materials* (1978); Macneil, I., 'Values in Contract: Internal and External' (1983) 78 *Northwestern University Law Review* 340; and Macneil, I., 'Relational Contract: What We Do and Do Not Know' [1985] *Wisconsin Law Review* 483.

24 Beale, H. and Dugdale, T., 'Contracts Between Businessmen: Planning and the Use of Contractual Remedies' (1975) 2 *British Journal of Law and Society* 45.

25 Intuition and 'casual empiricism' suggest that this is true; comprehenisve studies have yet to be done in this field in Australia.

26 Harris, D. and Tallon, D. (eds), *Contract Law Today: Anglo-French Comparisons* (1989).

27 Macneil, R.W., 'Contract in China: Practice and Dispute Resolution' (1986) 38 *Stanford Law Review* 303.

28 Macaulay, S., 'Non-Contractual Relations in Business: A Preliminary Study' (1963) 28 *American Sociological Review* 55.

1.2 *Relational Contracting is Intrinsically Harmonious*

Kawashima devotes much of his chapter to a discussion of dispute resolution clauses in contracts, specifically the Japanese preference for 'confer-in-good-faith' clauses like the following:

> If in the future a dispute arises between the parties with regard to the rights and duties provided in this contract the parties will confer in good faith (*seii o motte kyōgi suru*).

He attributed this in part to a Japanese conception of rights and duties as tentative, even where these are recorded in writing. 'Accordingly, they think it desirable at that time to fix such rights and duties by means of *ad hoc* consultation.' The preferred means of doing this is through conciliation (*chōtei*).[29] This effects a harmonious settlement (*enman na kaiketsu*) and allows parties to 'let the dispute wash away' (*arasoi o mizu ni nagasu*).

Relational, however, does not mean immutable. Given the right circumstances, or more attractive alternatives, Japanese parties will terminate relational, as well as discrete, 'one-shot' transactions.[30] In a highly competitive economy like Japan's, new or potential transaction partners abound. By developing interdependent relationships, parties maximise mutual benefits and discourage one another from seeking substitute partners.

Part of the glue that binds parties to agreements in Japan is the ideological use of 'harmony' and 'consensus'. The way in which 'illusory harmony' is maintained is acknowledged and explained by Wagatsuma and Rosett.[31] Informal dispute resolution keeps conflicts private and allows the parties' pre-existing relationship to permeate the process. Generally, informal dispute resolution will favour the stronger party in a vertical relationship.[32]

1.3 *Relational Contracting is Intrinsically 'Fair'*

When non-Japanese read Kawashima, they frequently conflate his description of 'traditional' contract relationships in Japan as being 'harmonious' with the notion that they are also 'fair'. However, almost without exception Kawashima consciously chose examples of parties with unequal bargaining power:

- a wartime agreement between a farmer and an urban university professor's wife, in which the promised potatoes are sold to another customer;[33]

[29] A preference for conciliation is asserted by Kawashima in his famous piece 'Dispute Resolution in Contemporary Japan' in von Mehren, *op. cit.* n.5, 41, and vigorously criticized in Haley, *op. cit.* n.20.

[30] *E.g.*, Gerlach, M., 'Trust is not Enough: Co-operation and Conflict in Kikkomans' American Development' (1990) 16 *Journal of Japanese Studies* 389, describing the acrimonious breakdown of the commercial realtionship between soy-sauce manufacturer Kikkoman, its American distributor, and the distributor's Japanese-American president.

[31] Wagatsuma and Rosett, *op. cit.* n.20.

[32] One of the major criticisms of conciliation in both Japanese and Western legal settings is that it often disempowers the weaker party. In a commercial setting it can facilitate coercion through economic pressure. Other studies have looked at its effect in family law, and its historical use as a form of social control, *e.g.*, Bryant, T.L., 'Marital Dissolution in Japan: Legal Obstacles and Their Impact' (1984) 17 *Law in Japan* 73 and Henderson, D.F., *Conciliation and Japanese Law: Tokugawa and Modern*, Vols 1 and 2 (1965). For a discussion of how this relates to continuing contracts, see Hadfield, *op. cit.* n.23.

[33] Kawashima, T., *Nihonjin no Hōishiki* (The Legal Consciousness of the Japanese) (1967) in Stevens, C.R. (trans.), 'Contract Consciousness of the Japanese' (1974) 7 *Law in Japan* 1, 3.

- consignment sales between department stores and wholesalers (where unsold stock is customarily returned to the latter);[34]
- Meiji statesman Fukuzawa Yukichi's agreement to buy a house in Tokyo in the 1890s (where samurai spirit constrains Fukuzawa from trying to avoid monetary loss);[35]
- pre-war agreements between tenant farmers and landlords;[36]
- pre-war construction contracts between governmental agencies and contractors;[37] and
- personal suretyship (*min:oto hoshō*) contracts in which the guarantor's liability is extremely comprehensive.[38]

The only example in which the parties are relatively equal is litigation over a soy-bean supply contract between a trading company, Marubeni-Iida K.K., and a large manufacturer, Aji-no-moto K.K.[39]

Professor Hoshino suggested in his 1966 treatise that it was the prevalence of such one-sided, standard-form contracts that had contributed to the Japanese people's distrust of contract.[40] He argued that the Japanese courts had not, at that time, developed effective responses to contracts of adhesion (standard form contracts), but tended to enforce them in the name of freedom of contract.[41] He likened the modern standard-form contract to Kawashima's description of 'feudalistic contracts': 'Such contracts embrace the notion that the inferior party alone is bound through the trickery of the opposite party.'[42] The net effect of this type of contract, he argued, was that:

> [It] causes [the public] to think that to escape its effect is a necessary evil that is the best alternative. This kind of contract fails to produce the notion that contracts are something through which justice is realized or the notion that the parties are ethically or voluntarily bound by contracts.[43]

Hoshino did not volunteer any empirical evidence of his observation, but it is an interesting sidelight on the question of the internalization of modern contract norms, and the development of an overt recognition of contractual inequality by the Japanese Judiciary.[44]

34 *Ibid.* 5.
35 *Ibid.* 7.
36 *Ibid.* 8.
37 *Ibid.* 9.
38 *Ibid.* 12.
39 8 *Kakyū minshō* (Lower Court Law Reports) 1366 (Tokyo District Court, 31 July 1957), discussed in Kawashima, *ibid.* 6.
40 Hoshino, *op. cit.* n.17, 45.
41 *Ibid.*
42 *Ibid.*
43 *Ibid.*
44 A further kind of status worth exploring is the relationship of social class to Kawashima's model. Kawashima describes in passing the samurai conception of contract: Fukuzawa's word is his bond. But contrast this with Tokugawa village contracting norms (the written, publically announced contract) described in Henderson, D.F., *Village Contracts in Tokugawa Japan* (1974) and another of Kawashima's examples, the Tokyo professor's wife and the farmer. During World War II food shortages, the wife of a university professor travels to the countryside. She asks a farmer to reserve some rice and potatoes, for which she will return and pay in a few days' time. The farmer sells the potatoes to someone else in the interim. It is not immediately clear in this story who is demonstrating Kawashima's 'traditional' contractual attitude. Presumably it is the professor's wife, the object of village scorn for her failure to secure the transaction with a deposit or evidence in writing. Instead, she relied on the oral agreement. But which class is determining the norm? A more recent empirical study of attitudes to law in Korea reveals class to be an important variable. See Park S.C., Park S.H.

Real life and contemporary contract theory suggest that limitations on the freedom of contract are normal in most legal systems. Parties are recognised as having, in many cases, inequalities of status, information, economic power, education, experience, gender, and class. Contracts are also subject to extensive state intervention regarding their form and content.

1.4 *Relational Contracting Obviates the Need For Contract Formalities*

In Kawashima's model, harmony and trust in the relationship are said to result in a more flexible attitude to contract formality. Thus the unwritten, informal agreement is preferred to the minutiae of tightly-drafted contracts in writing. It follows that parties will not be concerned with whether or not their agreement is a contract in the strictly legal sense. Thus:

> [A]scertaining [whether or not a contract has been formed] ... or adopting certain means to accomplish this [such as writing or deposit] can be regarded as an expression of one form of mistrust toward the other party. Instead, it is thought better not to worry about such matters.

The second reason advanced for avoiding tightly-drafted agreements in a relational transaction is the difficulty of predicting future developments:

> [T]o the extent that the parties take such other problems into consideration, it probably follows that they will not desire beforehand to make the contents of their contracts definite or precise.

Relational contract theorists in the West would agree with both propositions. Businesspeople in both the American and British empirical studies cited above give similar reasons for avoiding written agreements.

However, the use or non-use of formalities is not purely a result of individual party choice, or the degree of relational intimacy. Contract formalities, including writing, perform multiple functions. Formalization of an agreement ritualizes the parties' seriousness of purpose. It may signal a willingness to enforce performance and it diminishes the difficulty of proving the content of the promises and obligations.[45] It is no coincidence that many of the contract formalities required by legislation and commercial custom in 18th century England were intended to promote commercial certainty.

Contract writing is also frequently informational — a means of enabling the parties to recall the details, and to communicate these to other people likely to be affected by the transaction. These informational and evidentiary functions of 'contract' writing are certainly not alien to the North-East Asian legal tradition.[46]

and Choi S.G. (eds), Song S.H. (trans.), *A Survey on the Korean People's Attitude Towards Law* (1992).

In relation to family law and divorce, the evidence in *The Women of Suye Mura* is that very different social norms operated in urban and rural areas. See Smith, R. and Wiswell, E.L., *The Women of Suye Mura* (1982) 149-75. The Meiji Civil Code is now regarded as a codification of elite norms, particularly bolstering the institution of the samurai household: Nolte, S.H. and Hastings, S.A., 'The Meiji State's Policy Toward Women 1890-1910' in Bernstein, G.L. (ed.), *Recreating Japanese Women 1600-1945* (1991) 151, 172.

[45] This may be particularly relevant in legal systems like Japan's where, it has been argued, legal sanctions are weak, access to formal adjudication is limited and enforcement is burdensome. See generally Haley, J.O., *Authority Without Power: Law and the Japanese Paradox* (1991).

[46] Formal contracts were common to all dynasties in China — examples from the Han dynasty survive because they were transcribed on durable materials: wood, bamboo, stone and jade. The agreements were witnessed, the parties, subject matter and price recorded, and the transaction was completed with wine drinking. The physical contract was the primary evidence in case of dispute, and in some cases was also a kind of notarial law, where land ownership or the existence of a debt ran with the record. See Scogin, H.T., 'Between Heaven and Man: Contract and the State in Han Dynasty

Henderson's research on 17th century contracts in Tokugawa Japan[47] revealed that even village agreements were customarily recorded in writing as an informational device which helped to ensure their social enforcement. There was no local court in which to dispute contract performance at the time, so in this sense they were non-justiciable agreements, but they were written and sealed documents. Ramsayer's study of indentured prostitution in 19th century Meiji Japan also shows that written agreements were not uncommon and in some cases were proof-read by local police to ensure that the content was 'reasonable' and acceptable.[48]

Ethnographical accounts of life in remote villages in contemporary Japan also underscore the significance of contract formalities within communities that seldom use formal legal sanctions or remedies. Although (or because) personal relationships were intimately entwined in the village studied by Moeran, he needed a formal introduction by an intermediary before he could rent a house in the valley in which he had chosen to live.[49] The lease agreement was formalised thus:

> 'You stay here and listen, Hanako' explains Tatetarō. 'Takeshi here has agreed to lend (Moeran) that old house of his up in Okubo. Even though Takeshi has been very kind and said that he doesn't want any rent, I've said that (Moeran) ought to pay thirteen thousand yen a month, payable in advance . . . Hey! I nearly forgot. We're supposed to be clapping hands on the matter' . . . Tatetarō looks around at us, his face suddenly solemn. 'Right then, O-o-o-oh!' he booms out and we all clap our hands together twice. 'O-o-o-oh!' And twice more. 'Good then.' Tatetarō relaxes back into his normal voice, and we slip our feet back into the *kotatsu*.[50]

Later, when Moeran seeks to buy the house, the agreement is formalised in writing:

> Takeshi really has little alternative but to do as he is told. After all, his own intermediary has agreed to Inoshige's terms. So Tatetarō quickly tells Inoshige to write the whole thing down so nobody will go back on his word. So we have bought our house and land for a little less than $2,000. And I even manage to talk Takeshi into letting us have a piece of the adjoining land as well. He agrees to let us pay him in two instalments, which means that we will have until next April to find the remaining 100,000 yen. It is all too good to be true.
>
> Takeshi is looking less and less happy with each new agreement. 'What about the two plum trees on the land I've given you?' he asks. 'Write it down in the contract,' Inoshige quickly tells Tatetarō. 'Fruit from the trees on (Moeran's) land should be shared between both parties. 'Does that include the gingko tree?' asks Takeshi. He is referring to a tree he planted less than two years

China' (1990) 63 *South California Law Review* 1325. These formalities were not the product of statutory law; they were customary, and evidenced a high degree of party autonomy. Freedom to develop transaction forms also carried with it the burden of planning transactions that would work, and enforcing those that went awry. Enforcement through Imperial courts was possible, but often impracticable. See Scogin, H.T., *supra*; Brockman, R.H., 'Commercial Contract Law in Late Nineteenth Century Taiwan' in Cohen, Edwards and Chen (eds.), *Essays on China's Legal Tradition* (1980) 76; and Macneil, R.W., 'Contract in China: Law, Practice and Dispute Resolution' (1986) 38 *Stanford Law Review* 303. For more general descriptions of contracting practices see Chen, F. and Myers, R.H., 'Customary Law and the Economic Growth of China during the Ch'ing Period' (1978) 3(10) *Ch'ing-shin wen-t'i* 4; Chan, W., 'Merchant Organizations in Late Imperial China: Patterns of Change and Development' (1975) 15 *Journal of the Hong Kong Branch of the Royal Asiatic Society*; Buxbaum, D.C., 'Some Aspects of Civil Procedure and Practice at the Trial Level in Tanshui and Hsinchu from 1789 to 1895' (1971) 30(2) *Journal of Asian Studies* 255.

47 Henderson, D.F., *Village Contracts in Tokugawa Japan* (1974).

48 Ramsayer, J.M., 'Indentured Prostitution in Imperial Japan: Credible Commitments in the Commercial Sex Industry' (1991) 7 *Journal of Law Economics and Organisation* 89.

49 Moeran, B., *Okubo Diary: Portrait of a Japanese Valley* (1985).

50 *Ibid.* 28. Moeran's respect for, and endeavours to comply with, community norms in the village are particularly poignant because his son is later severely injured in a swimming accident at the local school. Despite the apparent negligence by the school, the school board refuses to pay compensation or to apologize for the accident, and Moeran reluctantly sues to recoup the costs of complex medical treatment.

ago. 'Yes, yes, I'll write that down, too,' Tatetarō answers impatiently. But there is no room on the sheet of paper, and it seems silly to draw up a new sheet, just for this, so we end up getting all the gingko nuts too.[51]

Writing or formality may also underpin and stabilise the relationship at the core of the transaction. Mouer and Sugimoto observe that interpersonal relationships in Japan are characterised by emphasis on written forms of communication and pervasive, contractual ties. Detailed employment contracts, written leases and non-refundable initial payments to landlords (*shikikin* and *reikin*), personal suretyship (*mimoto hoshō*) agreements and signed I.O.U.s for personal loans all illustrate this tendency. Mouer and Sugimoto conclude that:

[Although] another characteristic often attributed to the Japanese is sentimentality, a concern for *ninjō* (human feelings) and an ability to identify emotionally with others . . . it is the extensiveness of the 'dry' or calculated relationship which seems to set them apart from other peoples. This aspect of Japanese life can most easily be seen in the pervasiveness of the contractual relationship. The whole idea behind basic concepts such as *giri* and *on* is that of reciprocity or social exchange.[52]

Kawashima's essay, then, is a shaky basis for asserting a cultural preference by Japanese for unwritten agreements that transcends the historical period, transaction type, economic context, specific function of the writing and the requirements or shortcomings of positive law.[53]

1.5 *Systemic Factors: the Legal System, the Civil Code and Internationalisation*

In his essay, Kawashima does not emphasise the nature of the Japanese legal system or the relevant 'rules' of contract law as having any impact on Japanese legal consciousness. Many non-Japanese commentators have taken their cue from this omission, assuming that positive law and judicial or scholarly analysis has little impact on contracting practice in Japan. Such assumptions are seriously flawed.

