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TERMINATION OF A CONTINUOUS CONTRACT AND GOOD FAITH UNDER JAPANESE AND ENGLISH LAW*

Makoto Shimada

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I . Introduction

Under laws of Japan and quite a few of the other countries, terms of a contract are qualified by a general rule of law, which is called “the principle of good faith.” Particularly, on the basis of this general rule, a continuous contract may not be terminated in accordance with its terms. In consideration of such effect, commercial lawyers argue that the principle of good faith is a ‘demon,’ which unexpectedly overrides what the parties have agreed in the contract. However, under Japanese law, the function of the principle of good faith is quite the opposite. First, the principle generally works to protect the contracting parties’ reasonable expectation. Second, rules

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established under the principle are mostly certain and predictable. This paper attempts to demonstrate such function by showing some rules and the way they are applied.

For the above purpose, the paper first expands on the meaning of “good faith” and how the concept has been developed in Japan. The paper turns to how Japanese courts apply it, by introducing specific rules applicable to termination of a contract, which are identified by an analysis of cases. The paper then examines English concept of good faith, which has been developed recently, in comparison with Japanese good faith.

II. Good Faith under Japanese Law

A. History and Function of “Good Faith” in Japan

The principle of good faith is a concept which was imported from German civil law when Japan had enacted the modern Civil Code in 1895.¹⁾ Japanese translation of the term “good faith (*shingi*)” implies an important Japanese word, “trust”, however, originally “trust” and “good faith” represented different concepts. For over several centuries, trust has been the basic requirement of any conducts, acts and behaviours in the Japanese society. Until about 150 years ago, the state of Japan consisted of numerous numbers of small communities, each of which was its members’ foundation of life.²⁾ Since any social and economic activities in a community were based on mutual trust, a community member would not be able to live if he or she lost trust with the other members. A social norm to keep the relations based on mutual trust (“the trust

1) The Civil Code of Japan provides that “the exercise of rights and performance of duties must be done in good faith”. This provision was inserted in the Code after the Second World War, however, the principle had been introduced long before this insertion. For history of enactment of the Civil Code, see H. Oda, *Japanese Law*, 3rd ed (OUP 2009), 13-19 & 113-117.

2) Y Sakane, *Ie to mura: Nihondentoshakai to keizaihatten* (Nosan-gyoson Bunka-kyokai 2011), 132-138, H Takeda, *Nihonjin no keizaikannen* (Iwanami 2008), 57-80, T Doi, *The anatomy of dependence* (kodansha 1973), 49.

relation”) has been developed over centuries and regulated business activities of the Japanese society as a fundamental rule.³⁾

Such rule of the trust relation was not provided in the modern Civil Code when it was drafted. The legislators attempted to get rid of old Japanese social norms when enacting the statutes. However, once the Civil Code came into force and applied by courts for specific dispute resolutions, judges could not ignore the trust relation as the basic rule of conducts. In order to incorporate “trust” into the legal system, judges used the term “good faith”, a Germany originated concept.⁴⁾ In this way, rules under the trust relation have become part of Japanese civil law as court-decided law based on the principle of good faith.

Under civil laws of continental countries, the principle of good faith is used where a judge needs to (i) supplement and clarify contractual terms and statutory provisions, (ii) correct unfairness and injustice resulting from a dishonest conduct, such as abuse of law or contractual right, and (iii) protect a weaker party to a contract between the parties having unbalanced bargaining power.⁵⁾ In Japan, although the principle serves

3) M Yasunaga in T Taniguci and others, *Japanese Civil Law Annotated Vol 1, 2nd ed* (Yuhikaku 1988), 81-85.

4) During the Meiji era, various civil law theories and doctrines in France and Germany were imported and introduced by Japanese scholars, and the principle of good faith is one of them. Courts relied on this principle soon after the enactment of the Code. The Supreme Court first expressed the term “good faith” in its judgment on 18 December 1920, *Minroku* 26-1947. See H Hatoyama, *Saiken-ho niokeru shingi-seijitu no gensoku* (Yuhikaku 1955), 257-260, M Yasunaga in T Taniguci and others (note 3), 73.

5) W Ebke and B Steinhauer ‘The Doctrine of Good Faith in German Contract Law’ in J Beatson and D Friedman (eds), *Good Faith and Fault in Contract Law* (OUP 1995), 399-400, L. Russi ‘Substance or Mere Technique? A Precipit on Good Faith Performance in England, France and Germany’ *Hanse LR* Vol5 No 1 (2009) 21, 27, D. Maltese and M. Ferina ‘Theory of the Firm and Organisational Contracts: The Remedial Aspects of Good Faith’ *EBLR* [2016] 51, 73, M. Ishida, *Minpo sosoku* (Shinzansha 2014) 71-78.

the same function as in other civil law countries, courts also apply this principle to fill a gap between results of strict application of the statute law and common sense based on the trust relation. As a result, the principle is applied by Japanese courts more extensively in certain circumstances and more restrictively in other circumstances than those applied in other countries.

B. Duties to Act in Good Faith

The principle of good faith has been applied by courts in various cases in different manners. In most cases, specific duties are imposed on a party under a specific circumstance in the name of a duty to act in good faith (“the good faith duty”). Typical good faith duties stated by courts include the followings.⁶⁾

1. Duties during negotiations⁷⁾

Negotiation is a process to reach agreement pursuant to which a transaction is contemplated. For most Japanese people, negotiation is also an important process to build the trust relation since it is the first ‘collaborative work’ of the parties. In the course of negotiations, each party evaluates and determines whether or not the counterparty is trustworthy based on their words, conducts, behaviours, business manner and other information. The parties may enter into a contract when both of them confirm that they can build and keep the trust relation. In consideration of such function of negotiations, courts impose on a negotiating party (i) a duty to disclose material information to another party,⁸⁾ (ii) a duty not to withdraw from negotiations unilaterally⁹⁾ and (iii) a duty to indemnify expenses incurred by the other party for services rendered before execution of contract.¹⁰⁾

6) M Yasunaga in T Taniguchi and others (note 3), 85-117.

7) For an exhaustive casebook, see S Kato and others, *Hanrei check keiyakuteiketu-jo no kashitu*, revised (Shinnihon hoki 2012).

2. Duties during performance of contract

Generally, contracts between Japanese parties are very short and provide only basic terms of transactions. This is because each of the contracting parties may expect that the other party will act in good faith without specific provisions. Between the mutually trusted parties, undecided details may be discussed and resolved only when a problem occurs in performance of the contract.¹¹⁾ To support such practices, courts impose on a contracting party (i) a duty to abide by the agreed terms,¹²⁾ (ii) a duty to disclose information which would prejudice the other party's interest,¹³⁾ (iii) a duty to discuss matters which are not clearly provided in the contract¹⁴⁾ and (iv) a duty to mitigate

8) Judgment of the Supreme Court ("SCJ") 18 November 2004, *Saimin* 58-8-2225, Judgment of the Tokyo High Court ("Tokyo HCJ") 31 March 1977, *Hanta* 355-283, Judgment of the Osaka High Court ("Osaka HCJ") 31 October 2001, *Hanji* 1782-124, Osaka HCJ 10 December 2015, *Kinsho* 1483-26, Tokyo HCJ 30 August 2006, *Kinsho* 1251-13, SCJ 18 Nov. 2004, *Saimin* 58-8-2225 (where it was held that a negotiating party shall be entitled to claim damages to the other party under this rule even if the injured party could not prove the causal link between his execution of contract and non-disclosure of the other party.) and SCJ 27 November 2012, *Hanta* 1384-112 (where it was held that in certain circumstances the good faith duty overrides the effect of exclusion and non-reliance clauses).

9) SCJ 19 April 1983, *Hanta* 501-131, Tokyo HCJ 17 March 1987, *Hanta* 632-155 and Judgment of the Tokyo District Court ("Tokyo DCJ") 26 December 1996, *Hanji* 1617-99. See S Ikeda, *Keiyaku-kosho no haki to sonosekinin* (Yuhikaku 1997), 9-37, R Kato 'Torihiki niokeru shingi-seijitu no gensoku' Kobegakuin-hogaku 36-3.4 (April 2007), 111.