The nature of a legal system arguably influences contracting practice, even when, as frequently happens, legal regulations are disregarded and formal requirements breached. Systemic factors relevant to contract norms include the nature of the legal profession;[54] lawyers' roles in transactions based on contracts;[55] whether the legal and political systems are federated or unitary; the type and stage of development of the economy with which the legal system interacts; and whether contract law is well 'settled'.[56] The role of the Civil and Commercial Codes in influencing contract formalities also needs to be considered. As in other civil law

51 *Ibid.* 148. Needless to say, Takeshi reneges on the agreement later in the narrative, notwithstanding considerable criticism from his village neighbours.

52 Mouer, R.E. and Sugimoto, Y., *Images of Japanese Society* (1986) 219-26.

53 For an interesting comparison of contract formation and formality questions see Michida, *op. cit.* n.20.

54 Whitmore Gray, for example, has also drawn attention to the identity of the parties whose perceptions of contracts are being described. In most cases these are Japanese businesspeople on the one hand, and American lawyers on the other: Gray, W., 'The Use and Non-Use of Contract Law in Japan: A Preliminary Study' (1984) 17 *Law in Japan: An Annual* 98.

55 Wagatsuma and Rosett trace the impact of the American legal profession on contracting norms in that country, and suggest that Japan to date has escaped the widespread incursion of lawyers into the domain of business negotiations: Wagatsuma and Rosett, *op. cit.* n.20.

56 Haley, for example, has suggested that Japanese case law imparts greater certainty within that system because of the uniformity in training and experience of a career judiciary. See Haley, J.O., 'Commercial Litigation and Arbitration' in *Japan Business Law Guide* (1991). To this can be added factors such as the absence of a trial by jury, and the fact that decisions are generated within a single court hierachy, thus reducing the need for 'defensive drafting'.

systems, party autonomy is a core concept within contract law. Thus the Civil Code does not prescribe the form that contracts must take to be valid. The paradigm within the Civil Code is the consensual contract — formed merely through the agreement of the parties. Contracts which need to be evidenced by writing or part performance are an exception to this general rule:[57]

> Consensual contracts are those in which the contract gains its validity merely from the parties' expression of mutual intent; a real contract (*yōbutsu keiyaku*)[58] is one which requires delivery of the subject matter of the contract, or some other kind of performance or payment before it becomes effective. Of the 'type' contracts in the Civil Code,[59] sales (*baibai*), leases (*chintaishaku*), employment contracts (*koyō*), contracts for work to be done (*ukeoi*), mandates (*i'nin*), partnerships (*kumiai*), life annuities (*shūshin teikikin*) and compromises (*wakai*) are all consensual contracts; gifts[60] (*zoyō*) are treated in principle as consensual contracts. In contrast to this, loans for consumption (*shōhi taishaku*), loans for use (*shiyō taishaku*) and bailments (*kitaku*) are regarded as contracts requiring payment or performance. Outside the Civil Code, pledges (*shichi keiyaku*) and earnest money agreements (*tetsuke keiyaku*) are contracts requiring payment or performance.[61]

The Civil Code provisions reflect this party autonomy; there are some compulsory provisions (*kyōko hōki*) like the article 1 duty to transact in good faith or the article 90 invalidation of juristic acts 'contrary to public policy and good morals', which are implied into all agreements, but the balance are 'non-compulsory' (*nin'i hōki*), which state general rules and may be expressly varied by the parties. Where the parties do not make a clear choice, the non-mandatory provisions can be used by the courts as interpretive provisions (*kaishaku kitei*) or to supplement the intent where it does not exist (*hojū kitei*).[62] In this sense the Japanese Civil Code sections on contract perform the same function as article 2 of the U.S. Uniform Commercial Code — to provide rules for private transactions where the parties do not.[63] Some commentators have suggested that Japanese contracts are characteristically brief because there is no need to duplicate Code rules in each and every agreement. Yet no-one has suggested that the U.C.C. has a similar effect on American contracts.

The exponential growth of international transactions involving Japanese companies, too, is both a systemic and a practical influence on the structure and performance of contracts in Japan. Empirical studies of this are as yet incomplete,[64] but practitioner's views and some preliminary research suggest that Japanese contracting practice in international markets both conforms to, and shapes, international norms.[65] Japan's ratification of the Convention on the International

[57] Michida, *op. cit.* n.20.

[58] *Yōbutsu keiyaku* is a translation of the German term '*Realvertrag*'.

[59] In addition to the principles of contract appearing in the general provisions of the Civil Code, the Code sets out provisions on 13 specific 'types' of contract, often called 'named' contracts. Nine 'type' contracts are also named in the Commercial Code. Contract rules relating to more recent kinds of contracts, *e.g.* franchises and distributorships, are often developed by applying by analogy the provisions relating to 'type' contracts.

[60] Civil Code, art.550: 'A contract of gift which is not in writing may be revoked by either party; however this shall not apply in respect of any part as to which performance has been completed'.

[61] Kurusu, S., '*Dakusei keiyaku — yōbutsu keiyaku*' (Consensual Contracts and Real Contracts) in Matsukawa, H. (ed.), *Minji Hōgaku Jiten, Jōmaki* (Civil Law Dictionary, Vol. 2) (1964).

[62] Hoshino, *op. cit.* n.17, 20.

[63] See, *e.g.* Foote, D., *op. cit.* n.22.

[64] A major empirical study in this area is being undertaken at the Asian Law Centre, University of Melbourne during 1992-94: Smith, M., Taylor, V., Menon, K., Biddulph, S. and Cooney, S: 'Internationalisation of Contracts in Asia', Asian Law Centre.

[65] For a discussion relating to long-term sales to Japan in the primary sector, see Smith, B., 'Long-Term contracts for the Supply of Raw Materials' in Crawford, J.G. and Okita, S. (eds), *Raw Materials and Pacific Economic Integraton* (1978) 229; McCarthy, S., 'Change and Stability in LNG Sales

Sale of Goods (Vienna Sales Convention) will contribute to this process.[66] This article focuses exclusively on domestic contracts; issues of Japanese attitudes and practice in international contracts are reserved for another discussion.

The real significance of the Civil Code model of contract is that the principle of consensual contract validates oral agreements as a matter of course, and makes writing completely optional in all but a very few situations. This is the principle that the Tokyo District Court upheld in the *Marubeni Iida v. Aji-no-moto* case,[67] where Aji-no-moto sought to rescind a purchase agreement for soy beans worth $5 million because the market price had plummeted. Aji-no-moto argued that its oral agreement with the seller should be set aside because there was no contract in writing. The Court disagreed. It held that there was insufficient evidence that contracts in writing were part of commercial custom in these circumstances and found no reason to overturn the consensual contract principle. Even where writing is prescribed by special legislation, the failure to comply does not invalidate the contract.[68]

1.6 *The Divergence of Custom and Positive Law*

Kawashima perceives that the ordinary person's conception of contract resulted in a dysfunctional application of positive law; that inevitably compromises were made and national law adjusted to take into account popular contract consciousness.[69] He also points to the importance of commercial custom, citing practices such as oral agreements between merchants and consignment sales. He seems to suggest that these practices existed outside the operation of positive law. The evidence of the 1990s is that custom continues to be an important part of contracting in Japan, but it coexists with, and is often incorporated within, an increasingly comprehensive body of positive law.

Revisionist scholars, such as Uchida, now suggest that the 'dualism' of Kawashima's analysis is no longer a useful tool; the evidence, he suggests, is that custom and relational transactions are reshaping the contours of formal contract law in Japan.[70]

Contract Terms' [1985] *Australian Mining and Petroleum Law Association Yearbook* 212; Daintith, T., 'The Design and Performance of Long-Term Contracts' in Daintith, T. and Teubner, G. (eds), *Contract and Organizations: Legal Analysis in the Light of Economic and Social Theory* (1986) 164; and Sono, K., 'Comparative Aspects of Legal Issues Relating to Long-Term Contracts in Trade between Australia and Japan' in *Attorney-General's Department Fifteenth International Trade Law Conference Proceedings* (1989) 453.

66 Japan's ratification is expected in the very near future: personal communication from Professor Kazuaki Sono, Faculty of Law, Hokkaido University and former Secretary-General of the United Nations Commission on International Trade Law (UNCITRAL).

67 8 *Kakyū Minshū* 1366, 1415-6 (Tokyo District Court, 31 July 1957).

68 The consensual contract principle is followed legislatively as well. One illustration is the *Takuchi tatemono torihikigyōhō* (Building Sites and Building Transactions Law) (Law No. 176, 1953). The statute stipulates that before the contract is formed, the broker must record important provisions in writing, deliver this to the buyer and explain its contents (art.35). Once the contract is formed, a contract document must be delivered to the buyer (art.37). If the broker fails to deliver a contract in writing, will the sale of the residential land or building be invalid? All that the statute prescribes in this case is that a broker who fails to deliver a contract in writing 'is subject to a fine of no more than 100,000' (art.83(1)(3)). So the presumption is that, according to Civil Code principles, the validity of the sale flows from the parties' intentions, manifested in their oral agreement: Michida, *op. cit.* n.20, 211.

69 Kawashima, *op. cit.* n.33, 2.

70 Uchida, T., 'The New Development of Contract Law and General Clauses: A Japanese Perspective', Unpublished paper delivered at the University of Tokyo (undated).

2. *COMMERCIAL CUSTOM IN CONTEMPORARY JAPAN*

Much of the current debate about Japanese competition policy and the distribution system centres on so-called 'traditional transaction practices' (*torihiki kanshū*) and commercial custom. Transaction types identified as 'traditional contracting practices' include the *itaku hanbai* (consignment sale) and the *shōkashiire* contract, both widely used in the manufacturing sector, in wholesale distribution networks and in wholesale supply agreements with department stores.

2.1 *Traditional Contracting Practices*

In an ordinary sales agreement, risk usually passes to the other party at the same time as ownership in the goods (the principle of *caveat emptor*). Although this was also the pattern in wholesale transactions during the Edo period,[71] contemporary consignment sales reverse the risk. In *itaku hanbai* there is a sales agreement between the parties, but the buyer only stores the goods; the seller retains ownership of the goods. Where goods remain unsold, these can be returned to the seller at no cost to the buyer. The seller then has the problem of how to dispose of unsold merchandise.

In *shōkashiire* contracts, the buyer simply stores the goods, and acquires ownership of the goods only at the moment when they are purchased by a third party. Until this point the original seller bears the risk. These arrangements are facilitated by payment being in the form of 30, 60 or 120 day promissory notes.[72] In this way large retailers can maximise the variety of their stock, and the burden of disposing of unsold merchandise falls to the supplier. My personal favourite is the 'cry-yourself-to-sleep' transaction, in which a seller is faced with a sudden cancellation of an order, or a request to reduce the volume, and simply absorbs the consequent loss, in the hope that it will be made up in future.[73] Not all of these practices are supported by classical contract law, but all represent commercial expectations within certain markets, and to that extent, they can be viewed as a kind of 'law'.[74]

The frustration of non-Japanese businesspeople for whom this 'law' is unfamiliar was reflected in the claims by U.S. negotiators during the 1989 Structural Impediment Initiative talks. It was argued that continuing contracts in Japan were an invisible trade barrier which precluded new market entrants from establishing links in the manufacturing and distribution sectors of the Japanese economy. Negotiators argued that continuing contracts are the means by which unfair competition devices like resale price maintenance, rebates, and cartels are established and maintained, and that such practices are seldom made explicit in the terms of a contract, which creates pressure on the weaker party.[75]

[71] Ejiri, '*Nihon ni okeru shōtorihiki keiyaku no keitai no ruikei to tokusei*' (Form, characteristics and similarities of commercial contracts in Japan) (1990) 950 *Jurisuto* 39, 40.

[72] *Ibid.*

[73] Described by Kashiwagi, N., '*Nihon no torihiki to keiyakuhō: Kyōdō kenkyū — keizokuteki torihiki o kangaeru*' (Japanese Transactions and Contract Law: Joint Research — Continuing Transactions Considered) *NBL* 16; 501 *NBL* 16.

[74] Uchida, *op. cit.* n.70.

[75] The U.S. Department of Commerce Structural Impediments Initiative claims were silent about

Partly in response to these claims, a private study group established by Japan's Fair Trade Commission ('the FTC') prepared a Report on Distribution and Traditional Transaction Practices: the Future of Competition Policy.[76] The 1990 Report acknowledges, among other issues, criticisms of continuing contracts and sets out examples of possible contraventions of the Anti-Monopoly and Fair Trade Law.[77] These include:

- undertakings to resell at a given price;
- retail and wholesale prices prescribed by manufacturers;
- restrictions imposed by the manufacturer other than price — *e.g.*, prohibitions on handling other products and limitations on sales territories;
- involvement in the management of the distributor;
- payment of rebates;
- return of unsold goods by retailers;
- dispatching support staff to retailers;
- systemisation of purchases by large scale retailers;
- collaborative boycotts; and
- transactions between parent and subsidiaries.

In its Report, the FTC study group acknowledges that consignment sales are a widespread practice in Japan and recommends, *inter alia*, that practices like returning unsold goods be expressly set out in supply and distribution contracts.[78]

The Report neither suggests nor advocates that the use of continuing transactions be abandoned or substantially modified. Thus the FTC appears to accept tacitly what many recent economic studies of Japan now indicate: continuing transactions are integral to the operation of Japanese-style capitalism.

While accepting that such transaction patterns do create barriers for new market entrants, some economists now argue that they also have an internal logic:

> [Q]uite complicated transactional arrangements such as are found in Japanese distribution systems reflect the outcomes of transactions partners to organise their transactions in long-term efficient

the widespread use of consignment sales within the United States; *cf.* article 3-236 of the U.C.C. which recognizes this. In the U.S. the utility of consignment sales is that they allow the seller to retain a security interest in the goods while awaiting payment from the intermediate buyer. The Japanese position may be somewhat different, depending on the contract type and the industry. In many cases the use of promissory notes will be the primary guarantee of performance. If an issuer defaults on promissory notes twice within a six-month period, the obligee need only report this to the financial clearing house. The latter has an informal rule that member banks — almost all commercial banks in Japan — must cease doing any kind of business with the obligor for two years. In effect this will force the obligor into bankruptcy, since no business can survive for two years without loans, credit and deposit facilities. Although the procedure is a purely contractual and private form of sanctioning, it ensures that promissory notes are nearly as good as cash, and that they can be used as collateral by creditors: Haley, J.O., *Authority Without Power* (1992) 182. Where security over inventory would be insufficient, as in the case of a food franchise, other forms of real property security will be sought. The function of consignment sales in some distribution channels is that suppliers of luxury goods can prevent the goods being discounted and resold in locations which might detract from the usual prestige and pricing of the merchandise.

[76] *Ryūtsū — torihiki kankō to korekara no kyōsō seisaku: hirakareta kyōsō to shōhisha rieki no tame ni*, 21 June 1990; outlined in (1990) 453 *NBL* 9.

[77] *Shiteki dokkin no kinshi oyobi kosei torihiki no kakuho ni kansuru hōritsu* (Act Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade): Law No. 54, 14 April 1947. For a comprehensive discussion of the ambit of the Antimonopoly Law, see: Matushita, M., *International Trade and Competition Law in Japan* (1993).

[78] The utility of this suggestion is questionable, given the high incidence of oral contracts of this type. Ejiri, for example, cites 70 percent of contracts in the Japanese textile industry as being oral contracts in 1987: Ejiri, *op. cit.* n.71.

ways in the presence of problems of contractual incompleteness, uncertainty, possible opportunistic behaviour and highly non-standardised products.[79]

For this reason, attempts to make traditional Japanese transacting practices conform to some kind of Western classical contract model are doomed to failure. More importantly, we should ask whether the classical contract model has any utility for representing contracts outside Japan 'as they are', as opposed to 'as they should be'.

Both classical common law and civil law contract theory use the discrete, or 'one-off' contract as the paradigm transaction.[80] A major development in Japanese legal discourse has been the recognition that it is the continuing, not the discrete, contract that is used most often in business. However, the Japanese commercial practices described above also vividly illustrate the harsh 'underside' of relational contracting. 'Relational' does not mean 'warm and fuzzy':

- the relationships are invariably asymmetric: there is always a stronger party;
- commercial life is seldom 'fair' — transactional partners squeeze each other; and
- a reluctance to litigate can be just as much a rational fear of being cut out of a trading relationship, and a recognition of the futility of this, as a deeply-felt moral or cultural principle.[81]

79 Sheard, P., 'Introduction' in Sheard (ed.), *International Adjustment and the Japanese Firm* (1992) 5.

80 Modern contract theorists such as Macneil and Macaulay challenge this model of contracting. Both argue that contracts are more likely to be continuing transactions, between parties who know, or come to know, each other. Macneil and Macaulay contend that contracts embody social exchange, and need to be considered in light of a surrounding matrix of societal factors: kinship, custom, law, economic interdependence and ties that bind: Macneil, *op. cit.* n.13, 6. The purpose of such exchange is to maximise the mutual benefits of specialisation in labour. The value of contract, or promise, is that it allows these benefits to be projected into the future. Macneil divides contracts into two broad categories: discrete and ongoing. The discrete contract is the contract ideal of classical theory, characterised by:

- short duration;
- limited personal interaction between the parties;
- precise measurement by the parties of the objects of exchange, *e.g.* price and quantity of a specified object;
- minimum future cooperation;
- no sharing of contract benefits or burdens;
- tightly and precisely binding terms;
- clearly defined content, in which everything is presentiated ('rendered present in time'): Macneil, *supra* 13-6.

Ongoing transactions, on the other hand, generally have:

- significant duration;
- close, whole-person relations;
- an object which may be easily measurable, or not;
- individual and collective poles of interest;
- future cooperative behaviour anticipated;
- shared, rather than pre-allocated, benefits and burdens;
- entanglements like friendship, reputation, interdependence, morality and altruistic desires;
- trouble in the transaction is anticipated as a matter of course.

The ongoing contract is never fully presentiated, that is, parties view it as an ongoing integration of behaviour, which will grow and vary. The normative principles in ongoing transactions are (i) flexibility; (ii) preservation of the continuing relationship; (iii) a fair process for solving disputes; and (iv) cooperation and good faith: Macneil, *supra* 253. For a Japanese formulation of the same idea, see Fukunaga, M., '*Keizokuteki torihikikeiyaku no kaiho to songaibaishō*' (Termination and Damages in Continuing Transactions) (1983) 496 *Hanrei Taimuzu* 32, describing parties' priorities in continuing contracts as: (i) mutual trust and reliance; (ii) a stable contractual relationship; and (iii) a degree of permanency. These can, and do, occur to some degree in discrete transactions as well; in this sense all contracts are 'relational'. Furthermore, even discrete contracts rest on tacit assumptions by the parties about the surrounding social matrix.

81 It can also be a product of the ideological use of a 'non-litigious' ethic, which is self-reinforcing.

The litigated cases discussed later in this article also suggest that, in some circumstances, Japanese parties will cheat on each other, act opportunistically, use their superior leverage and informational advantages, lie, and default on their obligations.[82] *Dainichi Kagaku Sangyō K.K. v. Maruichi Shōkai* (the *Hula-Hoop* Case)[83] is an example of such opportunistic contracting. At the height of the 1957 hula-hoop craze in Japan, Dainichi Kagaku told Maruichi that it was supplying 2,000 hula-hoops a week to Sumitomo Bakelite, and could re-route about 200 of these to Maruichi. The contract was concluded, and Maruichi presumably paid an amount as a deposit of guarantee.[84] Weeks went by and no hula-hoops appeared; in fact Dainichi had neither a contract with Sumitomo Bakelite, nor the technology for making hula-hoops. Maruichi immediately terminated the contract without notice. The Court of First Instance approved the immediate termination, and the Osaka High Court upheld the decision, citing the *haishinteki gendō* (deliberately false statement and betrayal) of the defendant. Dainichi's appeal was summarily dismissed.

Contrary to another widely-held assumption about Japan, such business behaviour will frequently result in transactional breakdown, and in some cases, litigation, failure to settle and final judgment.

2.2 *Formal Recognition of Custom: Codes and Courts*

Even where cases do proceed to court, commercial custom is recognised and applied. Custom (*kanshū*) is an important source of law in Japan, as it is in other legal systems.[85] We can classify commercial custom, or trade usages, in at least three ways. At the lowest level of abstraction are factual trade usages, that is, what people or corporations actually do in their industry transactions. Next are contractual trade usages or customs, determined by express or implied agreement between transaction partners. At the highest level of abstraction are trade usages which have been elevated by statute or universal acceptance and have the force of law within a jurisdiction.[86]

Many legal systems simply make a distinction between the unlegislated or uncodified custom on the one hand and codified or formulated usages on the other.[87] Japan makes a dual distinction ; between custom (*kanshū*) and commercial customary law (*shōkanshū*). Custom is the product of either trade norms or party choice. Article 92 of the Civil Code prescribes that custom can be determinative:

On this point, in relation to the supposed Japanese abhorrence of hostile takeovers, see Ramsayer, J.M., 'Takeovers in Japan: Opportunism, Ideology and Corporate Control' (1987) 35 *U.C.L.A. Law Review* 1.

82 I am not suggesting that this is the norm; see for example, Ronald Dore's view of transactions in the Japanese fibre industry, which he regards as seldom opportunistic: Dore, R., 'Goodwill and the Spirit of Market Capitalism' (1983) 34 *British Journal of Sociology* 459.

83 *Dainichi Kagaku Sangyō K.K. v. Maruichi Shōkai* (Osaka High Court, 11 June 1963); (1962) 304 *Hanrei Jihō* 24.

84 The appellate decision does not deal with this point, but the headnote is prefaced 'A *kōso* appeal from a claim for return of guarantee money'.

85 See, *e.g.*, Schmitthoff, C.M., *International Trade Usages (Special Issue): International Business Law and Practice Newsletter* (1987), which surveys domestic and international trade usages (or commercial customs) in both civil and common law juridictions.

86 *Ibid.* 26.

87 *Ibid.* 25.

> If, in cases where there exists a custom which differs from any provisions or laws or ordinances which are not concerned with public policy, it is to be considered that the parties to a juristic act have intended to conform to such custom, the custom shall prevail.

Article 2 of the *Hōrei* (Law Regarding Conflicts of Law)[88] reinforces this by recognising custom as applicable where indicated as party choice. There is no distinction made between domestic and international commercial custom, so commercial custom established by case law will be 'trade usage' for the purposes of, for example, the Convention on the International Sale of Goods.

Japanese courts treat custom as a question of fact. Thus in the *Aji-no-moto* case, the Tokyo District Court accepted that a dislike of written agreements was customary, and (by inference) that this applied to international sales of soy beans between Japanese parties.[89] The Court accepted evidence presented in *Aji-no-moto* which showed that even a large company like the Honen Oil Refinery seldom used written agreements because their customers preferred it that way.

Two observations are in order. First, custom is always context-specific; the product of an industry or sector of the economy, and of a certain point in time. The second factor is that the determination of custom is made on a case-by-case basis. Both Kawashima[90] and March — thirty years later — suggest that *Aji-no-moto* stands for the customary avoidance of written contracts in Japan.[91] They cite the case for the wrong proposition. *Aji-no-moto* was decided in 1957, and does not apply automatically to other kinds of transactions. So, for example, consideration of commercial custom in *Suehiro Shōji*, a 1975 kōso appeal to the Tokyo High Court,[92] resulted in a (seemingly) contradictory finding that in a sale of land where writing is not required by law, but where preparation in writing is customary, a mere oral agreement will not be enforceable.

Suehiro Shōji was a real estate brokerage in Tokyo commissioned to sell a private school property. After lengthy negotiation a buyer was found and the price set at ¥3,600,000,000. The brokerage fee was to be ¥4,000,000 *per* party. Before the agreement was recorded in writing, the seller sold the property to a third party. Suehiro Shōji sued to recover the fee due from the seller. The claim was rejected by the Chiba District Court, but the Tokyo High Court reversed this decision on appeal.

The Tokyo High Court found that, since there was no contract formed between the buyer and seller, Suehiro's claim for compensation based on the contract could not be sustained. But the Court found against the seller in the amount of ¥3,200,000 plus 20 percent *per annum* interest between the date of judgment and date of final payment. It based its decision on art.648(3) of the Civil Code and on the 'special circumstances in which the mandator (principal) has breached his duty of good faith and has abused his freedom'.[93] The Court found that a contract

88 *Hōrei* (Law Regarding Conflicts of Law) Law No. 10, 21 June 1898.

89 Tokyo District Court, 31 July 1957; (1957) 8 *Kakyū Minshū* 1366, 1415-6.

90 Kawashima, *op. cit.* n.33, 6.

91 March, *op. cit.* n.1, 111.

92 *Suehiro Shōji v. Seisho Gakuen* (Tokyo Supreme Court, 30 June 1975) (1975) 790 *Hanrei Jihō* 63 (hereafter referred to as '*kōso* appeal').

93 'Good faith' is the principle of good faith and trust found in article 1(2) of the Civil Code: 'The exercise of rights and performance of duties shall be done in [good] faith and in accordance with the principles of trust.'

on the verge of formation is not a contract, but was prepared to recognise the efficacy of 'actual agreement' in order to deal with the case as an application of the principle of good faith. In relation to the writing requirement, the Court applied article 92 of the Civil Code and held that:

> (1) In a sale of property for a considerably high price, it is clear that in reality the well-settled custom is to prepare a contract in writing which incorporates standard form conditions, including penalty provisions, and the details of the transaction, and make a payment of earnest money or part of the sale price;
> (2) This custom must be given due weight; if one adopts this position and parties in a real estate sale transaction are regarded as following the custom, then it is appropriate to view preparation of a contract in writing and payment of part of the sale price as essential elements in the formation of the sale; and
> (3) In this case, there is no clear manifestation of an intent not to follow the custom outlined above. Because the parties agreed, in line with usual custom, to prepare a contract in writing and pay part of the sale price, failure to do so must result in failure to form a contract of sale.[94]

On a *jōkoku* (second) appeal to the Supreme Court, the case settled, and so there is no Supreme Court comment available.[95]

A 1982 case, *Asahi shoseki*,[96] is a more recent illustration of Japanese courts' readiness to consider commercial custom. In this case the parties concluded a twenty year contract for the wholesale distribution of magazines and textbooks. The contract was in writing, but the Court held that it was unenforceable, in part because contracts of such long duration were not customary in the wholesale book trade. Examination of the industry practice in turn cast the inference that the plaintiff, who was objecting to a purported termination, had abused its superior bargaining power.

In contrast to commercial custom, customary commercial law (*shōkanshūhō*) in Japan is a body of transactional norms that have acquired the force of law. This is reflected in article 1 of the Commercial Code, which provides:

94 *Suehiro Shōji v. Seisho Gakuen*, (1957) 790 *Hanrei Jihō* 63, 65 (Tokyo High Court, 30 June 1975).

95 Michida Shinichirō, who discusses the case at length in *Contract Societies*, *supra* n.20, also notes that:

> If there was a well-established 'custom', then Suehiro, as an industry broker, was in a position where it must have known this, and should have ascertained with more clarity the parties' 'intention' to follow the 'custom' or to disregard it. However, the *Annotated Compilation of Laws*, cites two Taishō Period (1912-1926) Great Court of Judicature decisions in relation to Article 92:
>
> In relation to the practice of raising land rents (*chidai neage*) in metropolitan Tokyo, a person in the position of expressing an intention to transact in this way must be taken to have such an intention unless they make a particular objection ... The party asserting the existence of an intention to follow [such] custom is not required to show special proof of this: Osumi, K. (ed.), *Mōhan Roppo* (Annotated Compilation of Laws) (1982), cited in Michida.
>
> If we apply these approaches, then defendant Seisho Gakuen would not have been required to prove anything with regard to the custom of drawing up a contract in writing. The Tokyo High Court decision that presumed Suehiro to have followed the custom should not be criticised.

Michida also suggests that textbooks in Japan have been slow to take account of the case. The typical statement is:

> Oral [agreements] are not uncommon ... Writing is not a requirement. This is what is meant by freedom of form being one of the elements of freedom of contract. Thus a so-called 'oral promise' has binding force ... but to avoid the unnecessary danger of inviting disputes, in a high-value contract like a real estate transaction, preparation of a contract in writing is almost essential.': Ishida, K. and Osawa, M. (eds), *Fudōsanhō Nyūmon (Hōgaku Nyūmon Kōza) (Introduction to Real Estate Law (Lectures in Introduction to Law))* (1978) 80-1: Michida, *supra* n.20.

96 *Asahi shoseki hanbai K.K. v. Suzuki Takashi and Saijō Kanji*, (1982) 1045 *Hanrei Jihō* 105 (Tokyo District Court, 30 September 1982).

As to a commercial matter, the commercial customary law shall apply if there are no provisions in this Code; and the Civil Code shall apply, if there is no such law.

In practice, applications of commercial customary law are relatively rare; the decided cases listed in the *Mohan Roppō* (Annotated Compendium of Laws)[97] deal almost exclusively with promissory notes and banking law. There is an emerging view in Japan that the distinction between custom (*kanshū*) and customary commercial law (*shōkanshūhō*) may be disappearing; custom as a question of fact under article 92 of the Civil Code can be viewed as a type of customary commercial law.[98]

Whether we view commercial custom under classical contract law labels, or see it as a fusion of law and practice, it is clear that in Japan there is a dynamic interaction between custom, codes, legislation and judicial construction.

3. *CONTEMPORARY CONTRACT LAW IN JAPAN*

Understanding these commercial customs and cultural norms is important, but it does not reveal the totality of how a legal system operates. Absent from both the Kawashima and the Sugar Dispute folklore is an understanding of what constitutes Japanese contract doctrine, and how this might affect commercial negotiations.

Positive, or 'black-letter' law in Japan, as in other legal systems, is not static. The Codes which are the foundation of that civil law system are now over a hundred years old. In the case of contract law, the Civil Code is a 19th century summation of principles relating to offer, acceptance, mutual intent, breach, mistake, misrepresentation, impossibility of performance, and remedies, which are immediately recognisable to us as the functional equivalents of 18th and 19th century doctrines in our own system which are now being critiqued and amended through judicial and statutory intervention.

Similar developments have occurred within the Japanese legal system; examples include the enactment of the Instalment Sales Law,[99] the Law Concerning Door-to-Door Sales and Mail-Order Sales,[100] and the more indirect impact of the Anti-Monopoly and Fair Trade Law[101] and projected legislation such as the Product Liability Law. There is also a substantial and growing body of case law which has interpreted and expanded the Code, examples of which are given below. The catalyst for much of this regulatory change has been the emergence of new types of continuing contracts.

3.1 *New Transaction Types: Franchises and Distributorships*

Continuing contracts are a feature of most areas of capitalist economic activity, from natural resource sales through employment contracts of all kinds to supply contracts in both the wholesale and retail sectors of economies.[102]

97 Published annually.

98 Toda S. and Nakamura, M. (eds), *Shōhōsōsoku — Shōkōihō* (*General Provisions of the Commercial Code — Commercial Acts*) (1984) 32.

99 Law No. 159, 1 July 1961.

100 Law No. 57, 4 June 1976.

101 Law No. 54, 14 April 1947.

102 Continuing contracts can be structured in a variety of ways:

A Ministry of International Trade and Industry Report lists Japanese examples including: transactions between manufacturer and retailer, and first and second tier wholesalers; transactions between agricultural product suppliers and manufacturers; distribution of chemical products among companies within the same corporate grouping; water, electricity and gas supply agreements; consumer contracts for milk and newspaper delivery; banking transactions; and transactions between insurance companies and their agents.[103]

Of these, franchises and distributorships are sub-categories of continuing contracts that have particular economic significance in developed economies.[104] They represent a highly developed form of retailing, in which a product or service is 'bundled' with an efficient delivery system and intellectual property rights, to create an instantly-recognisable product of unvarying quality. Franchises alone accounted for one-third of all retail sales in the U.S. in 1987.[105] In Australia, it is estimated that there are at least 17,487 franchisee-operated outlets employing over 173,000 people and experiencing a gross turnover exceeding $32 billion.[106] Franchising in Japan is an equally significant, growing sector of the economy.[107]

3.1.1 *Complex Relational Ties*

Both franchises and distributorships are complex commercial relationships, distinguishable by two indices: control and ownership. In a franchise the franchisor typically exercises the control in the relationship and has almost unlimited decision-making authority:

> The franchisor provides the marketing concept, product ideas and design; it develops procedures for delivering the product; it creates operating manuals and it sets quality standards ... the distinguishing characteristic is that the franchisee is under the control of the franchisor and thus is instructed how to run her business much as an employed manager would be.[108]

The difference between a franchise and an employment relationship, however, is that the franchisee usually owns or leases most of the assets which will produce the joint product. The franchisee is typically a small businessperson who raises this investment capital through savings and personal loans.[109] Distributors, by

- 'long-term' contracts with stipulated, periodic deliveries and payment;
- long-term master-contracts under which a series of subsidiary, independent sales are made;
- open-ended contracts with a staggered series of obligations; or
- a series of orders placed with a transaction partner on the same terms each time, within a trading relationship.