10) SCJ 18 September 1974, *Hanta* 542-200, SCJ 27 February 2007, *Hanta* 1237-170, Tokyo DCJ 29 May 1978, *Hanji* 925-81. Generally, in the case where negotiations break down, due to neither party's fault, cost and expenses incurred by each party in respect of negotiations will be borne by respective party unless otherwise agreed. This duty is an exception to such general understanding.

11) Oda (note 1), 151, T Kawashima, *Nihonjin no ho-ishiki* (Iwanami 1967), 87-123.

12) SCJ 28 January 1954, *Saimin* 12-349, SCJ 16 June 1981, *Hanta* 447-80, SCJ 1 July 1997, *Minshu* 51-6-2452. In Germany, a contracting party owes duties to renegotiate and change contractual terms in the event of changed circumstances under the "doctrine of changed circumstances". The doctrine was imported into Japan and recognized by courts, however, it is applied only in exceptional circumstances. (SCJ 6 December 1944, *Minshu* 23-613, Judgment of the Kobe District Court Itami Branch 26 December 1988, *Hanji* 1319-139). See also cases mentioned in III.A.5.5 below.

expansion of damages caused by the other party's breach of contract.¹⁵⁾ In respect of enforcement of contract, (v) courts restrict or limit the rights under the contract if such rights are exercised in a way causing unexpected costs or loss of the other party.¹⁶⁾

3. Duties after termination of contract

In the Japanese business society, the trust relation should be kept even after termination of business relationship so long as the parties carry out businesses in the same industry. In consideration of such commercial practice based on the social norm, courts require the parties to act in good faith even after termination of the contract. The duties imposed on either party include prohibition of (i) using the other party's technology or information obtained in performance of the contract,¹⁷⁾ (ii) trading with the other party's customers¹⁸⁾ and (iii) hiring the other party's employees away from the other party.¹⁹⁾

4. Duties to or against a relevant third party

In certain circumstances, a contracting party owes good faith duties to, or has rights against, such third parties as agent, broker, arranger, carrier, subcontractor, sublessee and insurer of the other party.²⁰⁾

13) Tokyo DCJ 16 December 2011, *Hanta* 1384-196 (where the franchisor was held to owe a duty to inform the franchisee that it received "secret profits" from wholesalers in the course of franchising transactions).

14) Judgment of the Osaka District Court ("Osaka DCJ") 12 October 1961, *Kamin* 12-10-2434.

15) SCJ 19 January 2009, *Minshu* 63-1-97 (where the court held that the innocent party owed duty to mitigate expansion of damages caused by the other party's breach of contract).

16) SCJ 1 March 1973, *Kinsho* 358-2 (where the court restricted claims under the continuous guarantee agreement), SCJ 25 May 1976, *Minshu* 30-4-554 (where the court did not accept the defence relying on the prescription period of claim). In respect of restrictions on termination of a continuous contract, see cases mentioned in III.A below.

17) Osaka HCJ 26 December 1994, *Hanji* 1553-133, Tokyo DCJ 26 August 1998 *Hanta* 1039-199.

18) Judgment of the Yokohama District Court ("Yokohama DCJ") 29 October 1984, *Hanta* 545-178, Tokyo DCJ 18 September 2001, *Kinsho* 1153-50.

19) Tokyo DCJ October 28 2005, *Hanji* 1936-87, Tokyo DCJ 12 December 2006, *Hanji* 1981-53.

III. Termination of Contract and Good Faith under Japanese Law

A. Duty Not To Terminate Contract Without Justifiable Ground

1. Basis of the Rule

Under the principle of good faith, a party to a continuous contract shall not terminate the contract without a justifiable ground ("Rule 1").²¹⁾ The rationale of this rule is that sudden termination by one party causes damage to the other party who would waste expenses spent for the business under the contract. Except in the case of a one-time-only transaction between the parties in unrelated industries, the contracting parties generally intend to develop a long-term mutual business relation, and each party carries out businesses based on the expectation that the contract will continue for many years.²²⁾ . In order to protect such trust and expectation, each party to a continuous contract shall keep the contractual relationship unless the trust relation between the parties is destructed by or due to the other party or it becomes extremely unfair and

20) SCJ 12 October 1973, *Saimin* 27-9-170, SCJ 28 March 2002, *Saimin* 56-3-662 (where the landowner-lessor's proprietary right against the sub-lessee was limited), SCJ 30 October 1998, *Hanta* 980-101 (where the court limited the amount of damage claimed by the owner of lost property against the carrier, who had no contractual relationship with the owner, for the carrier's negligence), SCJ 4 September 2006, *Hanta* 1223-131 (where the university, which has yet to decide to order certain works to a contractor, was held to be liable to indemnify costs of works carried out by a potential subcontractor) and SCJ 27 November 2012 (note 8) (where the arranger of the syndicated loan was held to owe a duty to disclose information to potential participating banks).

21) Oda (note 1), 155-158. This rule has been established by a considerable number of lower courts' judgments. The Supreme Court also recognises this rule although it has yet to decide its direct application (see SCJ 5 February 1981, where the court upheld the lower court's decision that a land management agreement should not be terminated unilaterally under the principle of good faith). For detailed study and exhaustive case analysis, see K Kawagoe, *Keizokuteki-torihikikeiyaku no shuryo*, NBL separate vol 19 (Shojihomu 1988), H Nakata, *Keizokuteki-keiyaku no kaisho* (Yuhikaku 1994), 16-112, J Masuda, *Keizokuteki-keiyaku no hori to hanrei* (Nihonkajo shuppan 2013) and S Kato and others, *Hanrei check keizokuteki-keiyaku no kaijo, kaisho*, revised (Shinnihon hoki 2014).

22) Oda (note 1), 155.

unreasonable to continue the contract due to change of circumstances.

2. Remedies

If a party to a continuous contract notified the other party to terminate or not to renew the contract without a justifiable ground and ceased to perform duties under the contract, such termination notice and non-performance of the duties would constitute a breach of contract of such party (the “terminating party”). The other party (the “injured party”) is entitled to require the terminating party to (i) confirm that the injured party has the rights under the contract,²³⁾ (ii) perform the duties (such as delivery of the ordered goods) under the contract,²⁴⁾ and/or (iii) pay damages.

The remedy (i) is rather symbolic and is not have actual effect unless the terminating party voluntarily accepts to continue the contract. The remedy (ii) has also limited effect since the court’s judgment only covers the performance of the duties existing at the time of termination notice. The most effective remedy is (iii) above.

Damages to be compensated would be the amount of loss suffered by the injured party caused directly or indirectly by the terminating party’s unlawful termination notice and non-performance of the duties under the contract.²⁵⁾ In many cases, courts decide that the amount of damages would be the lost profit of the injured party for the next one year period after the unlawful termination.²⁶⁾ The period of lost profit would be longer if the injured party proves that the investment was made based on the longer contract period.²⁷⁾ It could also be shorter than one year if the court found that the parties

23) Judgment of the Kobe District Court 17 September 2002, LLI/DB, Judgment of the Otsu District Court Hikone Branch 11 September 1997, *Hanta* 892-250.

24) Tokyo DCJ 27 September 1995, *Hanta* 833-233 and Tokyo DCJ 18 July 1994, *Hanta* 855-111.

25) Tokyo DCJ 12 September 1974, *Hanji* 772-71 (where damages calculated based on the amount of investment spent) and Tokyo HCJ 24 December 1984, *Hanji* 1144-99 (where lost profit was compensated).

expected early termination.²⁸⁾ If the injured party insists and proves that loss of expected profit from a specific transaction, courts would calculate the amount of damage based on such alleged transaction.²⁹⁾

Under Japanese law, damages are granted only for compensation of actual loss. If the injured party did not suffer damages as a result of termination notice, the court would not award damages or would decide only a nominal amount.³⁰⁾

3. What is “a continuous contract”?

To decide whether or not Rule 1 is applied, meaning of the term “a continuous contract”, in this Rule 1 must be clarified. “Continuous contracts” means contracts which usually continue to be effective for a certain period. Such contracts include distributorship agreements, basic agreements on continuous sale and purchase of goods, franchise agreements, lease agreements, continuous supply of service agreements, agency agreements, licensing agreements.³¹⁾ Rule 1 is applicable not only to contracts between the parties in unbalanced bargaining position such as merchant and consumer, employer and employee, landlord and tenant, principal and agent, etc., but also to contracts between the parties on an equal footing.