[103] Kigyōbu (Industry Section) (ed.), *Torihiki jōken no jittai (Present state of transaction conditions)* cited in Kugizawa, I., *Keizokuteki torihikikeiyaku no kaiho o megutte* (Termination of continuing transactions) (1975) 94 *NBL* 6, 6.

[104] For expositional simplicity, in this part of the paper I will assume that they share common characteristics, whether found in Japan, the U.S. or Australia.

[105] Hadfield, *op. cit.* n.23, 933, quoting U.S. Department of Commerce, *Franchising in the Economy 1985-87* (1987) 14. The U.S. Department of Commerce defines any relationship in which the retailer operates under its supplier's trademark as a franchise. The retail sales figure thus includes the sale of snack foods, beer and soft drinks — products we usually associate with distribution.

[106] Figures for 1989/90, compiled from a survey of 350 franchised systems conducted by a Franchising Task Force established by the former Commonwealth Minister for Small Business, Mr. David Beddall: cited in Fitzgerald, R., 'Franchising Code of Practice' (1993, unpublished). Copy held by the author.

[107] For an account of the success of U.S. and British franchises in Japan, see *Business Tokyo* (Tokyo), May 1992.

[108] Hadfield, *op. cit.* n.23, 933-4.

[109] *Ibid.* 934.

contrast, are usually independent businesses over which the product manufacturer has little direct control. Distribution may be exclusive or non-exclusive; the more exclusive the transaction, the more interdependent the parties will be. Ownership and control generally reside with the individual distributor.

The structure of both franchise and distributorship leads to two core problems. The franchisor (or manufacturer) needs to control the quality of service offered by the franchisee or distributor. The value of the trademark must be maintained through providing the goods and services in the agreed manner, to both increase sales and also maintain the trademarks' resale value.[110]

On the other hand, a franchisee or distributor wants to ensure that she is protected against opportunism — the unfair exercise of control by the franchisor or manufacturer. This problem is particularly acute for franchisees, because the investments they make in a franchise outlet are highly specialised, and not easily recoverable. If a franchisor makes decisions that result in losses for the franchisee, the latter is more likely to continue operating at a loss than to pull out of the venture and risk losing the entire investment.[111] A distributor, by contrast, may be able to use her existing infrastructure to substitute one product line for another.

Franchises and distributorships are more than arm's length transactions. Often the precise nature of the exchange is ambiguous. Franchisees and distributors purchase more than trademark rights; they purchase expertise and management advice. Franchisors and manufacturers seek partners who will follow their directions in detail, but who will also energetically promote and protect the product as if it were their own. Parties to franchises and distributorships are mutually reliant, but this does not imply that they are equals. In fact, 'the franchisor's relative superiority and the franchisee's relative inexperience is an essential component of the typical franchise exchange'.[112] The differences in economic power and social status which permeate the 'relationships' that allegedly make Japanese contracts culturally distinct, are characteristic of franchises and distributorships everywhere.

Inequality manifests itself in a number of ways, beginning with the standard-form, non-negotiable contract offered to the franchisee. In return for following the rules and working hard, the inexperienced franchisee is given a measure of protection from the mistakes that cause most small businesses to fail.[113] A distributor, on the other hand, may enjoy full ownership and control of the business, but he or she is still vulnerable to control exercised by the manufacturer or higher-level distributor, often through the distribution agreement. The Japanese case *Asahi Shoseki v. Suzuki and Saijō*[114] is a good illustration of a dispute which turns on the parties' unequal relationship.

Asahi Shoseki was a large wholesaler of books and magazines. Defendants Suzuki and Saijō operated an intermediate wholesaling operation, selling to retailers. Asahi and the defendants concluded a 20 year consignment sale agreement, in which the defendants undertook to: (i) purchase exclusively from Asahi; (ii) give Asahi written notice of any transfer of ownership of substantive change in

110 *Ibid.* 949.
111 *Ibid.* 952.
112 *Ibid.* 961.
113 *Ibid.* 963.
114 *Supra* n.96.

the nature of the defendants' business and obtain its consent; and (iii) refrain from competing with Asahi for a period of three months after the termination of the agreement. Resale price maintenance and limitation of sales territories also formed part of the agreement, but were not argued.

Eight months into the transaction, the defendants began to find it onerous and formed a new supply agreement with Nihon Shuppan, one of Asahi's competitors. They gave ten days' notice that they intended to terminate, and requested that Asahi stop further shipments. Asahi brought suit for breach, claiming profits from the remaining 19 years of the contract. The issue was whether the termination was effective.

The Court looked first at the validity of a 20 year distribution agreement under the Anti-Monopoly and Fair Trade Law.[115] It determined that the transaction did not undermine competition, but was rather a rational economic organisation of the plaintiff's business. It did not violate articles 2(7) or 2(9)(4), nor was it an 'unfair business practice' prohibited by article 19.[116] This was because Asahi's supplier, Chūō, held only 30 percent of the market share for books and magazines of the kind transacted for here. Chūō competed with Tokyo Shuppan and Nihon Shuppan, who between them accounted for 70 percent of the market.

However, the 20 year term was found to be problematic, because of the difference in status of the parties. The court conceded that both Asahi and the defendants were 'merchants', but of very different kinds. Asahi was a wholesaler with a staff of over 100, while the defendants were self-employed men who had changed jobs frequently before going out on their own. They had been first recruited and trained in-house by Asahi, which also supplied them with business advice and some capital equipment. Their distributorship had the colour of Asahi doing business under the defendants' names. Nevertheless, the imposition of the 20 year agreement, in an industry where such fixed-term contracts were uncommon, looked like an abuse of Asahi's dominant position. Asahi's behaviour was characterised as a violation of articles 2(9)(5) and 19 of the Antimonopoly Law,[117]

[115] *Shiteki dokkin no kinshi oyobi kosei torihiki no kakuho ni kansuru hōritsu* (Act Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade) *supra* n.77.

[116] Antimonopoly and Fair Trade Law:

Art. 2(7):

> The term 'monopolistic situation' as used in this Act shall mean a situation whereby the market structures and undesirable market performances referred to in the following list exist in any particular field of business involving goods or services where, during the preceding one-year period . . . the aggregate total amount of prices . . . of such goods of the same type . . . is more than fifty billion yen.

Art. 2(9):

> The term 'unfair business practice' as used in this Act shall mean any act coming under any one of the following items which tends to impede fair competition and which is designated by the Fair Trade Commission as such.
>
> . . .
>
> (4) Dealing with another party on such conditions as will restrict unjustly the business activities of such party.

Art. 19:

> No entrepreneur shall engage in unfair business practices.

[117] Art. 2(9):

> The term 'unfair business practice' . . . shall mean . . .
> (5) Dealing with another party through undue use of one's bargaining position.

and a breach of public policy and good morals (Civil Code, art.90), and was thus unenforceable.

On the question of notice, the Court found that the termination would only be justified if the defendants could show (i) an unavoidable reason; (ii) sufficient notice; and (iii) compensation in damages to cover the notice period. Holding that the first two elements had not been made out, the Court ordered the defendants to compensate Asahi, not for the 19 years of lost profits claimed, but for profits lost during six months, the period for adequate notice.

Part of the folklore of franchising is the presumed intimacy betwen the parties. Like Japanese relational contracts, franchises in the U.S. are often portrayed as inherently harmonious.[118] In the United States this is reinforced by the use of family metaphors. In Kentucky Fried Chicken terms:

> [F]ranchising has been described in many different ways, but actually what it is, is a wedding. Lots of music, lots of flowers, money exchanging hands and lots of kisses, the couple is from the best of two worlds; one of the partners is experienced, with plenty of food know-how, with a proven system; and the other partner is a virgin, who hopefully has never been in business before. The vows they exchange are almost the same as you exchanged when you married your wife, the virgin bride must have a burning desire to be 'his' own boss and to run 'his' own business.[119]

In fact, as with marriages, internal disputes are common. The interests of franchisors and franchisees diverge, but franchisors are able to control their transaction partners through explicit contract provisions and negotiation, relying on the quality control rationale.[120] Franchisees are more likely to lobby for legal regulation, citing franchisor opportunism. Specific complaints include: (i) a lack of support; (ii) manipulation of the price or quality of products sold to the franchisee; (iii) lack of advertising support; (iv) attempts to buy out or terminate successful franchisees; and (v) making changes to the franchise name or image which result in increased cost to franchisees.[121]

Those disputes which stretch into litigation fall into two broad categories: franchisees violating established standards, and franchisors who change the franchise environment. Violation of express standards are often clearcut, as in the McDonalds franchise kitchen that had oil dripping from the roof and a resident stray dog.[122] A dramatic Japanese example is the saga of *Hokka Hokka v. Murahira*.[123]

Hokka Hokka should have sensed trouble when their new franchisee, Murahira, insisted on modifying the name of his franchise store. Murahira had previously operated his own food store and wanted to preserve part of his former business name. Hokka Hokka acquiesced, then reconsidered, and asked Murahira to use only the franchise name. Murahira complied, but the relationship soured.

Murahira stopped using the franchisor's colour photographs of its take-out boxed lunches; he displayed a different logo on his signs; he no longer used the

118 Hadfield, *op. cit.* n.105, 965.
119 *Ibid.* 964.
120 *Ibid.* 966.
121 *Ibid.* 967-8.
122 *Dayan v. McDonald's Corp* 162 Ill. App. 3d 11; 466 N.E. 2d 945 (1984).
123 *Hokka Hokka Tei K.K. v. Murahira Tadashi and another* (1986) 1223 *Hanrei Jihō* 96 (Osaka District Court, 8 August 1986); see also a case commentary: Kansaku, H., '*Shōji hanrei kenkyū: Furanchiyaizu keiyaku no kaiho*' (Rescission of franchise contracts) (1990) 975 *Juristo* 110.

franchise wrapping paper and began selling 'sets' of items prohibited by the franchise agreement. He purchased ingredients from suppliers other than those selected by the franchisor. Murahira's royalty payments to the franchisor stopped, and he established another store in the same line of business as the franchise.

More galling to the franchisor was the letter Murahira and a colleague circulated to all franchisees in the Kansai area. He alleged that the franchisor's only interest was profit; that rebates to its selected suppliers inflated the cost of ingredients and ancillary services; that the franchisor was unqualified to train and support franchisees; and that the royalty payments were being used for undisclosed purposes. The letter called on franchisees to sever their ties with Hokka Hokka and attend a meeting to discuss forming a cooperative. Murahira went ahead with the meeting. Hokka Hokka sued.

In *Hokka Hokka v. Murahira*, the five-year contract was detailed and, we can probably infer, standard-form. Neither party contested the validity of the provisions; the dispute was about who was in breach. The contract gave the franchisor an immediate right to terminate if the franchisee breached any of the contract provisions.[124] Breach also triggered a liquidated damages clause, in the amount of 60 months' royalties.

Hokka Hokka is a story about a food retailer seeking to go it alone, armed with the experience and knowledge gleaned from his time with the franchise. (Despite his criticisms of the franchisor's expertise, a court order was necessary before he surrendered the operation manuals). His allegation of franchisor breach echoes the kinds of complaints made by franchisees in Hadfield's U.S. study.[125] In particular, Murahira seems to have been concerned about the approval of new outlets close to his own.

Nevertheless, the Court viewed Murahira's claims as being without substance, and his actions as direct breaches of express contract provisions. One of these was an undertaking not to engage in conduct which would 'undermine the franchise system'. Thus Murahira's criticisms of the franchisor, and organisation of the protest meeting, could be treated as breaches, without the Court making any comment about whether this was bad faith behaviour. Judgment was given for Hokka Hokka, and Murahira was ordered to pay the full liquidated damages amount plus all outstanding royalty payments, and to return the operation manuals to Hokka Hokka.[126]

[124] Japanese contract law, like its Anglo-American counterparts, recognizes a distinction between contract obligations or provisions which are important and those which are less so. Nevertheless, the 'all-or-nothing' approach suggested in this contract is consonant with the idea that franchising is an interlocking system of obligations: if one is breached, the transaction may no longer function as intended.

[125] Hadfield, *op. cit.* n.105, 968-9.

[126] Despite the formalist nature of the decision, the facts also show an attempt to use extra-legal sanctions before the problem was litigated. There was at least one meeting to discuss Murahira's actions and ask him to cease. In return for this, Hokka Hokka undertook to give its franchisees advance notice of planned openings near existing outlets. Murahira attempted to characterise the meeting as chōtei, or conciliation, at which Hokka Hokka acquiesced to the establishment of his unauthorised outlet. Significantly, Hokka Hokka also requested a written apology from Murahira at the meeting, but neither the apology nor cures for the breaches were forthcoming. On the significance of apology as a non-legal norm in Japan, see Wagatsuma, H. and Rosett, A., 'The Implications of Apology: Law and Culture in Japan and the United States' (1986) 20 *Law and Society Review* 461; and Haley, J.O., 'Comment: The Implications of Apology' (1986) 20 *Law and Society Review* 499.

'Violation of standards' works both ways; it can also be a pretext for the franchisor to terminate for opportunistic reasons. A well-known example of this is a case involving Burger King. The fast-food franchisee who bought into the then fledgling Burger King business in the United States agreed to open ten outlets in ten years. After ten years the franchisor was highly successful and the franchisee had only nine outlets open. The franchisor terminated all nine, resold them at higher prices and deprived the franchisee of the fruits of its early efforts.[127] Other cases involve franchisors who induce franchisees to terminate voluntarily, in order to sell the businesses at a profit;[128] make explicit changes in the franchise system;[129] or modify contracts, ostensibly in response to changing market conditions.[130]

Similar issues have arisen in Australia, where the response has been to encourage franchisors to subscribe to a voluntary Franchising Code of Practice, which is administered by the Franchising Code Administration Council Ltd.[131] The Code entered into force on 1 January 1993, and it is still too early to determine what effect, if any, it has had on the business environment of franchising.

3.1.2 *Planning and Contractual Incompleteness*

Because a franchise or distributorship extends over time, much of the parties' cooperation, communication and performance takes place 'off the contract'.[132] Thus the 'contract', or the part of the transaction which is verifiable by a third party, is often incomplete. This is often deliberate: a tacit or conscious acknowledgment that not all future developments and contingencies can be foreseen. If the transaction is to survive future uncertainties, it requires a measure of flexibility. This is not surprising, considering that the manufacturers and suppliers in Macaulay's early study routinely used oral agreements and order forms, rather than formal written contracts, and modified their agreements as circumstances changed. They also had a strong desire to avoid lawyers and litigation.[133] This appears to be characteristic of many contemporary British and Australian business transactions too, although empirical work in the area is scarce.[134]

[127] *Burger King Corp. v. Family Dining* 426 F.Supp 485 (E.D. Pa), aff'd 566 F.2d 1168 (3d Cir. 1977), discussed in Hadfield, *op. cit.* n.23, 971.

[128] *Fox Motors Inc. v. Mazda Distribs. (Gulf) Inc.* 806 F.2d 953 (10th Circuit 1986); *Photovest Corp. v. Fotomat Corp.* 606 F.2d 405 (2nd Circuit 1981); *certiorari* denied 474 U.S. 825 (1985), discussed in Hadfield, *ibid.* 973.

[129] *Arnott v. American Oil Company* 609 F.2d 873 (8th Circuit 1979); *certiorari* denied 446 U.S. 918 (1980). Amoco persuaded its franchisee to install and pay for a carwash, in exchange for which the franchisee would receive a minimum monthly rebate on the carwash. Four months after installation Amoco presented the franchisee with a new contract which halved the rebate; discussed in Hadfield, *ibid.* 974.

[130] *Dunne Leases Cars & Trucks Inc. v. Kenworth Truck Co.* 466 A.2d 1153 (R.I. 1983), in which the franchisor revoked the leasing part of a truck dealership to create space for displaying the franchisor's products and additional customer amenities. Discussed in Hadfield, *ibid.* 975.

[131] The Code became operative on 1 February 1993. It requires franchisors to register each franchise they create, and to observe detailed procedures in relation to disclosure, cooling-off, standards of conduct and dispute resolution. Although voluntary, the Code is being trialled for a two year period. Widespread failure to self-regulate during that period will result in mandatory legislation.

[132] Hadfield, *op. cit.* n.23, 928.

[133] Macaulay, S., 'Non-contractual Relations in Business: A Preliminary Study' (1963) 28 *American Sociological Review* 55; Macauley, S., 'The Use and Non-Use of Contracts in the Manufacturing Industry' (1963) 9 *Practical Lawyer* 13.

[134] Hugh Beale and Tony Dugdale conducted a study of 19 firms of engineering manufacturers in

3.1.3 *Extra-legal dispute resolution*

Leaving the contract incomplete allows the parties flexibility and room to negotiate when problems arise. The franchise or distributorship agreement rarely spells out obligations to cure imperfect performance, or establishes clear guidelines for resolving disputes informally. Parties to continuing contracts will usually try to negotiate around problems, unless there is a compelling reason for terminating the agreement.[135] However, even where informal dispute resolution — negotiation or mediation — and informal sanctions are used, these are not neutral processes:

> [T]he private relational balance is there to insinuate itself back into place through the gaps in the incomplete contract.[136]

The more powerful contracting party remains so when the transaction runs into difficulty. This is illustrated by termination clauses in the U.S. and Japan weighted in favour of the franchisor. Every franchise agreement examined in the 1971 U.S. Senate Report on franchises had a clause entitling the franchisor to terminate.[137] 76 percent of the agreements studied required the franchisee to agree that violation of any condition of the contract was a material breach, and 68 percent gave a grace period of ten days for curing defaults.[138] The model franchise agreement from Japan reproduced in the Appendix to this paper contains the same kind of clause.

The desire to terminate is often the catalyst for propelling dispute resolution into the formal, legal sphere. When confronted with unforeseen problems, unmet obligations, unfulfilled expectations or unrealised profits, the key issue is how to terminate. The grounds on which Japanese courts attempt to define the circumstances in which a party can exit a contract spanning five, or ten, or an unspecified number of years, and how business people deal with winding down an ongoing, intimate commercial relationship are discussed below.

3.1.4 *Good Faith*

Perhaps the key distinguishing feature of continuing contracts is the importance of good faith. Contract law doctrine in both the U.S. and Japan implies a requirement of good faith in every franchise and distributorship agreement.[139] In ongoing

Bristol which broadly confirmed Macaulay's findings: Beale, H. and Dugdale, T., 'Contracts Between Businessmen: Planning and the Use of Contractual Remedies' (1975) 2 *British Journal of Law and Society* 45. Why more empirical studies of contract are not undertaken is a question that vexes legal academics on both sides of the Pacific: see Crystal, *op. cit.* n.23, 305.

135 Most of the Japanese cases discussed below went to litigation after negotiation or mediation failed.

136 Hadfield, *op. cit.* n.23, 928.

137 Ozanne, U.B. and Hunt, S.D., 'Report Prepared for the Small Business Administration : the Economic Effects of Franchising' in *1971 Senate Select Committee Report on Small Business* 92nd Congress, 1st session, cited in Hadfield, *op. cit.* n.23, 934, as the most current U.S. government publication on franchising.

138 Hadfield, *ibid.* 940-1.

139 In the U.S., a covenant of good faith and fair dealing is implied through the operation of statutes including state franchise laws, the Automobile Dealer's Day in Court Act and the Petroleum Marketing Practices Act. Case law has also applied article 1-203 of the Uniform Commercial Code to franchise contracts: 'Every contract or duty within this Act imposes an obligation of food faith in its performance or enforcement.' See Hadfield, *ibid.* 984, note 260, for a list of franchise cases in which

contracts where much is left unstated, the parties' mutual interests are likely to be achieved only if each acts in good faith. Similarly, parties will demand a showing of good cause if the agreement is to be terminated. As the Japanese cases below illustrate, this is a primary doctrinal tool for the formal adjustment of franchise and distributorship relationships.

One of the commonly noted characteristics of continuing contracts in Japan is the 'bias toward renewal'. Parties often expect that, even where there is a fixed duration, renewal of the contract will be virtually automatic. Renewal clauses like this one from the *Hokkaido Tractor Case*[140] are typical:

> This contract shall become effective from 1 October 1970 and continue until 30 September 1971. Unless any of the parties to the contract gives notice of an intention to terminate, or proposes a revision, at least three months before the end of the contract, this contract will be automatically renewed for another year and thereafter, under the same terms.

Of 157 continuing contracts studied by Kawagoe, most contained automatic renewal provisions and 90 percent were in fact renewed.[141] He found that franchises in Japan appear to be, on average, shorter that their American equivalents: three to five years rather than ten or twenty years in duration, but tended to be renewed more readily. No statutory provisions specifically govern the length of such contracts, so limitations really only amount to the principle of good faith and abuse of rights doctrine[142] and conformity with public policy or good morals.[143]

When a Japanese court is asked to intervene in a franchise or a distributorship dispute, it does so in the absence of definitive rules governing this type of transaction and against a background of deliberately vague party choices.

3.2 *Accommodating Continuing Contracts Within Existing Japanese Contract Law*

Most of the disputes at the heart of reported cases in Japan concern termination. Continuing contracts can terminate either through operation of contract (the agreed period expires) or through subsequent party agreement. Frequently, however, the duration of the contract is unspecified, and the parties have left open questions of how and when to terminate, and what obligations this might give rise to. The failure to perform an obligation, changed circumstances,[144] or extinction of the subject matter of the contract can all spark a termination dispute.

article 1-203 has been applied. See also Gellhorn, E., 'Limitations on Contract Termination Rights — Franchise Cancellations' [1967] *Duke Law Journal* 465.

In Japan all juristic acts are subject to article 1(2) of the Civil Code which provides that: '[t]he exercise of rights and performance of duties shall be done in faith and in accordance with the principles of trust'.

[140] *Hokkaido Ford Tractor K.K. v. Minoru Sangyō* (1988) 1258 *Hanrei Jihō* 76 (Sapporo High Court, 30 September 1987). Discussed in Hanamizu, Y., 'Termination of Distributorship Agreements in Japan' in Campbell and Wolfe (eds.), *Legal Aspects of Business Transactions and Investment in the Far East* (1988) 5; Sono, K., 'Comparative Aspects of Legal Issues Relating to Long-Term Contracts in Trade between Australia and Japan' in *Attorney-General's Department Fifteenth International Trade Law Conference Proceedings* 453 (1989).

[141] Kawagoe, K., '*Keizokuteki keiyaku no shūryō*' (Termination of Continuing Contracts) (1985) 342 *NBL* 6, 9.

[142] Civil Code art. 1.

[143] Civil Code art. 90. Invalidation on the basis of length is rare: see *Asahi shoseki hanbai K.K. v. Suzuki Takashi and Saijō Kanji* (1982) 1045 *Hanrei Jihō* 105 (Tokyo District Court, 30 September 1982), discussed below.

[144] For an analysis of the contours of this doctrine in Japanese law, see Waer, P., 'Frustration of Contracts in Japanese Law: The Doctrine of Changed Circumstances' (1987) 20 *Law in Japan* 187.

The franchise or distribution agreement in Japan is essentially formulated by one (or both) of the parties.[145] No special legislation governs franchises or distributorships; nor do these transaction types fit within the 'type' or named contracts of either the Civil Code or the Commercial Code.[146] This creates some theoretical problems of construction, but a lack of statutory regulation may not be as problematic as it first appears. At least one scholar suggests that existing piecemeal legislation in the U.S. has minimal impact on the legal treatment of franchises because the underlying relationships are too complex to reduce to statutory terms.[147] In Australia, a presumption that legislation would be necessary has given way to experimentation with a voluntary Code.[148]

Commercial custom in some sectors of the Japanese economy continues to prefer the oral contract. However, in practice, agreements combining oral and written undertakings[149] and standard form agreements are also found. No empirical research identifies common forms of franchise or distributorship agreements, but some extra-legal influences suggest that the use of written contracts and standard form agreements may become usual, if this is not already the case. Among these influences are industry guidelines, do-it-yourself contract form books,[150] and more abstract trade negotiation demands from the U.S. for greater 'transparency' in the distribution sector.

The Japanese Civil Code principles of contract generally presuppose short-term transactions. The exceptions are the provisions dealing with leases (chintaishaku)[151] and employment (*koyō*),[152] although contracts of mandate (*i'nin*) and partnership (*kumiai*) can also be viewed as continuing contracts. Special legislation now governs the termination and renewal of leases and employment contracts, displacing the general Code provisions.[153] Whether these original Code provisions can now be applied by analogy to other kinds of continuing contracts, such as franchises and distributorships, is unclear.[154]

[145] The same is true in the United States and Australia, although in all three jurisdictions, these transaction forms also raise issues in anti-trust, product liability, intellectual property, securities and agency law: Hadfield, *op. cit.* n.23, 928.

[146] Federal legislation in the United States governs automobile dealerships and gasoline franchises, and many states have enacted general regulatory statutes that focus on termination and renewal, but there is no overarching uniform regulation: 15 United States Code ss 1221-5 (1988) (Automobile Dealer's Day in Court Act); 15 United States Code ss 2801-6 (1988) (Petroleum Marketing Practices Act); California Business and Professional Code ss 20020-6 (1981) (California Franchise Relations Act); New Jersey Revised Statutes s.56:10-1-51 (1971) (Franchise Practice Act); Wisconsin Statutes ss 135.03-.04 (1985) (Wisconsin Fair Dealership Law) and accompanying discussion in Hadfield, *op. cit.* n.23, 929.

[147] Hadfield, *op. cit.* n.23, 939.

[148] Fitzgerald, *op. cit.* n.106, 2.

[149] A corollary of the parties' freedom to choose the form their contract takes is the absence of a parol evidence rule in Japan.

[150] See *e.g.*, Yamazaki, I. (ed.), *Keiyakushoshiki no sakusei zenshū* (Collected Contract Forms) (1991), which suggests that both franchises and distributorships in Japan take the form of standard form written agreements.

[151] Civil Code arts 601-22.

[152] Civil Code arts 623-31.

[153] Land and House Lease Law, Law No. 90, 1991; Employment Standards Law (*Rōdō kijun hō*) Law No.49, 1947.

[154] Professor Hoshino is critical of the automatic application of Civil Code 'type contract' provisions to new kinds of transactions like franchises and distributorships. He suggests that attempts to do so stem from (i) the traditional nature of legal education; (ii) practitioners who, when drafting, too easily adopt the format of 'type' contracts; (iii) accounting procedures within companies and (iv) lack of confidence in the judiciary's ability to intepret new types of contract: Iijima Noriaki, '*Keizokuteki*

The general judicial approach to leases and employment contracts has been to favour preservation of the transaction until the agreed termination date. This in turn has prompted scholarly and judicial theories challenging the presumption. The concept of the 'breakdown of the trust relationship' (*shinrai kankei no hakai*) was developed to justify early termination. This was then applied analogously by courts to other types of continuing transactions.

An attempt to argue the employment contract analogy is well illustrated by *Konō v. Yasuda Kasai Kaijō Hoken K.K.*[155] The plaintiff was an insurance agent for the defendant, one of Japan's largest insurance companies. Four years into their agreement, Yasuda Kasai suddenly terminated Konō's agency for no stated reason. The reported facts give no indication that there had been any relational breakdown until Konō received notice of intention to terminate. Nevertheless, Konō asserted that the interdependency of the agency relationship precluded Yasuda Kasai from terminating without 'good cause' (gōriteki na riyū). The Yokohama District Court disagreed.

Konō presented a three-part argument. First, he asserted that the termination clause in the parties' written agreement was a standardized, 'boiler-plate' clause (a *reibun*)[156] and therefore not binding. Second, he argued that the termination clause destroyed his right to livelihood and had been imposed by a party in a much stronger economic position. Thus it should be viewed as void for public policy reasons. Third, he suggested that even if effective, the termination clause required good cause in the same way as a contract of employment would. Konō argued that although the contract in question was for a commercial agency, in fact Yasuda exercised considerable control over his business, and the relationship was analogous to employment. Finally he claimed that Yasuda's refusal to deal with him without good reason was a tortious infringement of his rights and entitled him to compensatory damages in the amount of ¥5,840,000.

The Court rejected each of these arguments as being unsupported by Konō's evidence. Instead it relied on a 'plain meaning' reading of the Civil and Commercial Codes. Paragraph 18 of the parties' agreement permitted either Konō or Yasuda Kasai to terminate after giving 30 days notice in writing. Yasuda had done this. The Court noted that article 651 of the Civil Code permits either party to rescind a mandate (agency agreement) at any time,[157] whereas article 50(1) of the Commercial Code takes account of the financial effects of terminating a commercial agency and requires two months notice.[158] Here the parties had reduced the notice period to 30 days in their agreement, but were able to do so

torihikikeiyaku no gendaiteki kadai' (Contemporary issues in continuing transactions) (1977) 146 *NBL* 36, 37.

155 *Konō v. Yasuda Kasai Kaijō Hoken K.K.* (1976) 327 *Hanrei Taimuzu* 313 (Yokohama District Court, 28 May 1975).

156 For a discussion of court interpretations of *reibun*, see Tanaka, H., *The Japanese Legal System* (1976) 126-31.

157 Civil Code art. 651:

> A mandate may be rescinded by either party at any time.
> (2) If one of the parties rescinds a mandate at a time when it would be unfavorable to the other party, he shall compensate for any damages occasioned thereby; however, this shall not apply when unavoidable reason exists for such rescission.

158 Commercial Code art. 50(1): In cases where the parties have not fixed a term for duration of the contract, either of them may terminate it on giving two months' notice.

because article 51(1) is a *nin'i kitei*, or non-mandatory Code provision.

The Court then briefly considered Konô's argument that the termination clause was a *reibun*, and concluded that although it was possible that he had affixed his seal to the contract without much thought, there was no indication that the parties did not intend to be bound by the clause. The Court rejected the argument that a special reason was required for termination, because neither the Civil nor Commercial Code prescribes this for agency agreements.[159]

Finally, the Court considered the nature of the parties' relationship. It found that although a mandate is a type of contract for service, nothing in this transaction suggested employment. Konō had operated his agency at home initially, then moved to a commercial office building where he employed his own staff and controlled his own time. Thus he 'was able to operate his own business as a commercial agent with freedom, and the contractual relationship with the defendant was not one of employment'.[160] Furthermore, there was no evidence that Yasuda Kasai had controlled or coerced Konō in any way, so the termination clause was not invalid for public policy reasons.

This case is interesting because the plaintiff makes an almost purely relational argument, and the Court replies in formalistic terms. In doing so, it follows previous decisions and the prevailing scholarly theory that commercial agents stand independently of the companies with which they transact, and may be terminated as of right, with no ancillary obligation to compensate for resulting loss.[161] This type of commercial agency agreement in Japan is common, and the decision is a significant precedent for straightforward terminations of the kind described. However, had Konō been able to show evidence of an abuse of Yasuda's bargaining position, fraud, duress or a deliberate attempt to undermine the relationship, the result may have been somewhat different.

The need to show 'good cause' as a basis for terminating franchises and distributorships in Japan is much debated. The right to terminate derives from an interplay of Civil Code principles and non-Code judicial and scholarly theory. The general provisions on contract in the Civil Code allow termination as of right. Article 541 states that:

> If one of the parties does not perform his obligation, the other party may fix a reasonable period and demand its performance, and may rescind the contract, if no performance is effected within such period.

There is an ongoing debate about whether article 541 creates the right to terminate a continuing contract at will. One school of thought favours the direct application of article 541; we could call this the free choice, efficient breach approach.[162] Notice and an opportunity to perfect performance may be required, but a party can terminate the agreement, even before the stipulated time.

Another school of thought objects to this approach as being inappropriate. First, article 541 implies that there is a single transaction, in which termination (*kaijo*) is retrospective.[163] This may be appropriate for a contract which was

[159] Civil Code art. 651; Commercial Code art. 50, *supra*.