26) Nagoya HCJ 29 March 1971, *Hanji* 634-50, Tokyo DCJ 26 May 1981, *Hanta* 455-127, Osaka DCJ 7 November 1995, *Hanji* 1566-85, Tokyo DCJ 28 August 2000, *Hanji* 1737-41, Tokyo HCJ 5 December 2002, *Hanta* 1139-154 (where the court awarded one year lost profit plus loss of reputation) and Osaka DCJ 16 September 2006, *Hanji* 1920-96.

27) Osaka DCJ 28 March 1983, *Hanta* 503-102 (where the court awarded more than two years' lost profit in the sales via vending machines contract in consideration of exhaustion period of the machines).

28) Osaka HCJ 28 March 1997, *Hanji* 1612-62 (where the court found that damage resulting from the termination was five months lost profit).

29) Tokyo DCJ 26 May 1981, *Hanta* 455-127.

30) Tokyo DCJ 14 June 2007 LLI/DB and Tokyo DCJ 2 February 2015, *Hanji* 2272-71.

According to courts, a business relationship under a number of spot sales contracts or service supply contracts, which are frequently executed between the same parties during a certain period, also considered to be a “continuous contract”.³²⁾

4. Termination of a contract covered by this rule

For the purpose of Rule 1, termination of a contract includes the following events.³³⁾

4.1 Non-renewal of the period of contract upon expiry

As the common practice in Japan, a contract provides that it will continue valid and effective for comparatively a short period, which is normally one year and is no longer than three years. Notwithstanding such provision, generally, the parties expect that the contract period will be extended by renewal upon expiry of the original and extended terms. It is not unusual that a one-year term contract continues more than 20 years as a result of repeated renewals. In consideration of such common practice, courts have established that a party is not allowed to refuse renewal of the contract without justifiable grounds.³⁴⁾

31) S Kato and others (note 21), 4-9. Courts sometimes admit the effect of immediate termination of an agency or entrustment contract because such contract could not continue when the trust relation was destructed for whatever reason. However, even in such cases, the terminating party was required to compensate damages suffered by the other party unless there was a justifiable ground. Accordingly, the consequence is the same as those where the court applied this rule. See Tokyo DCJ 21 January 2013, *Hanji* 2192-53 (where the cleaning service agency contract was terminated by 30 days advance notice, but damages suffered by the agent was held to be compensated).

32) Osaka DCJ 21 June 1993, *Hanta* 829-232 and Tokyo HCJ 24 December 1984, *Hanji* 1144-88.

33) H Nakata, *Keizokuteki-torihiki no kenkyu* (Yuhikaku 2000), 131-158.

34) Judgment of the Sapporo High Court 29 July, 2011, *Hanji* 2133-13 and Judgment of the Fukuoka High Court Kurume Branch, 22 September, 2006, *Hanta* 1244-213. These two cases concerned non-renewal of the newspaper distribution contracts by suppliers. In the former case, it was held that change of the distributor’s representative director was not a ground to justify non-renewal and, in the latter case, a false sale report by the agent was not held to be a material breach to justify non-renewal.

4.2 Termination by notice

In some cases, a continuous contract does not provide the valid period of the contract. Under the general rule of the Civil Code, a continuous contract for indefinite period may be terminated at any time by giving notice by one party to the other party.³⁵⁾ However, under Rule 1, which overrides the Civil Code provisions, a termination notice shall not be effective without a justifiable ground.³⁶⁾

4.3 Termination upon occurrence of an agreed early termination event

A continuous contract often contains provisions for early termination, which entitle either or one of the parties to termination the contract upon an occurrence of a default event of the other party such as insolvency or a breach of contract, or by notice of termination to the other party. A typical termination notice clause provides that one or either of the parties may terminate the contract by giving notice and the contract shall terminate upon passage of a certain period after the notice. Under Rule 1 a party to a continuous contract cannot rely on any early termination clauses without a justifiable ground.³⁷⁾

5. What is 'a justifiable ground'?

In many cases, courts decide that termination of a continuous contract is justified if the trust relation between the parties has been unrestorably destructed due to conducts or behaviors of the other party. In some other cases, courts find a justifiable ground if performance of duties under the contract becomes impossible under the changed

35) Civil Code arts 617 (Lease contract), 627 (Employment contract) and 651 (Agency contract).

36) Judgment of the Nagoya High Court ("Nagoya HCJ") 29 March 1971, *Hanji* 634-50, Tokyo HCJ 24 December 1984, *Hanji* 1144-99, Judgment of the Fukuoka High Court ("Fukuoka HCJ") 19 June 2007, *Hanta* 1265-253 (where termination of distributorship or continuous sales contracts by the supplier is prohibited) and Osaka DCJ 16 September 2006, *Hanji* 1920-96 (where termination by the distributor is prohibited).

37) Tokyo DCJ 27 September 1993, *Hanta* 833-223 and Osaka HCJ 28 March 1997 (note 28).

circumstances resulting from an event beyond the parties' control. The former reasoning of justification is called "the doctrine of destruction of trust relation" and the latter is called "the doctrine of changed circumstances." Both doctrines are derived from the principle of good faith. Detailed events consisting of "destruction of trust relation" are described in 5.1 through 5.4 and of "changed circumstances" are in 5.5 and 5.6 below.

5.1 Insolvency

A continuous contract often provides one or either of parties' right to terminate the contract upon occurrence of such event as (i) suspension of payment, (ii) insolvency, (iii) suspension of banking transactions, or (iv) application for or commencement of bankruptcy or rehabilitation proceedings in respect of the other party. Generally, a contract may be terminated by such provision since occurrence of any of these events is presumed to destruct the trust relation.³⁸⁾ However, if an insolvent party appears to be capable and willing to continue the business under the contract, the other party cannot terminate the contract immediately pursuant to the above clause.³⁹⁾ In such case, the trust relation is not yet destructed because a risk of non-performance by the insolvent party may be eliminated if a sufficient security or deposit is offered by such party.⁴⁰⁾

38) Tokyo DCJ 17 April 2003, LLI/DB (where the court admitted termination of the exclusive distributorship agreement by the supplier upon insolvency of the distributor) and Osaka DCJ 29 January 1991, *Hanta* 777-208 (where the court admitted termination of the building lease contract by the lessor upon the lessee's suspension of payment).

39) Tokyo DCJ 9 December 1992, *Kinho* 1371-86 and Tokyo DCJ 6 November 2003, LLI/DB. In these two cases, the court held that the lessor was not entitled to terminate the building lease contract after the insolvent tenant had continued payment of rent for a certain period.

40) Yokohama DCJ 27 February 1976, *Hanta* 341-203 (where the court concluded that the trust relation was not destructed because the insolvent tenant might have offered security for rent payment).

5.2 Breach of terms

As a statutory rule, if one party fails to perform its obligation under the contract and if such party, after receipt of a notice from the other party requiring performance of such obligation, does not rectify the failure within a reasonable period of time, the other party is entitled to terminate the contract⁴¹⁾ This statutory requirements for termination may be changed by agreement between the parties, and a commercial contract usually provides that a party may terminate the contract without a prior notice in the event of a material breach by the other party. However, in the case of continuous contracts, these statutory and contractual termination rights are qualified by the principle of good faith and the doctrine of destruction of trust relation.⁴²⁾ Generally, a single failure of performance under or a breach of contract does not constitute a sufficient ground for termination. Courts consider that the trust relation between the parties is still restorable at such stage.⁴³⁾ However, if one party breaches a material term of the contract repeatedly and continuously despite requests of performance from the other party, it is reasonable to presume that the former party has no intention to maintain the trust relation. In such cases, the latter party may terminate the contract.