[160] *Konō v. Yasuda Kasai Kaijō Hoken K.K.* (1976) 327 *Hanrei Taimuzu* 313, 316 (Yokohama District Court, 28 May 1975).

[161] *Ibid.* 314.

[162] Although, of course, article 541 does not technically place the party terminating in breach.

[163] The Japanese Civil Code uses both *kaiyaku* (dissolution of future contractual obligations); *kaijo* (dissolution of contractual obligations with retrospective effect) and *kokuchi* (notice of intention to

flawed in its formation, or in which problems arose shortly after formation, but it sits uneasily with continuing contracts.[164] Typically the continuing contract will be a master agreement under which a series of subsidiary agreements are concluded and often executed. The parties are usually seeking prospective termination of the master agreement, not the dissolution of many years of transacting which may not have been problematic.[165]

Second, article 541 imports the concept of fault. This is a familiar device in traditional civil law contract theory,[166] but transactional breakdown will not always be the result of clearly ascribable fault.[167] Instead of applying article 541, the second school argues that a separate ground for termination is required: a serious reason, or the *jūdai naru jiyū*, adopted by analogy from Civil Code articles 628, 663(2) and 678(2).[168] This theory recognises a right to immediate termination where it would be unjust to compel the obligee to continue with the entire contract, because of the breakdown of the parties' trust relationship (*shinrai kankei no hakai*).[169] An alternative interpretation of the 'serious reason' approach is to

terminate). The distinction between these concepts in Japanese law is discussed in the text above. Non-code terminology includes *shūryō* (ending a transaction). None of these terms have direct equivalents in Anglo-American law. The EHS translation of the Civil Code renders *kaijo* as 'recission' in article 541, but translates *kaiyoku* variously as 'terminate', 'rescind' and 'retire' in articles 651(2); 663(2) and 678(2). Although 'rescission' in Anglo-American law is retrospective dissolution of contractual obligations in which the parties are returned to their original positions, it is an equitable remedy and its availability is limited. 'Rescission' and 'rescind' are, of course, also used loosely and confusingly by Anglo-American lawyers, to mean non-equitable termination. Japanese jurists similarly use *kaijo* and *kaiyaku* interchangeably. I prefer not to add a comparative gloss to the current confusion and use 'termination' throughout this paper.

164 Kawagoe, K., '*Keizokutaki keiyaku no shūryō*' (1986) 350 *NBL* 40, 42.

165 The effects of *kaijo* and *kaiyaku* are not always clear when these terms are used in Japanese legal writing. *Kaijo* appears in the Code in article 545 as termination with restrospective effect. However article 620 states that 'the termination (*kaijo*) of leases shall have only prospective effect', and this definition can be applied by analogy to other continuing contracts like employment (art.630), mandate and partnership (art.684). Thus on the face of the Code, *kaijo* can have either retrospective or prospective effect.

Kaiyaku (termination) appears in the phrase 'a request to terminate a lease without a fixed term' in articles 617-21 of the Civil Code, and in related provisions of the House Lease and Land Lease Law. It is interpreted as having prospective effect only.

Perhaps to minimize confusion, scholars tend to use *kaiyaku* or *kokuchi* to refer to prospective termination,(including the termination of continuing contracts) and reserve *kaijo* for retrospective termination: Matsuzaka, S., *Minpō teiyō: saiken kakuron* (Outline of the Civil Code: Special Provsions) (3rd ed. 1976) 184.

The prevailing theory seems to be that, as the Civil Code is silent, termination of continuous supply agreements should not be retrospective, but should be treated as *kaiyaku*: Matsuzaka, *supra* 105, citing Kurusu, S., *Keiyakuhō* (Contract law) (1974) 138.

The ambiguity resulting from the different usages in the Code and in scholarly writing means that it is not always clear whether *kaijo* connotes retrospectivity or not. I am indebted to my colleague Mr. Yutaka Nakamura for his helpful advice on this point.

166 *Culpa in contrahendo.*

167 Kawagoe, *op. cit.* n.164, 43.

168 Civil Code art. 628 (Employment Contracts) provides that:

> Even where a period for the service has been fixed by the parties, either party may, if any unavoidable cause exists, immediately terminate the contract; however, if such cause has arisen by the fault of one of the parties, such party is liable for compensation for damages to the other party.

Art. 663(2) (Bailment) provides that:

> If a time for the return has been specified, the bailee cannot, in the absence of any unavoidable reason, return the thing before such time.

Art. 678(2)(Partnership) provides that:

> Even where a period has been fixed for the duration of the partnership, each partner may retire, if any unavoidable reason exists for doing so.

169 Kawagoe, *op. cit.* n.164, 43.

classify the basis for termination as an 'unavoidable reason', borrowing the concept from articles 628, 651(2), 663(2) and 678(1) of the Civil Code, on the basis that these classical 'type' contracts are analogous to continuing contracts.[170] Both 'breakdown of the parties' trust relationship' and 'unavoidable reason' are concepts developed through judicial reasoning and scholarly theory, but they can also be accommodated within the general Code principle of good faith.[171]

Requiring the terminating party to point to a significant reason for doing so allows the court to scan the agreement for its impact on the weaker party — the 'fairness' principle at work. This further analytical step gives the court a basis for examining the actual nature of the parties' relationship. This approach is reflected in the following decision:

> [In this] continuing contract without a fixed term, the retailer being supplied with goods has an obligation to stock only the wholesaler's goods and distribute them only within a certain area. The wholesaler profits from the retailer's expanding sales service to the wholesaler and economic activities, and under these circumstances, in the absence of any serious reason making continuation of the contract extremely difficult, the principle of good faith dictates that it would be improper to allow a unilateral request for termination. It follows that where there is no relevant serious reason, a wholesaler who requests termination merely for his own benefit, or who stops delivery of foods, is in fact forcing the collapse of the retailer. The request for termination in effect damages the retailer's right to operate, and violates the wholesaler's obligations to act in good faith and in accordance with public welfare and good morals.[172]

Good faith, public policy and unavoidable reason are flexible and useful tools, but nebulous. A party relying on these concepts may be accused of using a claim of last resort.[173] A further problem is that the breakdown of a trust relationship is essentially subjective, but in seeking formal adjudication, the parties are treated (at least in theory) objectively. These observations are familiar to common law scholars, who have often viewed the civilian doctrine of good faith as being too broad and imprecise.[174]

Kawagoe argues that a better basis for allowing termination would be an inquiry into the continuing contract that focuses on the transactional relationship created. Termination should be permitted where there is a strong probability that the purpose of the contract cannot be realised in future, *i.e.*, transactional break-

[170] Arts 628 and 663(2) are set out in the previous note. Art. 651(2) (Mandate) provides that:

> If one of the parties rescinds a mandate at a time when it would be unfavorable to the other party, he shall compensate for any damages occasioned thereby; however, this shall not apply when an unavoidable reason exists for such rescission.

Art. 678(1) (Partnership) provides that:

> If by the partnership contract no period has been fixed for the duration of the partnership, or if it has been fixed thereby that it shall continue its existence during the life of a partner, each partner may retire at any time; however, he cannot, in the absence of any unavoidable reason, retire at a time when it would be unfavorable to the partnership.

[171] Civil Code art. 1(2) provides that:

> The exercise of rights and performance of duties shall be done in faith and in accordance with the principles of trust.

[172] 539 *Kinyū Shōji Hanrei* 9 (Tokyo District Court, 22 February 1977) quoted in Kawagoe, K., '*Keizokuteki keiyaku no shūryō*' (Termination of Continuing Contracts) (1986) 345 *NBL* 26, 29.

[173] Literally, 'running away to the general provisions of the Code': Kawagoe, *op. cit.* n.164, 43. Although there is an extensive body of scholarly writing and judicial decisions on the doctrine of good faith in Japan (Civil Code art. 1(2)), as there is also in Germany and the United States, this provision is regarded by lawyers as being too vague to be a major ground for most claims.

[174] For a persuasive rebuttal of these general objections see: Lucke, H.K., 'Good Faith and Contractual Performance' in Finn, P.D. (ed.), *Essays in Contract* (1987) 155.

down. Where there is clearly unilateral fault, then the innocent party will have the right to terminate, but this should not automatically be the basis for liability in damages.[175]

Despite the divergence in existing theory, both approaches to article 541 allow immediate termination of continuing contracts in practice. What the courts have done in most cases is to impose an obligation to give notice to the other party, and in many cases, an obligation to make a compensatory damages payment.

3.2.1 *Grounds for Termination*

Cases can be found to support both the application and non-application of article 541, but the latter are far more numerous.[176] The necessary 'serious reasons' usually derive from non-performance of contract obligations: the breakdown of the parties' trust relationship;[177] unreliable delivery;[178] non-payment; breach of a non-competition clause; intense anxiety about the other party's trustworthiness (*shinyō fuan*);[179] a change in product line making it difficult to continue the contract;[180] a 'breach of faith' or 'betrayal' through the actions or statements of the other party (*haishinteki kōi*);[181] or a disruption of the distribution channel.

In *Y.K. Gunsan Saika Un'yu v. Tōin Gunsan Saika K.K.*,[182] termination was permitted because of problems with product delivery. The parties had a ten-year master contract for road transportation of fruit, vegetables, eggs and processed foods, which Tōin (the respondent in this appeal) eventually terminated. The transportation company repeatedly failed to keep tropical fruit covered in winter, which caused it to spoil, and failed to deliver in time for the morning market, which led to lost profits on fruit that had to be held over for the next market day. The transport company seemed unwilling or unable to cure its performance, because of changes in its team of drivers. The Sendai High Court dismissed the appeal, and upheld the Lower Court's decision allowing Tōin to terminate the master agreement, releasing it from the obligation to place any further orders for transportation services with Gunsan Seika Un'yu.

Although the result is plain, the Court made it clear that it accepted Tōin's reluctant desire to terminate a longstanding relationship. The transportation company owner had begun as a small self-employed operator; as his volume of business grew he incorporated, and Tōin assisted him in his application for a transportation license from the Ministry of Transport. The problems at the heart of the litigation had been the subject of numerous warnings and discussions between the parties. The crux of the case is not damages, but legal confirmation

175 Kawagoe, *op. cit.* n.164, 45.
176 Kawagoe, *op. cit.* n.172, 52.
177 *Konō Tarō v. Hokkaidō Shimbunsha K.K.* (1978) 881 *Hanrei Jihō* 134, (Sapporo District Court, 30 August 1977).
178 (1981) 435 *Hanrei Taimuzu* 120, (Sendai High Court, 24 December 1980).
179 (1982) 1054 *Hanrei Jihō* 92, (Tokyo High Court, 25 August 1982).
180 (1984) 1105 *Hanrei Jihō* 70, (Tokyo District Court, 8 September 1983).
181 *Dainichi kagaku sangyo K.K. v. Y.K. Maruichi Shokai* (1962) 304 *Hanrei Jihō* 24, (Osaka High Court, 11 June 1963).
182 *Y.K. Gunsan Saika Un'yu v. Tōin Gunsan Saika K.K* (1981) 435 *Hanrei Taimuzu* 120, (Sendai High Court, 24 December 1980)).

that the business relationship was at an end, and that the transportation company could not anticipate any further orders for services from Tōin.

Takagi, Yaguchi et al. v. Unnamed defendant[183] is a brief case report to similar effect. The plaintiffs had a continuing contract for the supply of retail goods from the defendant, which the latter terminated. The question was whether the plaintiffs' late payments and failure to pay transportation costs justified the defendant's decision to stop shipment on the basis of Civil Code article 533:

> One of the parties to a bilateral contract may refuse performance of his own obligation until the other party tenders performance of his obligation; however this shall not apply where the obligation of the party is not due.

The Tokyo District Court did not consider the parties' relationship, but it did comment generally on the effect that the defendant's actions would have on the plaintiffs' business: the plaintiffs' relationship with their customers would be compromised if supplies were withheld for more than a day or so. The Court then distinguished between magnitudes of breach; if the plaintiffs' breach were small and curable, then this would not justify a refusal to perform simultaneous obligations. Termination was only justified where future breaches by the plaintiffs seem inevitable. The Court went on to approve some of the defendant's actions and disapprove others.

A further basis for termination is a severe change in circumstances which is beyond the control of either party.[184] In this situtation a party can seek termination where he or she would otherwise suffer unjustly from continuation.[185] *Wakō Kōgyō K.K. v. Mekō Kōgyō K.K.*[186] is a case of this kind. Here the plaintiff was a steel products wholesaler which bought products on a continuing basis from Mekō, a steel furniture manufacturer. Mekō terminated the transaction and Wakō claimed damages. The Tokyo District Court found that this was a continuing contract rather than a series of discrete orders, and that there was no time stipulation. Consequently, either party was free to terminate provided that: (a) there was sufficient notice, and (b) if the timing caused ill-effects for the other party, that those ill-effects were compensated for by the party seeking termination. The exception is where, as here, the termination is the result of an unavoidable reason. The Court found that Mekō had an unavoidable reason, and so dismissed Wakō's claim for damages. The balance of the decision is really the anatomy of transactional breakdown, where the wholesaler was in financial difficulty and had lost its creditworthiness. The manufacturer reluctantly began to wind down the transaction. The Court explicitly approved the steps taken by Mekō in this case, and these are worth describing in full.[187]

Mekō began to feel uneasy when a non-party steel wholesaler, Tokyo Steel, dishonoured some promissory notes and went bankrupt. Tokyo Steel's managing director was both the father-in-law of Wakō Kōgyō's managing director and a

[183] *Takagi, Yaguchi et al. v. Unnamed defendant* (1973) 283 *Hanrei Taimuzu* 274, (Tokyo District Court, 30 May 1972).

[184] (1981) 1007 *Hanrei Jihō* 67, (Tokyo District Court, 30 January 1981).

[185] Kawagoe, K., *'Keizokuteki keiyaku no shūryō'* ('Termination of Continuing Contracts') (1986) 353 *NBL* 20.

[186] *Wakō Kōgyō v. Mekō Kōgyō* (1975) 772 *Hanrei Jihō* 71, (Tokyo District Court, 12 September 1974).

[187] *Ibid.* 75.

shareholder in the company, and the two companies were generally believed to have exchanged promissory notes. Mekō notified Wakō that it was stopping shipment. The companies then renegotiated Wakō's line of credit, limiting its promissory notes to an aggregate value of ¥2,000,000 at any one time.[188]

There was then a change in personnel. Mekō acquired a new Tokyo office chief, and it was decided that sales to Wakō would be wound down. The industry-wide economic health of steel wholesalers was not good, and there were fears that there were more bankruptcies in the pipeline. Industry rumours about Wakō prompted Mekō to ask their bank to do a credit check; the report returned by the bank was that Wakō's trading position was not favourable. Mekō sought real property security from Wakō, which the plaintiff resisted.

Against this background, Mekō began a more attractive transaction with a large trading company for the manufacture of steel chairs. The trading company bought 35 percent of Mekō's total output, rising to 55 percent at the time of trial. Mekō representatives took the opportunity of a New Year courtesy visit to Wakō's office to suggest that the plaintiff source its product lines from other manufacturers. The new commitment to the trading company was given as the reason for not being able to meet Wakō's order requirements. A second visit along the same lines followed. Finally, realising that the defendant probably intended to stop transacting with Wakō completely, Wakō revised its catalogue and dropped the Mekō product lines.

Having accepted Mekō's version of the story, the court concluded that Wakō's credit and trustworthiness problems were objectively evaluated by Mekō, and that Wakō had time to prepare itself for the eventual termination because the defendant was signalling this by gradually decreasing the volumes transacted.

Other cases also establish that these kinds of unavoidable reasons or breakdowns in the parties' trust relationship may be sufficient grounds for terminating the contract.[189] *Konō Tarō v. Hokkaidō Shimbunsha K.K.*[190] is a case in which a relationship with a distributor was terminated when it began to endanger the newspaper company's reputation. Konō was a distributor for the Hokkaidō Newspaper Co., with an exclusive territory. The distribution contract was for three years, with a provision allowing the newspaper to terminate without notice in a variety of circumstances, including those where the distributor's actions 'would damage the reputation of the newspaper company'. During the period of the contract, Konō was prosecuted for illegal gambling and received a suspended sentence of eight months hard labour. This was reported in newspapers, including the defendant's own. Hokkaidō Shimbunsha gave Konō two months notice of its intention to terminate. It claimed that the parties' trust relationship had broken down, and that it was likely that the newspaper would be identified with Konō and its reputation gravely harmed.

188 Promissory notes are a primary credit device in commercial transactions in Japan. They can also be controlled as an informal sanction; Haley, J.O., *Authority Without Power: Law and the Japanese Paradox* (1991) 182-3.

189 They may also establish sufficient grounds for defending a decision to stop the shipment or supply of goods to the other party: Kawagoe, *op. cit.* n.164, 44-5.

190 *Konō Tarō v. Hokkaidō Shimbunsha K.K.* (1978) 881 *Hanrei Jihō* 134, (Sapporo District Court, 30 August 1977).

The Sapporo District Court found that the termination clause in the parties' contract did not apply because it did not cover circumstances which were curable, or circumstances where there had been a breach of good faith, or an irreparable breakdown in the parties' relationship.

It then considered the nature of Konō's actions. The gambling had involved two members of an organised crime group and the sale of lottery tickets to some 30 people, so it was perceived to be an organised, large-scale crime with deep social ramifications. The Court concluded that it would be extremely difficult for the newspaper to embrace a distributor like Konō, because its status required it to be sensitive to the public trust, and it was likely that the public would identify the newspaper with Konō.

Two months notice was judged sufficient; the Court rejected Konō's argument that this was an abuse of rights. The Court also found insufficient evidence that the termination would adversely affect Konō's livelihood, even though it accepted that the Hokkaidō newspaper accounted for 75 percent of his business.

Japanese courts recognise the need to distinguish non-performance of important obligations and non-performance of less important ones.[191] It is debatable, however, whether non-essentiality of obligations should be evaluated in the same way for simultaneous and continuing contracts. Kawagoe points out that in a one-off transaction, the breach of an obligation to provide information, deliver or transport goods, store foods, perform administrative procedures, and respect non-competition and trade secret clauses may not of itself be fatal to the transaction. In franchise or distribution contracts however, these obligations form the distribution system. Failure to perform one of these — or a more specific undertaking regarding intellectual property, security or maintenance of standard procedures — strikes at the heart of the agreement.[192] The parties may agree that breach of any of the provisions of the franchise or distribution contract will be grounds for termination, subject to conformity with mandatory provisions of the Codes.[193] Neither of the Japanese model agreements reproduced in the Appendix to this article adopt this approach, but Kawagoe points out that express agreement is not a prerequisite for asserting grounds for termination. The breach of any obligation in a continuing contract which is necessary to operate the primary requirements of a distribution system can be characterised this way.[194] The effect of breach needs to be evaluated in light of the particular circumstances of the transaction.

3.2.2 *Notice Requirements*

The unilateral right to terminate provided under article 541 requires only that the other party is given the opportunity to tender his or her contractual performance. Once the demand for performance is made and the stipulated period

[191] Discussed in a decision of the Sendai High Court: (1981) 435 *Hanrei Taimuzu* 120, (Sendai High Court, 24 December 1980).

[192] Kawagoe, *op. cit.* n.185, 21.

[193] For example, conformity with Civil Code art. 90, public policy and good morals. This is the approach taken in over 70 percent of the U.S. franchise agreements examined by Hadfield, which stipulate that breach of any provision will be regarded as material breach: Hadfield, *op. cit.* n.23, 939-40.

[194] Kawagoe, *op. cit.* n.185, 21.

passes, the party seeking termination has no obligation to give notice of this intention. If article 541 is not applicable, however, the terminating party has an obligation to give sufficient notice. The rationale is that this furnishes an opportunity to save the transaction.[195] The only exception to the notice requirement is where it is clear that the transactional relationship is beyond help: circumstances like bankruptcy, fraud, or impossibility of performance.

Of course the applicability of article 541 and the state of transactional relationships are evaluations that can only be made after the fact. A party seeking termination who neglects to give any, or sufficient, notice may be liable for compensatory damages if the purported termination is litigated. The prudent course is to give ample, unequivocal warning of the intention to terminate. This is also the approach favoured by the Japan Franchise Association in their model guidelines for franchises.[196] Both the Franchise Association guidelines and the cases also presume that the parties will renegotiate in good faith.[197] In practice this imposes no greater requirement than adequate notice, because either the relationship has broken down completely, or notice is part of a negotiation process.[198]

What constitutes reasonable notice of termination? This varies markedly with the particular circumstances of a case. Thus in *Nihon Shoseki Hanbai K.K. v. Kōki Shuppan Hanbai K.K*[199] the notice was effective immediately. This is really a case about competition within distribution chains. Nihon Shoseki, the plaintiff (and appellant), was a major wholesaler of books. The respondent (and defendant), Kōki Shuppan, was an intermediate book wholesaler. Nihon Shoseki and Kōki Shuppan had a continuing consignment sales contract for a line of encyclopedias, which Nihon Shoseki terminated. The issue was whether the notice and termination were effective. The Osaka High Court determined that unilateral termination of a continuing contract is possible, but depending on the nature of the contract, a substantial notice period will be necessary in the absence of a serious reason preventing continuation of the contract.

Nihon Shoseki argued that it had such a serious reason: Kōki Shuppan had been spreading rumours about a non-party competitor which stood in the same relationship to Nihon Shoseki as Kōki Shuppan. Kōki Shuppan sought to poach its competitor's clients. Furthermore, Kōki had spread rumours that Nihon Shoseki would become insolvent. Nihon Shoseki asserted that Kōki Shuppan's actions had created unwarranted fears and had damaged Nihon Shoseki's reputation for trustworthiness. The Court held that this kind of rumour-mongering exceeded the bounds of permissible competitive behaviour, and was sufficient ground for Nihon Shoseki to give notice of immediate, effective termination.

195 *Ibid.* 23.

196 Japan Franchise Chain Association model franchise guidelines, art. 9(2), cited in Kawagoe, *ibid.* 24.

197 Japan Franchise Chain Association model franchise guidelines, art. 9(1), cited in Kawagoe, *ibid.*

198 Kawagoe cites a case in which the failure to renegotiate was sufficient grounds for recission, but suggests that this was not the ratio: Kawagoe, *ibid.*

199 *Nihon Shoseki Hanbai K.K. v. Kōki Shuppan Hanbai K.K.* (1984) 1126 *Hanrei Jihō* 42, (Osaka High Court, 14 February 1984).

In a case where there were no special reasons justifying termination, one month was too short,[200] whereas in another case ten days was insufficient and the court indicated that a month would be the minimum acceptable period.[201] Kawagoe suggests that something like one year in the case of a supplier, and six months in the case of a purchaser seeking termination, should be regarded as minimum notice periods.[202]

3.2.3 *Compensation*

Even where the terminating party has given reasonable notice and there has been an opportunity to negotiate, the court may accept a request for compensation from the other party.[203] In some cases this will be based on a liquidated damages clause contained in the parties' written agreement, such as the *Hokka Hokka* case discussed above and *Fujimoto Nagako and others v. Takaken Sunshine K.K.*[204]

The latter was a decision in which the appellants attempted to rely on a relational factor, and this was rejected by the Nagoya High Court. The appellants were a team of women cleaners who worked as agents for Takaken Sunshine. The parties concluded a written contract for three years, with provision for automatic renewal. The appellants were to pay 25 percent commission to Takaken on each month's sales, and their spouses were also parties to the agreement as joint guarantors.

When offered a more attractive deal by Takaken's competitor, the A Cleaning Centre, the appellants terminated their contract with Takaken. Takaken brought an action for damages based on the liquidated damages clause in the agreement. The clause was in essence a protection from competition clause; it assessed damages as the value of all sales generated by the appellants for the six months preceding termination.

The appellants argued that the contract was in pre-printed form and that the liquidated damages clause was merely a *reibun* (a standardised 'boiler-plate' clause) which did not bind the parties.[205] Furthermore, they argued that because they were women, and had no knowledge of law, a detailed pre-contractual explanation of the provision ought to have been provided. The Nagoya High Court rejected both arguments. It found that the contract was pre-printed, but was not of the kind sold commercially. The clause in question was customised and the appellants had been requested to read it carefully. Therefore it was not a *reibun*, but a clause agreed upon by the parties. The fact that the appellants had requested the help of a non-party, Koyama, to smooth over the anticipated dispute with Takaken suggested that the appellants knew and understood that the damages

200 *Fujimoto Nagako and others v. Takaken Sunshine K.K.* (1978) 884 *Hanrei Jihō* 69, (Nagoya High Court, 9 November 1977).

201 *Asahi shoseki K.K. v. Suzuki* (1982) 1045 *Hanrei Jihō* 105, (Tokyo District Court, 30 September 1981).

202 Kawagoe, *op. cit.* n.172, 34.

203 *Miku kakō K.K. v. Rikō sangyō* (1985) 1144 *Hanrei Jihō* 88, (Tokyo High Court, 24 December 1984), a case concerning termination of a sole distributor.

204 *Fujimoto Nagako and others v. Takaken Sunshine K.K.* (1978) 884 *Hanrei Jihō* 69, (Nagoya High Court, 9 November 1977).

205 For a discussion of court interpretations of *reibun*, see Tanaka, H., *The Japanese Legal System* (1976) 126-31.

clause would be operative. Their appeal was dismissed. On the validity of the clause, the Court found that Takaken could recover 25 percent of the amount claimed, but that the balance was excessive and thus void for public policy reasons.

In most cases, however, the court is asked to determine the quantum of compensation payable. Sometimes this is measured as reliance damages — the amount representing damage suffered as a result of believing that the contract would continue (or what could have been avoided had the party known that the contract and the sole distributorship would not continue): *Miku kakō K.K. v. Rikō sangyō*.[206] The majority of compensation awards, however, are based on projected profits.[207] Under the Civil Code, claims for damages are limited to those arising from non-performance or a tortious act. There is no specific compensation provided for the kind of reliance interest described above. In practice this may not be problematic, because even where the act complained of is 'destruction of the trust relationship' or 'loss of confidence', this often results from breach of an express or implied contract provision. Where a breach is not evident, but the courts recognise a right to claim compensation, this can be explained, according to Kawagoe, as an application of the Code principle of good faith.[208]

The actual amounts awarded in cases vary: in one case the amount was held to be projected contract profits for a year, with no basis reported; in another, the award of contract profits was calculated from the time required to convert to another product line and replace the supplier.[209] In another case an application for damages for mental distress and suffering (*isharyo*) in the amount of ¥1,000,000 was rejected.[210] The overall tendency appears to be an award of projected profits: where a supplier seeks termination, profits for a year, and where a purchaser seeks termination, profits for at least six months.[211]

In some cases, damages will not be the most appropriate form of relief. In *Okada Shōji and Kotobuki Bōeki v. Dōitsuyuaserufu K.K.*,[212] for example, the action was for retrospective termination of the contract (kaijo) and return of the parties to their original positions (*genjō kaifuku*).[213] Defendant Do-it-Yourself K.K. held the lease for a booth in the 'Tokyū Shopping Corridor' in Tokyu's Gakugei Daigaku store. The booth sold tools and materials for home handypeople and hobbyists.

The plaintiffs asked Do-it-Yourself to stock their home improvement tools. The parties concluded a written agreement for five years, which included an

206 (1985) 1144 *Hanrei Jihō* 88, (Tokyo High Court, 24 December 1984). In this case concerning termination of a sole distributorship, the Tokyo High Court reasoned that the continuation of the contract could not be compelled, and so it would be inappropriate to assess damages as the projected profit from the contract had it continued.

207 Kawagoe, *op. cit.* n.172, 34.

208 *Ibid.* 33.

209 *Hayashiya K.K. v. Y.K. Yamamotoyama* (1971) 634 *Hanrei Jihō* 50, (Nagoya High Court, 29 March 1971).

210 *Rikō sangyō K.K. v. Miku kakō K.K.* (1981) 1020 *Hanrei Jihō* 64, (Tokyo District Court, 26 May 1981).

211 Kawagoe, *op. cit.* n.172, 34.

212 *Okada Shōji and Kotobuki Bōeki K.K. v. Dōitsuyuaserufu K.K.* (1978) 903 *Hanrei Jihō* 70, (Tokyo District Court, 6 October 1977).

213 See the earlier discussion of *kaijo* contrasted with *kaiyaku*.

automatic renewal clause. Sales to Do-it-Yourself were to be on consignment, and Do-it-Yourself was to remit the monthly takings to Okada and Kotobuki. The plaintiffs made two deposits as guarantees, which were to be held by the defendant for the duration of the contract.

The parties' transaction proceeded smoothly until Do-it-Yourself defaulted on some promissory notes to a third party, and for all practical purposes became bankrupt. Unable to pay its rent to Tokyū, its lease on the booth was terminated. Do-it-Yourself requested the plaintiffs to take delivery of their unsold stock, and the consignment sale contract was terminated by agreement. The issue was the fate of the guarantee payments.

The plaintiffs sought immediate return of the deposits, as part of the return of the parties to their original positions. Do-it-Yourself refused, citing the provision in their agreement which stated that the deposits would be returnable three years after termination. The Tokyo District Court examined the provision and concluded that it had been inserted by Do-it-Yourself for its own benefit; it was designed to operate as security in the event that Do-it-Yourself experienced loss arising from the consignment sale transaction. Accordingly, the Court found that the provision did not apply to the parties' current circumstances:

> Furthermore, where the defendant has failed to perform an obligation, and for that reason maintaining the contract is now impossible, and it has been terminated (*kaijo*) (including termination by agreement); it is no longer necessary to take into account damage suffered by the defendant . . . (I)t must be said that there is no logical reason for allowing (the defendant) to rely upon the contract provision prescribing the time for returning the guarantee deposits and retain moneys (belonging to the plaintiffs).

Judgment was for the plaintiffs, with the court ordering return of the deposits, ¥1,700,000 to Okada and ¥500,000 to Kotobuki, plus six percent *per annum* interest from the date of termination to the date of final payment.

An alternative, and less common, remedy is injunction. The *Hokkaido Tractor Case*[214] is one such example. In 1961, a manufacturer appointed a company as its exclusive distributor of farm machinery in Hokkaido. The contract was renewed for a number of years, until the manufacturer gave notice that it no longer intended to continue with the arrangement. The distributor contested the validity of the termination. It argued that the contract was intended to be long-term, and that the renewal clause in question was primarily intended to enable adjustments of the contract terms as circumstances changed. The distributor argued that it had made substantial investments on the expectation that the contract would continue. It alleged that the manufacturer knew this, and stood to gain unjustly from taking over the market established by the distributor. The distributor's final argument was that the attempted termination constituted an abuse of right;[215] that the distributor was in a weaker position and that it would suffer unbearable economic loss if the contract was terminated unilaterally. The Sapporo High Court agreed. It found that:

> In the light of the nature of the contract, the circumstances of entry into the contract, and the

[214] *Hokkaido Ford Tractor v. Minoru sangyō K.K.* (1988) 1258 *Hanrei Jihō* 76, (Sapporo High Court, 30 September 1987).

[215] Civil Code art. 1(3): 'No abusing of rights is permissible'. This is really an application of the doctrine of good faith in art. 1(2), set out *supra* n.93.

> resulting distribution of losses and gains to each party by the alleged termination, it would not be proper to construe the clause in question to generally authorise a termination by the manufacturer by a mere unilateral declaration. Rather it should be construed to provide only for cases where the termination is reasonable and unavoidable because of the occurrence of circumstances which indicate that the continued imposition of the obligations under the contract is cruel to one of the parties. Although such situations may not be limited only to serious breaches of contract, the present case does not fall under that category.[216]

The Court upheld the distributor's claim for an injunction to prevent termination of the agreement. After examining the parties' relationship, the Court concluded that the injunction would be valid for one year.

4. *THE ROLE OF THE COURTS IN SHAPING THE 'NEW' JAPANESE CONTRACT LAW*

When a Japanese court is asked to adjudicate the termination of a continuing contract, much of which remains unspecified, it faces similar problems to those that arise in United States or Australian courts. The first is the basis on which the judicial intervention can be justified. Japanese legal scholars rationalise this on one of two bases: freedom of contract or protection of the weaker party. They argue that the freedom to form a contract implies the freedom to terminate that contract at will, and that the court should not bind a party to his or her agreement indefinitely. Alternatively, a continuing contract is usually one in which both parties have made a significant investment, and judicial intervention is required in order to safeguard the weaker party from a transaction partner's opportunism.