In a case of the Tokyo High Court,⁴⁴⁾ the claimant is a chain store selling cosmetic manufactured by the defendant, a cosmetic firm. In the chain store contract, the claimant is allowed to sell the defendant's products only by the method of face-to-face sale with counseling to each customer at the counter. However, in breach of such

41) Civil Code art 541.

42) In SCJ 13 December 1984, *Minshu* 38-12-1411, the court did not admit the landlord's termination of the land lease contract where the tenant had constructed an additional house on the leased land in breach of contract. The court concluded that the trust relation was not destructed by such breach.

43) In Fukuoka HCJ 19 June 2007, *Hanta* 1265-253, the newspaper company was not allowed to refuse renewal of a distributorship contract where it did not inquire or request the distributor to correct his false reports on the number of customers, knowing they were incorrect, until the renewal time.

obligation the claimant sold products by way of accepting orders from customers via fax and telephone. When the defendant had first found such breach and had requested the claimant to stop such method of sale, the claimant had assured in writing that it would never do it again. However, notwithstanding such written assurance, the claimant did not stop the telephone and facsimile sale method and refused further discussion for settlement with the defendant, ignoring the defendant's repeated requests. The court concluded that the provision requiring the face-to-face sale method in the contract was material because such method was reasonably necessary to protect customers against skin troubles. Based on that decision, the termination of the contract by the defendant was held to be justified because the trust relation was destructed and was not restorable as a result of the claimant's continuous breaches.

5.3 Dealings and conducts detrimental to the other party's interest

The trust relation is likely to be destructed if a party to the continuous contract repeated or continued such dealings or conducts as are against the other party's interests even though such dealing or conduct would not amount to a breach of the contract.

Typical examples of such conducts are competitive transactions such as parallel dealings in competitive products or with a competitor of the counterparty. In a case of the Tokyo District Court, the managing director of the defendant company, acting as

44) Tokyo HCJ 14 September, 1994, *Hanta* 877-201. For a similar decision involving another cosmetic manufacturer, see Tokyo HCJ 31 July 1997, *Hanji* 1624-55. For cases concerning repeated breaches of other collateral terms, see Osaka DCJ 29 November 2012 on the courts' website (where the supplier was allowed to terminate the distributorship contract due to the distributor's continuous use of the supplier's trademark in an unauthorized manner) and Tokyo DCJ 31 October 2013, LEX/DB (where termination of the franchise agreement by the franchisor was held to be effective on the ground that the franchisee made false report on the number and identity of customers, ignored the franchisor's request of correction, refused proposals of meetings and failed to attend the court's mediation proceedings initiated by the franchisor).

the sole distributor of the supplier's products (bonding agents) in Hong Kong, was also a director of another company, which was selling competitive products in Hong Kong. When the supplier found such fact and inquired the distributor about such dealings, the distributor only replied that it was not involved in the competitive sales and refused further explanation or discussion with the supplier. No action was taken by the distributor and its managing director to discontinue competitive sale. Taking into account such behavior of the distributor and the director, the court concluded that the trust relation was destructed and was not restorable.⁴⁵⁾

It is noteworthy that courts may decide a competitive dealing to be a justifiable ground for termination even if such dealings are expressly permitted in the contract. In such case, however, the court would also take into account additional factors. In a case of the Tokyo District Court, the claimant was a distributor of electric shavers of the defendant, a US shaver supplier (Gillette), for over 25 years.⁴⁶⁾ The claimant was allowed to deal with competitive products and indeed it acted as a major distributor of a competitor of the defendant. In various occasions, the defendant was advised by retailers and customers that the claimant did not attempt to sell the defendant's products diligently in comparison with the competitor's products. The defendant repeatedly requested the claimant to endeavor sales promotion, however, the claimant did not change its attitude. When the defendant notified non-renewal of the one-year term contract, the claimant claimed for damages caused by the defendant's unilateral termination. The court denied the claim, holding that termination by the defendant was justified in consideration of the claimant's behavior. In this decision the court also took

45) Tokyo DCJ 24 December 2006, LLI/DB. For another example of indirect dealing in competitive products, see Tokyo DCJ5 February 1999, *Hanta* 1073-171. There are also cases where courts admitted termination by the supplier due to the distributor's failure to report market condition (which was normally an immaterial breach) when the distributor dealt with competitive products without notifying the supplier and refused to report such fact (Osaka HCJ 25 October 1996, *Hanji* 1595-70).

46) Tokyo DCJ 5 February 1999, *Hanta* 1073-172.

account that the claimant failed to prove waste of investment costs for business with the defendant. The claimant insisted that it spent tremendous expenses for establishing sales network, however, since the claimant was also acting as a major distributor of a competitor, the sales network established would still be useful for the claimant.

Other typical cases are those where a contracting party intentionally injured the counterparty's reputation,⁴⁷⁾ trademark⁴⁸⁾ or confidential information⁴⁹⁾, or disturbed the counterparty's business or contract with other entities.⁵⁰⁾ There are also cases where conducts or behavior of one party that caused or enhanced anxiety of his creditworthiness were held to cause destruction of the trust relation.⁵¹⁾ It should be noted that in most of these cases courts took account that such party repeated or continued such conducts or behavior, refusing or ignoring the terminating party's requests, proposals or discussion for settlement.

47) Fukuoka DCJ 15 March 2011 on the courts' website (where the newspaper distributor repeatedly disclaimed and criticised the supplier to the public via net and refused discussion with the supplier to repair the relation), Osaka HCJ 14 February 1984 *Hanta* 525-118 (where the distributor of educational books divulged incorrect information that the supplier's rival company had financial problem to induce customers, and refused to stop such behavior when the supplier requested to stop it upon receipt of a claim from the rival company), Tokyo DCJ 27 January 2006, LLL/DB (where the exclusive distributor of beverage products advertised incorrect information about the supplier's products and ignored the supplier's inquiry about such conduct).

48) Osaka DCJ 29 November 2013 on the courts' website (where the purchaser under the continuous sale and purchase contract used the trademark of the seller for advertisement of a competitor's products without permission).

49) Tokyo DCJ 6 July 2005, *Hanta* 1214-226 (where the distributor notified wrong information about its position under the distribution contract to key customers and made the supplier's confidential information accessible via online without permission) and Osaka DCJ 18 February 2005, TKC (where the continuous purchaser of toys submitted details of invoices issued by the seller to a rival toy maker without permission).

50) Tokyo DCJ 30 April 2013 on the courts' website (where the supplier of waffles under continuous sales contract with the wholesaler attempted to induce the retailer, who repurchased the supplier's products from the wholesaler, direct transactions so as to exclude the wholesaler from the business).

5.4 Hostile behavior or conducts towards the counterparty

The trust relation is built and maintained by sincere discussion between the parties. Accordingly, courts find that the trust relation was unrestorably destructed in the case where it becomes difficult to commence or continue discussion between the parties due to hostile behavior of one party.

In a case of the Tokyo District Court, the claimant, a purchaser of glasses and aluminum sash windows from the defendant manufacturer, claimed that certain products sold by the defendant were defective. When the defendant visited the claimant to apologise and discuss solutions, the claimant blamed their fault loudly in the intimidating manner and rejected to listen to any explanation and suggestions. The same attitude continued at the following telephone conversations and meetings. The court concluded that the trust relation had been destructed and unrestorable due to the claimant's behavior and held that the defendant was entitled to terminate the continuous manufacturing contract.⁵²⁾

In other cases, courts concluded unrestorable destruction of the trust relation when one party made unreasonable claims and commenced a lawsuit without merit against the other party.⁵³⁾

51) SCJ 13 December 1962, *Hanta* 140-127 (where the seller's refusal of further delivery of products was justified when the purchaser issued a promissory note, which was likely to be refused by a designated bank, and refused any discussion with the seller to change the payment method) and Tokyo DCJ 20 December 1990 *Hanta* 757-202 (where the supplier of baby goods was allowed to stopped further deliver when the purchaser increased the volume of orders and accumulated debts, refused the supplier's request to provide a security or guarantee and failed to pay the debt on the due date).

52) Tokyo DCJ 25 October 2002, LLI/DB.

5.5 Unexpected Change of Circumstances by an event beyond the parties' control

Under certain exceptional conditions, a party may be discharged from a duty or liability under the contract if performance of such duty becomes impossible under unexpectedly changed circumstances as a result of an event beyond such party's control.⁵⁴⁾ In order to apply this rule, performance of the duty shall become physically impossible or, even if physically possible, commercially or economically unexpected under normal social conventions.⁵⁵⁾ The rule does not apply to cases where the performance of contract is merely commercially unreasonable or impracticable.⁵⁶⁾ Furthermore, it should be noted that the court only applies this doctrine where the court considers that it is extremely unfair and unreasonable for the relevant party to be bound by the contract.⁵⁷⁾ In this respect, courts consider whether the party to be discharged made efforts to avoid or minimize damages to be incurred by the other party. For example, in a case where the purchaser of carvings for a household Buddhist altar notified termination of the

53) Tokyo DCJ 17 September 2013 on the courts' website (where the distributor made unreasonable claim and brought proceedings against the supplier without any merit by which the supplier had suffered unnecessary legal costs), Tokyo HCJ 27 June 2013 on the courts' website and Tokyo HCJ 17 October 2012, *Hanji* 2182-60. In the latter two cases, a franchisee of lunch boxes chain store registered trademark related to the franchisor's business without approval and claimed and sued against the franchisor for that payment of royalty on the trademark.

54) This rule, called the doctrine of changed circumstances, has been established mainly by lower courts' decisions. The Supreme Court recognized the doctrine although rarely applies it to allow termination of a contract (SCJ 6 February 1951, *Minshu* 5-3-36, SCJ 28 January 1954, *Minshu* 8-1-234, SCJ 20 December 1955, *Minshu* 9-14-2027, SCJ 25 May 1956, *Minshu* 10-5-566 and SCJ 1 July 1997, *Minshu* 51-6-2452; all denied application of the doctrine). See Z Kitagawa '*Keiyakuteiketu-jo no kashitu*' in S Matusaka and others, *Keiyakuho Taikei* I (Yuhikaku 1962), 221-236, Oda (note 1), 153-154, M Yasunaga in T Taniguci and others (note 3), 115-116 and M Yasunaga in T Taniguci and others *Japanese Civil Law Annotated Vol 13, 2nd ed*, revised (Yuhikaku 2006), 66-90.

55) Judgment of the Nara District Court 6 February 1951, *Kamin* 2-2-146 (where the parties to a continuous contract for sale of dyestuff were held to be discharge from their respective duties when delivery became impossible due to short of transportation means as a result of intensification of war).

continuous purchase contract because of serious depression of the Buddhist altars' market, the court adopted the doctrine of changed circumstances taking account that the purchaser offered to introduce other customers of such carvings in his place, but the supplier refused such offer for his own reason.⁵⁸⁾

5.6 Expected Change of Circumstances

In principle, if a change of circumstances is foreseeable by the parties at the time of the contract, such changed circumstance is not considered to be a justifiable ground for termination.⁵⁹⁾ However, there are cases where the parties entered into the contract with mutual expectation that it would not continue under certain circumstances. In such cases courts are likely to mitigate the requirement of "a justifiable ground" for termination or non-renewal of the continuous contract. In deciding such "mutual expectation" courts appear to take into account the process of negotiations between the parties to reach agreement concerning the period of contract.

56) Tokyo DCJ 28 August 2000, *Hanji* 1737-41 (where continuous supply of certain drug was affected by a sudden governmental order of drug price revision, it was held that a party to the drug supply contract did not owe a duty to renegotiate the contract even if the revised drug price would cause economic difficulty of the other party in performance of the contract) and Tokyo DCJ 10 August 2013 TKC (where the purchaser of asbestos attempted termination of a continuous purchase contract on the ground that it became difficult to find customers as a result of change of law which restricts use of asbestos for buildings, the court denied application of the doctrine of changed circumstances because the changed law did not prohibit sale of asbestos).

57) SCJ 12 February 1954, *Minshu* 8-2-448.

58) Tokyo DCJ 28 August 1987, *Hanji* 1274-98.

59) SCJ 1 July 1997 (note 54) (where the golf course was destroyed by natural disasters, the court did not allow the golf course operator to terminate the golf club membership contract on the ground that such accident had been foreseeable) and Osaka HCJ 12 September 2000, *Hanta* 1074-214 (where the rooftop hoarding became difficult to be observed because of a nearby newly built building, the court did not allow termination by the advertiser of the hoarding rent contract because such change of circumstance had been foreseeable).

For example, in a case of the Osaka District Court, the parties entered into a license agreement, pursuant to which the claimant agreed to develop certain information security programme and to grant the right to use such programme to the defendant for manufacture and sale of certain IT products. During the negotiations, the claimant had proposed the period of contract to be 10 years to cover costs for development of the programme, but the defendant had insisted shorter period (five to seven years) in consideration of risk involved in the business and the total amount of fixed royalties during the term. As a result of discussion the parties agreed five year term. In the fourth year of the contract period, it became evident that the defendant's business under the license was not commercially successful, and in the fifth year the defendant gave three month prior notice of non-renewal. The court held that there was a justifiable ground to refuse renewal of the contract, taking into account that the period of the contract had been decided after substantial discussions.⁶⁰⁾

Courts also take account of the reason to reach agreement concerning the contract period. In a case of the Tokyo District Court, the defendant, a venture company who developed certain health food products, continuously ordered the claimant to manufacture and supply such products under the continuous manufacturing contract. Under the contract the payment of price by the defendant should be made within three days after issue of the claimant's invoice. Such payment term was decided since the defendant was not sufficiently creditworthy to secure its payment obligations under this transaction. The period of contract was agreed to be one year with a yearly based renewal clause. After several renewals, the defendant became a subsidiary of a creditworthy US company, and requested the claimant to change the contractual terms including the unfavourable payment term. The parties discussed amendment of the

60) Osaka DCJ 20 August 2015 on the courts' website. In this case, the judge also stated that the claimant did not demonstrate that ten year would be actually required for covering the initial development cost.

terms but failed to reach agreement on change of the payment term. Under the circumstance the defendant notified the claimant non-renewal of the contract. The court concluded that failure to reach agreement on the amendment to the payment term was a justifiable ground to refuse further renewal. In so deciding, the court took account that the parties had agreed the period of contract to be one year in consideration of the mutual convenience, i.e. neither party had wanted to be bound by the contract for a long period.⁶¹⁾

5.7 Reasonable Advance Notice

In relation to Rule 1, the court often refers that a continuous contract cannot be terminated without a justifiable ground “unless a notice is given reasonably in advance”. There are little cases where the court permitted termination of contract by giving reasonable advance notice without a justifiable ground. As discussed in A.2 above, in many cases courts require the defendant to compensate the claimant’s lost profit for the future one-year period. These cases indicate that generally a party may terminate the continuous contract by giving a termination notice no later than one year before the date of termination.⁶²⁾ However, in practice a party willing to terminate the contract would like to discontinue contractual relationship with the other party much earlier. Accordingly, in most cases a termination notice is given less than three months before intended date of termination. In such cases, whether or not and how advance termination notice was given is considered by courts as one of the factors in deciding a justifiable ground for termination.⁶³⁾

61) Tokyo DCJ 18 September 2008, *Hanji* 2042-20.

62) In Tokyo DCJ 15 April 2004, *Hanta* 1163-235, it was held that notice is required in addition to a justifiable ground and a reasonable notice period should be between 2 and 10 years. The case seems to be exceptional since the contractual relationship concerned had continued over 100 years.

63) Tokyo DCJ 18 September 2008 (note 61) (where non-renewal by the purchaser of the continuous supply contract was held to be allowed under the changed circumstance, the court also took account that the purchaser notified its intention of non-renewal more than one month in advance).