In Anglo-American contract theory the labels are different, but the normative approaches are broadly the same; we can identify economic rationality and fairness as two distinct approaches.[217] Court intervention in franchising, for example, can be justified as discouraging opportunism and promoting efficiency by lowering transaction costs.[218] The fairness stance justifies judicial intervention on the basis of bargaining inequality; the stronger party should be prevented from taking advantage of the other's vulnerability.[219] Common law tools like promissory estoppel, unconscionability and fiduciary duty have all been used in attempts to address the problem of bargaining inequality.[220]

The shortcoming of both the efficiency and fairness positions when applied to continuing contracts is their unidimensional nature. Neither fully takes account of the relational complexity within which a continuing contract is embedded. They leave unanswered questions like: 'Why should economic efficiency be the dominant principle?' and 'How do we identify the ''weaker'' party?'.[221] It is also suggested that doctrines such as promissory estoppel, unconscionability, and fiduciary duty are not well-tailored to the needs of unequal, but generally well-functioning commercial relationships. The problem with franchises (and to a

216 Translation by Kazuaki Sono: Sono, *op. cit.* n.65, 461.

217 John N. Adams and Roger Brownsword classify these approaches as 'formalist' and 'welfarist': 'Ideologies of Contract' (1987) 7 *Legal Studies* 205. These are, of course, just two of a number of rationales for modern contract law.

218 Hadfield, *op. cit.* n.23, 954, paraphrasing part of the law and economics analysis of contract.

219 *Ibid.* 953.

220 For examples of applications of these doctrines to franchises in the United States, see Hadfield, *ibid.* 985, note 262.

221 See also Hadfield, *ibid.* 954 for further shortcomings.

lesser extent distributorships) is not that they are unequal relationships at the outset, but that in the course of the transaction the other party has exercised power improperly in one of the many contract 'gaps'.[222] Hadfield observes that the application of these doctrines to franchise disputes in the U.S. has now been abandoned by the courts because they tend be overly protective and cut too deeply, often rendering the contract unenforceable.[223]

Instead, U.S. courts now predominantly apply a 'business judgment approach' to franchises.[224] Franchising is perceived as a 'method of doing business' selected by the franchisor. Clear breaches of operations manual standards by the franchisee are treated as contract violations and grounds for termination.[225] The courts are vigilant in protecting the 'franchisor's trade name, trademark, goodwill and image which, after all, is the heart and substance of the franchising method of doing business'.[226] When the dispute is less clearcut, and the franchisor seeks to terminate the agreement (in many cases for opportunistic reasons), the courts treat this as a business decision, for which the franchisor need only give a plausible commercial justification.[227]

The problem with this 'hardline' approach is that it misunderstands the reciprocal nature of franchise obligations; fails to protect the franchisee's interests; and fails to give effect to the parties' true agreement.[228]

In Japan, by contrast, even if a court accepts the termination under article 541 of the Civil Code, a continuing contract will invite some relational analysis. Kawagoe asserts that retail agreements that combine elements like the sale of goods, the use of a trademark, business support, patent and know-how protection and overall linkage into a distribution network are likely to be subject to judicial interpretation and adjustment through the general principle of good faith.[229] He also suggests that the predominance of small businesses in the distribution and retail sectors of the Japanese economy influences judicial attitudes to termination. Specifically, it is not improbable that a court would seriously consider the effect of removing a retailer's *ikigai* (reason for living) as well as the legal merits and economic rationality of a termination.[230]

Once a court decides to intervene, the next issue is whether to apply existing

222 *Ibid.* 985, note 262.
223 *Ibid.*
224 *Ibid.* 980.
225 *Ibid.* 980.
226 *Amerada Hess Corporation v. Quinn* 142 N.J. Super. 237, 251; 362 A.2d 1258, 1266 (N.J. 1976).
227 Hadfield, *op. cit.* n.23, 981.
228 Hadfield suggests that the function of contract law is to enforce private commitments made by the parties. The courts, she argues, should identity those commitments by examining the whole of the parties' relationship. What were their expectations of the transaction? What obligations arose, not only from the written document and the oral undertakings, but also from the relationship itself?: Hadfield, *ibid.* 983. Because all relational transactions are different this inquiry would have to be tailored to the individual case, not reliant upon notions of an abstract franchise agreement. The inquiry would also have to take account of the parties' subjective expectations, rather than relying on 'objective' evidence like contract provisions.
229 Kawagoe, *op. cit.* n.141, 7.
230 *Ibid.*

contract law rules to continuing, relational contracts. This is the question that relational theorists generally leave unanswered. In many cases the parties have deliberately ignored the law in structuring the transaction. Should they be able to do so once the dispute comes to court? Should existing rules be modified to take account of imprecise continuing contracts? The answer in Japan and the United States seems to be no. Hadfield's recommendation is that courts should continue to work within existing contract rules, but 'widen the judicial lens'.[231] Instead of dipping into relational information in an *ad hoc* way (often using this to inform decisions couched in formalist language), she argues that American courts should widen and systematise their relational enquiries. Her preferred doctrinal tool is good faith. Specifically, she recommends that courts look beyond the written provisions of franchises, giving presumptive force to franchisee obligations, but not enforcing clauses that give vague, sweeping power to franchisors.[232] Second, she suggests that courts reassess the franchise and recognise that:

> [F]ranchisors risk the value of their trademarks in return for shifting large sunk investments to franchisees. Franchisees commit themselves to complying with franchisor directives in anticipation that they will receive sound products, sound business advice, and support.[233]

The contract makes little sense unless it balances these mutual undertakings. Curtailing the right to make unilateral commercial decisions that disadvantage or terminate a franchisee will not unduly handicap a franchisor. It will simply mean that the franchisor may have to pay to achieve the desired result, by compensating the franchisee for losses incurred.

While some may view the relational approach as a novel proposal for Anglo-American law, the cases extracted above suggest that Japanese courts employ it frequently in franchise and distribution termination problems. In Kinoshita's view, the courts' interest in the relational aspect of commercial transactions has become more pronounced since the mid-1970s, although he does not indicate what factors have influenced the trend.[234] The cases analysed support this contention.[235] Each reveals something of the particular court's perception of the parties' relationship and its impact on the termination, albeit influenced by the arguments and evidence tendered by the parties themselves.

231 Hadfield, *op. cit.* n.23, 989.

232 *Ibid.* 987.

233 *Ibid.* 986-7.

234 Kinoshita, T., 'The Relational Contracting' (sic), in Kusuda-Smick (ed.), *United States-Japan Commercial Law and Trade* 684, citing Kawakami, M., '*Keiyaku no seiritsu o megutte*' (Concerning Formation of Contract) (1988) 655 *Hanrei Taimuzu* 11; (1988) 657 *Hanrei Taimuzu* 14. Kawakami's two-part article deals with postwar developments in the treatment of pre-contractual liabilities and obligations. He observes that from about 1955 onwards Japanese courts recognized a duty of care between parties in pre-contractual negotiations based on the principle of good faith (*shingisokujō no chūi gimu*) (655 *Hanrei Taimuzu* 11, 19).

From 1975 onwards there was a sharp increase in the number of pre-contractual claims for compensation where one party was responsible for frustrating formation of the contract and the other party suffered loss as a result (655 *Hanrei Taimuzu* 11, 20). Kawakami analyses a number of these cases and identifies relational factors influencing the courts' views of the pre-contractual transaction. These include: the type of transaction (whether it differs from traditional 'type' contracts); the extent of the agreement reached in negotiation; whether action was taken in anticipation of performance (the contract in dispute being embedded within an ongoing commercial relationship); and which party initiated or took the lead in negotiation (657 *Hanrei Taimuzu* 14, 22).

235 Whether Japanese courts cite relational factors more than their non-Japanese counterparts would be worth exploring, but is beyond the scope of this paper.

CONCLUSION

One way of interpreting the cases and commentary discussed is to view these as legal confirmation of the significance of relational contracting in Japan posited by Kawashima and others. To view them solely in this way, however, would be misleading. While the Japanese courts are willing to embark upon a relational analysis in some franchise and distributorship cases, they do so within a civil law tradition. The broad Code principles readily accommodate relational analysis, and there is probably less anxiety — in the absence of a formal doctrine of precedent — about producing consistent, universal outcomes.[236] The inherently vertical nature of the contracts also lends itself to this approach. Consistent with the civil law tradition, the doctrinal change is incremental.

We can roughly classify the sample of cases in three ways. A formalist approach is most obvious when the argument revolves around a written agreement, and there is no *prima facie* evidence of fraud or bad faith. The courts employ a 'matrix approach' when they consider the relationship as one of a number of factors relevant to termination, and check that there has been no exercise of bad faith. A highly relational approach is used when the parties' relationship becomes the core issue, and the court sanctions an overt abuse of a superior position, or a betrayal of the relationship.[237] Where the court considers the parties' relationship and their course of conduct, it is apparent that what were commercial (and some would argue cultural) norms have clearly been transformed into legal norms. Cases by themselves, however, are a necessary but not sufficient source of information about a legal system. The judicial responses presented here are neither comprehensive nor consistent; they are simply a departure point for further enquiry.

There may be a temptation to see, in the use of the doctrine of good faith, an overlap of problems and solutions in Japanese and common law contract. To some extent this is a good working hypothesis — similar contract types in similar markets in industrialised countries will probably give rise to similar problems and elicit equivalent legal responses. It would be wrong, however, to suggest that 'good faith' or 'justifiable reason' on the one hand, and 'unconsionability' or 'fiduciary duty' on the other, signal a systemic or doctrinal convergence. If there are similarities, these seem to lie in the contract type and the rules developed for specific transactions.[238] How clearly we perceive this depends on how well we have grasped the contours of change within our own legal system.

236 Although Kawagoe's close analysis of the cases attempts to generate some yardsticks.

237 John N. Adams and Roger Brownsword have done a more extended typology of contract decisions, in which they identify 'formalist' and 'welfarist' judicial approaches to interpreting contracts in England: *supra* n.217. Nathan Crystal labels the kind of classification attempted here as an 'internal' empirical study, in contrast to 'sociological' studies which try determine the relationship between contracting practices and general society: Crystal, *op. cit.* n.23, 295.

238 This is consistent with the argument that there is no longer a single 'law of contract' in Australia, but rather 'laws of contracts'. It also fits with the suggestion by Uchida that the values of discrete contracting communities in Japan will create and shape 'post-modern' contracting in that society: Uchida, *op. cit.* n.70, 16.

APPENDIX:

XYZ FOOD CHAIN AGREEMENT (in summary form)

(Address)
Chain store owner A
(Address)
Food producer B

Article 1 (Purpose)

Article 2 (Sales area)

Article 3 (A's method of sale)

Article 4 (Provision of know-how)

Article 5 (Product delivery)

Article 6 (Payment)

Article 7 (Guarantee payment)

Article 8 (Advertisements and promotion)

Article 9 (Employee education)

Article 10 (Store premises)

Article 11 (Termination of the Agreement) (*kaijo*)

Article 12 (Prohibition on Use of trademark after termination)

Article 13 (Accounts)

Article 14 (Jurisdiction)

(Parties' Seals)

In comparison with the Australian and U.S. franchise agreements, this is a rather brief document.[239] The text accompanying the Japanese contract form notes

[239] Issues which would be the subject of express provisions in the United States and which are not covered in this Japanese agreement include:
(i) Insurance (requiring the franchisee to hold full public liability insurance);
(ii) Duration;
(iii) Transfer (franchisor approval required, and franchisor right of first refusal in sale of outlet);
(iv) Franchisor's right to inspect premises;
(v) Trademark (franchisee has no ownership rights in trademark);
(vi) Enforcement (franchisor's failure to enforce the agreement is not a waiver);
(vii) Separability of invalid clauses from the remainder of the agreement;
(viii) Non-competition (covenant not to compete with franchisor after termination and expiration);
(ix) Inheritance (transfer to heirs possible on assumption of franchisee obligations);
(x) Agency status (No agency relationship created by the contract);
(xi) Hours and days outlet to be open;
(xii) Supplies (franchisor approval of suppliers required or operating supplies to be purchased for franchisor);
(xiii) Building construction (franchisor to build and lease to franchisee);
(xiv) Site selection;
(xv) Management consultation (when franchisor judges it to be necessary);
(xvi) Start-up date;
(xvii) Alteration of building or lay-out;

that the franchise system of retailing presumes that one party will have a superior capital and know-how position and will exert control over the franchisee, who is usually a novice businessperson. Accordingly, most franchise agreements are preprinted, and there is little likelihood that the franchisee will have room to negotiate alterations.[240] This agreement provides for a monetary payment as a guarantee, but other forms of security are also used such as a security interest in real property, security in stock or bonds, or third-party or jointly-provided security.[241] The commentary also cautions franchisors about franchisees who may seek to set up the Land and Household Lease Law[242] against a franchisor seeking to regain business premises after the termination of the agreement.[243]

XYZ DISTRIBUTORSHIP AGREEMENT

(Address) Sales Company A K.K.

(Address) Retail Store B K.K.

We request Retail Store B to undertake the sale of Manufacturer ABC's product and conclude this agreement in order to mutually benefit from the wider distribution of that product.

Article 1 The product that A requests B to sell is set out in the Attachment. A will give notice to B of any changes, extinction or supplementation to that product.

Article 2 We request B to display the product by creating a (product name) corner. A agrees to bear a proportion of the cost of installing showcases for the product corner. The amount will be determined by consultation between the parties.

Article 3 A will supply a stipulated number of advertising leaflets and samples relating to the product at no cost to B. A will advise B of promotional activities and requests A's cooperation in relation to this promotion.

Article 4 We request B to advise us immediately of any claim made in relation to the product by our valued customers.

(xviii) Lease (rental base for lease from franchisor, based on dollar amounts, plus a percentage of sales);
(xix) Sign (dimensions);
(xx) Employees (conduct requirements, uniforms);
(xxi) Arbitration;
(xxii) Pricing;
(xxiii) Self-employment (requiring franchisee to manage full time); and
(xxiv) Renewal fee;
The source for this is the 1971 Senate Select Committee on Small Business, cited in Hadfield, *op. cit.* n.23, 939-40.

240 Yamazaki, *op. cit.* n.150, 654.

241 *Ibid.* 657.

242 *Shakuchi shakka Hō* Law No. 90 (4 October 1991).

243 Yamazaki, *op. cit.* n.150, 658. For a discussion of the problems posed by long-term leases and the effect of the 1991 revision of the Land and House Lease Law, see Haley, J.O., 'Japan's New Land and House Lease Law' in Haley, J.O. and Yamamura, K. (eds), *Land Issues in Japan: A Policy Failure?* 149 (1992).

Article 5 B will work strenuously with the manufacturer to improve the quality of, and promote the product, and we hope for positive sales efforts by A, and respect for sales and distribution practices.

Article 6 We respectfully request B to refrain from returning or exchanging the product, except in circumstances which arise from fault on the part of A.

Article 7 B will display a plate provided at A's expense, showing its distributor status.

Article 8 When B wishes to dissolve its distribution arrangement, A will repurchase the remaining product at ten percent less than its purchase price, and requests return of the distributor plate referred to above.

Article 9 This agreement will be effective for one year. Provided that, if neither party seeks to terminate it one month before its expiry, this agreement will be automatically renewed on the same terms as those set out above, and will continue automatically until terminated. Article 8 will apply to such termination. (Parties' seals)

The commentary to this agreement notes that, although a distributor will wish to stock well-known brand names, and is thus dependent upon his or her supplier, competition between product manufacturers for market share is intense. Therefore, the agreement takes the form of a request to place a product line with a retailer.[244] This also explains the distinctive 'soft' language of the agreement. These agreements are usually standardized by the manufacturer, and distributed to retailers by the manufacturer's agent or sales representatives. Retailers in many cases appear to put their seal to such agreements at the request of the salesperson, without reading the contents.[245]

This agreement form contemplates a retailer who stocks more than one product line, and thus there is no provision for security for claims by the supplier. In exclusive distribution agreements such security provisions are routine.[246] We should note, *inter alia*, that this agreement is totally silent on the issue of what might form the basis of termination, or how disputes are to be resolved.

244 Yamazaki, *op. cit.* n.150, 661.
245 *Ibid.*
246 *Ibid.*