6. Rule 1 to be identified

Under Japanese system, decisions of courts do not constitute sources of law. However, in respect of application of general rules of law such as the principle of good faith, certain rules have been established by a number of cases over a century, and in practice there are only specific situations where courts may apply a certain rule under the principle of good faith in certain manners subject to certain requirements.⁶⁴⁾ In some cases, judges stated a rule under the principle and resolved the dispute by relying on such rule. In other cases, judges simply apply the principle to resolve the dispute. Even in the latter cases, it is possible to find a specific rule applicable to a similar situation by the analysis of decisions. The established rules so found are clear and certain like case law in common law countries.

In respect of termination of a continuous contract, the following “case law” can be identified based on the above analysis of cases.

Rule 1 (Termination of a Continuous Contract)

1. A party to a continuous contract shall not terminate the contract, either by notice of termination or of refusal to renew the contract or upon occurrence of an agreed termination event, without a justifiable ground.
2. In respect of the preceding paragraph, a continuous contract means a contract which usually continues to be effective for a certain period, including distributorship agreement, basic agreement on continuous sale and purchase of goods, franchise agreement, lease agreements, continuous supply of service agreement, agency agreement, licensing agreement and a chain of the same type of spot transactions.

64) For a similar remark concerning good faith under French law, see J. von Dunne ‘On a clear day you can see continent – the shrouded acceptance of good faith as a general rule of contract law on the British Isles’ CLJ 2015, 31(1) 3, 8.

3. In respect of Paragraph 1 above, there is a justifiable ground for a party to terminate the contract if the trust relation between the parties is destroyed and unrestorable due to the other party. The trust relation is presumed to be destroyed and unrestorable in the event that:
 - (1) the other party has become insolvent unless such party appear to be still capable to perform the duties under the contract;
 - (2) the other party breached a material term of the contract, or carried out certain conduct which is detrimental to interests of the former party, and (i) repeated or continued such breach or conduct despite the former party's repeated request to stop it or (ii) refused to discuss for settlement with the former party; or
 - (3) the other party acted hostile to the former party, and repeated or continued such hostile act despite the other party's efforts to restore the trust relation.
4. In addition to paragraph 3 above, change of circumstances by an event beyond the party's control may constitute a justifiable ground for termination of the contract if:
 - (1) such change of circumstances is not reasonably foreseeable at the time of the contract and, as a result of such change, duties under the contract becomes impossible to perform, provided that the terminating party makes reasonable efforts to avoid or minimize damages to be suffered by the other party; or
 - (2) such change of circumstances is foreseeable and expected by the parties in advance and termination of, or expiry of the period of, the contract upon occurrence of such event has been agreed between the parties upon substantial discussion in consideration of each party's interests.

B. Right to Terminate Contract on the Basis of the Principle of Good Faith

According to Rule 1 above, a continuous contract cannot be terminated upon the expiry of the agreed period of contract unless the court finds a justifiable ground for termination. The provisions of Rule 1 indicate that, under Japanese law, a fundamental element to decide termination of a continuous contract shall be whether there is a

destruction of trust relation or change of circumstances rather than whether the period provided in the contract is expired. Such indication derives a theoretical rule that a party may be discharged from duties under the continuous contract even in the middle of the agreed period of contract if there is a justifiable ground for termination (Rule 2). This rule is supported by several cases.

In a case of the Tokyo District Court, the wholesaler of vinyl records resold products purchased from the manufacturer to rental shops. Although the contract did not expressly prohibit resale to rental shops, such resale would arguably infringe copyright and would adversely affect the manufacturer's profit. Taking account that the wholesaler had continued resale to rental shops, ignoring numerous requests from the manufacturer to stop it, the court admitted termination by the manufacturer of the continuous sale contract before expiry of the agreed period by application of the doctrine of destruction of trust relation.⁶⁵⁾

In another case, the Tokyo District Court applied the doctrine of changed circumstance to justify the mid-term termination of the contract of mutual-aid fund. In this case, the operator of the mutual-aid fund attempted to terminate the fund contract with the members. Under the contract, the members were entitled to receive mutual aid money on the maturity date. However, because of the unexpected change of the financial market condition as a result of the central bank's low-interest policy, it became impossible for the fund to distribute the agreed amount of money to the members on the maturity date. The court admitted termination by the operator of the mutual fund contract before maturity date on the ground of the doctrine of changed circumstances,

65) Tokyo DCJ 29 March 1984, *Hanta* 525-305. For another case, a newspaper company was allowed to terminate the newspaper distributorship agreement in the middle of the period of the term on the ground that the distributor was punished for a charge of operating an illegal gambling establishment (Judgment of the Sapporo District Court 30 August 1977, *Hanji* 881-134).

taking account that the operator had considered possible alternative steps and had offered a reasonable settlement proposal to the members to pay sufficient compensation of the premiums paid by the members.⁶⁶⁾

According to these cases, criteria to decide a justifiable ground in application of Rule 2 should be the same as mentioned in Rule 1. Accordingly, Rule 2 can be identified as follows.

Rule 2 (Right to Terminate a Continuous Contract)

1. A party to a continuous contract shall be entitled to be discharged from the contract or may terminate the contract at any time if there is a justifiable ground for termination.
2. For the purpose of the preceding paragraph, the term “a continuous contract” shall have the same meaning as provided in Rule1, paragraph 2 and the term “a justifiable ground” shall be decided taking account of the same factors as provided in Rule 1, paragraphs 3 and 4.

C. Choice of Foreign Law and the Principle of Good Faith

Rules 1 and 2 explained above do not apply to a contract which is governed by laws other than Japanese law unless courts decide to exclude application of such governing law. Under the Japanese rules of conflict of laws, a contract shall be governed by the law of the place chosen by the parties, however, the court may not apply the foreign law chosen by the parties if the result of its application would be against public policy of Japan.⁶⁷⁾ According to judgments of courts, termination of a continuous contract in breach of a good faith duty could be against public policy only in exceptional cases where the Japan’s social order protected by the established legal system could be

66) Tokyo DCJ 31 March 2003 LLI/DB.

67) Act Concerning General Rule of Application of Laws art 42.

destroyed by such termination. For example, in the case where a Californian company attempted termination of the employment contract with an employee who was dispatched to a Japanese company and worked under such Japanese company's supervision, it was held that such termination was unlawful notwithstanding the termination could be effective under the law of the state of California, the governing law of the contract chosen by the parties.⁶⁸⁾ In this case, the court found that the defendant company terminated the employment contract with the employee, knowing that such employee was organising a labour union with other employees, and decided that the termination of the contract to prevent such employee's activity was not allowed under Japanese labour law without regard to the governing law of the contract.

On the other hand, there are two cases where a US employer unilaterally terminated an employment contract with a US citizen who worked in its branch office in Japan, in which the court rejected the employee's argument that it was unlawful under the doctrine of destruction of trust relation, holding that the termination was effective under the governing law of the contract (laws of the state in US) chosen by the parties.⁶⁹⁾ In those two cases, the court decided that the application of the foreign law did not destroy the social order maintained by Japanese law taking account of the fact that the contract concerned was executed between a US citizen and a US company in the territory of US. In another case concerning termination of a cross-border agency agreement between Korean manufacturer of silicon wafer and its Japanese sales agent, a Japanese agent applied for injunction against the Korean manufacturer, seeking the court's order to abide by the terms of the agency agreement. The court repelled such injunction, holding, among other reasons, that the agency agreement, governed by Korean law, was validly terminated in accordance with the clause providing that each party may refuse renewal of the agreement by notifying such intention to the other

68) Decision of the Tokyo District Court 26 April 1965, *Hanji* 408-14.

69) Tokyo DCJ 9 July 1967, *Hanta* 210-174 and Tokyo DCJ 14 May 1969 *Hanta* 240-215.

party 60 days prior to expiry of the term.⁷⁰⁾

Based on the decisions in the above cases, the following rule can be identified:

Rule 3 (the Principle of Good Faith and Foreign Law Governed Contract)

1. Rules 1 and 2 are not applicable to a contract governed by a foreign law unless courts find that application of such law in a particular situation would bring extremely unfair and unreasonable consequence in consideration of the Japanese social order.
2. In respect of the preceding paragraph, if a termination clause in the foreign law governed contract is exercised in a manner to evade mandatory provisions in a statute such as labour law, anti-monopoly law, etc., courts are likely to find that the application of the foreign law in such situation would destroy the social order maintained by Japanese law.

IV. Termination of Contract and Good Faith under English Law

A. English Rules Comparative to Japanese Rules 1 and 2

English contract law does not have a general principle of good faith, however, it is often pointed out that English courts can reach the same conclusions that would be reached in civil law courts by relying on the principle of good faith.⁷¹⁾ For example, English courts often use the test of presumed implication of a term in order to supplement a missing term in contracts. Injustice and unfairness resulting from abuse of stronger bargaining position of one party may be corrected by the doctrine of

70) Decision of the Tokyo District Court 28 August 2007 *Hanta* 1272-282.

71) R Brownsword, *Contract Law: Themes for the Twenty-First Century*, 2nded (OUP 2006), 120-121 and E McKendrick 'Good Faith: A Matter of Principle?' in A Forte (ed), *Good Faith in Contract and Property Law* (Hart 1999) 39, 41-44.

estoppel, the doctrine of economic duress, etc. as well as by statutory provisions.⁷²⁾ However, conclusions reached under English rules would not always be the same as those achieved by the principle of good faith. It is at least evident that English contract law does not have rules similar to Rules 1 and 2 mentioned in III above. Comparative rules under English law can be summarised as follows.

Rule (1): A continuous contract will terminate (i) upon expiry of the period of contract or (ii) upon the occurrence or non-occurrence of a specified event provided in the contract subject to special statutory provisions such as the Unfair Contract Terms Act 1977 or the Consumer Rights Act 2015.⁷³⁾

Rule (2): A contract, other than certain categories of contracts ruled by specific statutes,⁷⁴⁾ may be discharged or brought to an end by (i) performance, (ii) agreement, (iii) operation of law such as frustration, and (iv) termination on grounds of the other party's repudiatory breach of a contractual term.⁷⁵⁾

In most of the other common law countries, the above English Rule (1) has been modified by the principle of good faith.⁷⁶⁾ However, English courts have not yet decided to limit the scope of this rule.⁷⁷⁾

72) L. Russi 'Substance or Mere Technique? A Precise of Good Faith Performance in England, France and Germany' *Hanse LR* Vol 5 No 1(2009) 21.

73) E McKendrick in H Beale and others, *Chitty on Contracts*, 32nd ed, Vol 1 (Sweet & Maxwell 2015), 22-048.

74) Law of Property Act 1925 s 146, Consumer Credit Act 1974 ss 76, 86, 87, 98, Housing Act 1996 s 81.

75) E McKendrick, *Contract Law*, 9th ed (Palgrave 2011), 320 and J Beatson, *Anson's Contract Law* (OUP 2010), 459-530.

76) For example, the Supreme Court of Canada held in *Bhasin v Hynew* 2014 SCC 71 that the supplier's refusal to renew the commercial dealership contract was unlawful on the ground of a breach of a good faith duty. See J Tarr 'Case Comment A growing good faith in contracts' *JBL* 2015-5-410.

B. Recent English Cases Concerning Good Faith in Contract

In respect of the above English Rule (2), recent High Court cases mentioned below seem to recognise an additional ground for termination of continuous contracts, which is a breach of duty to act in good faith.⁷⁸⁾

1. Implied duty to act in good faith under English law - *Yam Seng Pte v International Trade Corporation* (“Yam Seng case”)⁷⁹⁾

In this case, a contract for exclusive distribution of certain products in specific territories, including duty free zone in Singapore, was terminated by the distributor (the claimant) on various grounds of the supplier’s (the defendant’s) breach of contract. One of the alleged breaches was of an implied term that the parties would deal with each other in good faith. The claimant argued that the defendant was in breach of such duty as he provided false information about the Singapore domestic price on which he knew that the claimant was likely to rely on. The judge (Justice Leggatt) accepted this argument, stating “the traditional English hostility towards a doctrine of good faith in the performance of contracts, to the extent that it still persists, is misplaced”. He held

77) *Hadley Design Associates v Westminster City Council* [2003] EWHC 1617 (TCC); [2004] T. C.L.R. 1; [2004] Masons C.L.R. 3, *Ilkerler Outomotive Sanayai ve Ticaret Anonim v Perkins Engine* [2015] EWHC 2006 (Comm).

78) As a matter of formality, wordings of Rule (2) does not have to be amended because courts categorise the good faith duty as an implied term of contract and its breach is included in (iv) of Rule (2).

79) *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] EWHC 111 (QB); [2013] 1 All E.R. (Comm) 1321 (QBD). For comments see E McKendrick ‘Good Faith in the Performance of Contract in English Law’ in L DiMatteo and M Hogg, *Comparative Contract Law: British and American Perspectives* (Oxford Scholarship Online Jan 2016, 2015) <www. Oxfor scholarship.com>, J Chuah ‘Good faith in commercial contract’ SL Rev 2013, 69 (Sum) 36, S Whittaker ‘Good faith, implied terms and commercial contracts’ LQR 2013, 129 (Oct) 463, S Bogle ‘Disclosing good faith in English contract law’ Edin LR 2014, 18(1) 141 and A Brown ‘Core expectation of honesty and swimming against the tide: *Yam Seng Pte Ltd v International Trade Corp Ltd*’ Bus LB 2014, 128 (Feb) 1.

that a duty of good faith could be implied based on the presumed intention of the parties into “relational contracts,” such as joint venture agreements, franchise agreements and long term distributorship agreements, which required a high degree of communication, cooperation and predictable performance based on mutual trust and confidence. The judge concluded that the claimant entitled to terminate the contract on the ground of the defendant’s breach of the good faith duties.

Many contract law scholars in UK and other countries consider the above High Court judgment as an epoch making decision on English good faith duties. Yam Seng case was referred and applied in various subsequent cases.⁸⁰⁾

The precedents in Yam Seng case can be summarised that (i) a duty of good faith could be implied into relational contracts, (ii) such good faith duty includes a duty not to provide false information on which the other party would rely, and (iii) a breach of the above duty (i.e. a duty not to provide false information on which the other party would rely) amounts to a repudiatory breach which justifies termination.⁸¹⁾

80) *Bristol Groundschool v Intelligent Data Capture* ([2014] EWHC 2145, Ch) is the case where the court applied the ratio of Yam Seng case. The case concerned a contract on producing training manuals for airline pilots based on mutually exchanged artworks. The defendant (IDC) argued that the claimant (BGS) breached the good faith duty by copying information from IDC’s computer. Applying Justice Leggatt’s decision in Yam Seng case, the judge (Spearman QC) held that the general duty of good faith was implied into the contract of this case, which was a relational contract. However, he decided that the breach was not repudiatory in consideration of extenuating circumstances that BSG did so genuinely, it took precautions steps, it used the fruit only for limited purposes and financial damages were minimal.

81) Yam Seng case (note 79) at [173]. In this respect, a decision of Japanese court would be different if the same case was brought in Japan. As mentioned in III.A.5.2 above, a Japanese judge would not accept unilateral termination of a continuous contract unless the trust relation was destructed and unrestorable.

According to the ratio (i) above, types of contracts implying good faith duties under English law could be narrower than those under Japanese law. Japanese law does not have a similar concept of 'relational contracts', however, relational contracts must always be included in 'continuous contracts'. The rule established by the ratio (ii) above appears to be identical to Japanese law under which a duty to disclose information which would be prejudice interests of the other party.⁸²⁾ The ratio (iii) held by Justice Leggatt seems to indicate that the grounds to justify termination of a distributorship contract under English law is broader than those under Japanese law. As in Japanese Rule 1, paragraph 3, Japanese courts would not accept unilateral termination of a continuous contract on the basis of a breach of contract unless the trust relation was destructed and unrestorable. According to the doctrine of destruction of trust relation, the claimant must make some efforts to restore the trust relation before he decided to termination the contract.⁸³⁾

Because Yam Seng case does not clarify a breach of what kind of good faith duties under however circumstances could be repudiatory. In respect of termination of a continuous or relational contract in breach of good faith duties, Japanese law, having the doctrine of destruction of trust relation, appears to be more certain and predictable than the English rule held by Yam Seng case.

2. Extended Application of Good Faith Duties? - *MSC Mediterranean Shipping v Cottonex Anstalt* ("MSC case")

In the High Court judgment of MSC case, the court decided that a duty of good faith

82) See Tokyo DCJ 16 December 2011 (note 13).

83) See Fukuoka HCJ 19 June 2007 (note 43). However, in Yam Seng case the judge found that the defendant also breached an express term of the contract based on the facts that the defendant ignored the claimant's inquiry about its false information and denied the claimant's exclusive right in a certain territory (Yam Seng case (note 79) at [113] to [115]). Taking into account these facts, the trust relation could be destructed and unrestorable.

was imposed in enforcement of a carriage of goods contract.⁸⁴⁾ The claimant (MSC) carries containers of raw cotton to Bangladesh pursuant to bills of lading under which the defendant (CA), a cotton merchant, was named as shipper. Due to the corruption of cotton market the consignee in Bangladesh failed to collect the consignment in the containers, which remained in the port uncollected over three years after arrival. Under the bills of lading, CA was obliged to return the containers to MSC within 14 days, failing which MSC had the right to claim “demurrage” at a daily rate. MSC brought proceedings against CA claiming demurrage. CA argued that MSC was not entitled to claim demurrage because it could have taken steps to mitigate its loss long ago. The judge (Justice Leggatt) did not accept this argument because the demurrage provision was a liquidated damages clause which excluded the duty to mitigate.⁸⁵⁾ However, the judge accepted CA’s alternative argument that a party faced with repudiatory breach must act in good faith, having regard not only to his own interests but also to the interests of the other party. He concluded that MSC was not allowed to affirm the contract beyond the day on which CA repudiated the contract, because it was suffering no loss after that date. According to Justice Leggatt a party owes a duty to enforce (i.e. terminate) the contract for the sake of the other party.

The above judgment was remarkable because the court recognizes a duty in a spot contract which is not relational. Substance of such duty is also different from Yam Seng case in which the court held a contracting party’s obligation to act honestly in

84) *MSC Mediterranean Shipping v Cottonex Anstat* [2015] EWHC 283 (Comm). For comment, see S Sidkin ‘Will English Law Take a Leap of (Good) Faith?’ in *Juriste International*, 2015.3 (UIA) 61.

85) If a similar case was brought in Japan, courts would not find difficulty in reaching the same conclusion on grounds of MSC’s duty to mitigate its loss. This is because under Japanese law, the “doctrine of mitigation” is one of the rules established by courts under the principle of good faith (See SCJ 19 January 2009 (note 15)). Duties under the principle of good faith may override the parties’ agreement on liquidated damages (Tokyo HCJ 5 July 2000, *Hanji* 1752-28 and Tokyo HCJ 29 May 1997, *Hanta* 981-164).

performing the contract. Justice Leggatt held that an innocent party's decision to terminate or affirm a contract after a counterparty's repudiatory breach, akin to a contractual discretion, must be exercised in good faith, must not be exercised arbitrarily, capriciously or unreasonably. According to his statement, the English Rule (1) above may also be modified. English good faith duties can be enlarged to various aspects in contract law like those in civil law countries. On the other hand, the decision causes a number of uncertainties including (i) what categories of contract in which good faith duty is implied, (ii) what kind of situations where the good faith duty would arise, (iii) what kind of duty it is, etc. There was a danger that English contract law would lose certainty and predictability, the important requirement for commercial transactions.

In 27 July 2016, upon appeal of the above judgment by MSC, the Court of Appeal denied application of the good faith duty in this case.⁸⁶⁾ In the judgment, Lord Justice Moore-Bick stated that "the recognition of a general duty of good faith would be a significant step in the development of our law of contract with potentially far-reaching consequences and I do not think it is necessary or desirable to resort to it in order to decide the outcome of the present case." He continued that "the better course is for the law to develop along established lines rather than to encourage judges to look for what the judge in this case called some "general organizing principle" drawn from cases of disparate kinds."⁸⁷⁾ As a result the High Court's judgment in MSC case is no longer the precedent of English law.

3. Limited Applicability of Implied Good Faith Duties

Although Justice Leggatt's decision in MSC case is denied by the appeal court, his

86) *MSC Mediterranean Shipping v Cottonex Anstalt* [2016] EWCA Civ 789.

87) *Ibid*, [45]. However, in conclusion the court limited the amount of demurrage claim by application of the doctrine of frustration, a traditional English rule.

decision in *Yam Seng* case still remain as precedent. However, applicability of *Yam Seng* case appears to be limited by subsequent cases.

First, *Yam Seng* case only concerns termination of contract on the grounds of a breach of good faith duty. The case may affect the English Rule (2) mentioned in IV.A above, however, whether or not termination is restricted on the ground of good faith (the English Rule (1) above) is out of the scope of *Yam Seng* case. Indeed, in subsequent cases, courts denied applicability of good faith to the latter situation.⁸⁸⁾

Second, subsequent courts do not extend a general duty of good faith to any relational contract. There are cases where the court denied a good faith duty in a continuous contract for catering service, consulting agreement and franchising agreement.⁸⁹⁾

Third, a good faith duty would exist only in the case where the court finds that such duty is an implied term of the contract. Under English law, courts identify a term implied in fact by using one of two criteria that the term is so obvious that it goes without saying (the officious bystander test)⁹⁰⁾ or that the term is necessary to give

88) In *Ilkerler Otomotive Sanayai ve Ticaret Anonim v Perkins Engines Co Ltd* [2015] (note 77), it was held that termination of the distributorship agreement pursuant to the termination clause should not be restricted by the good faith duty.

89) In *Compass Group UK and Ireland Ltd (t/a Medirest) v Mid Essex Hospital Services NHS Trust* [2013] EWCA Civ 200, the court denied an overarching duty to cooperate in good faith in circumstances where good faith had been expressly provided for in the contract for cleaning catering service in a precise manner. In *Monde Petroleum SA v Western Zagros Ltd* [2016] EWHC 1472 (Comm), the court denied general duty of good faith in the consulting agreement under which exchange of information and cooperation is required. In *Apollo Window Blinds Ltd v McNeil* QBD 14 July 2016 (unreported), the court denied an implied duty of good faith on the franchisor to remind the franchisee of the renewal notice period. See also the Court of Appeal judgment of *MSC* case (note 86).

90) *Shirlaw v Southern Foundries (1926) Ltd.* [1939] 2 KB 206 (CA).

business efficacy to the contract (the business efficacy test).⁹¹⁾ An implied duty to act in good faith shall not be identified unless such a duty is so obvious or is necessary for performance of the contract.

In respect of the above third point, it is important to note that in *Yam Seng* case, Justice Leggatt does not seem to attach importance on the above criteria to identify an implied good faith duty in relational contracts. In the main part of his reasoning, Justice Leggatt refers to and relies on Lord Hoffman's view in *Attorney General for Belize v Belize Telecom Ltd* held by the Privy Council in 2009.⁹²⁾ In that case Lord Hoffman stated that the process to identify implied terms could be analysed as the construction of the contract as a whole.⁹³⁾ In *Yam Seng* case, Justice Leggatt seems to find the implied duty of good faith largely in accordance with Lord Hoffman's construction of contract approach, i.e. whether such duty is reasonably expected in the commercial common sense.⁹⁴⁾

However, in a more recent case, the Supreme Court denied Lord Hoffmann's approach and confirmed that implied terms could only be identified by using the traditional criteria, i.e. either by the officious bystander test or by the business efficacy test.⁹⁵⁾ It is not certain that Justice Leggatt could reach the same conclusion if he did not use Lord Hoffmann's construction approach in recognizing an implied good faith duty.⁹⁶⁾

91) *The Moorcock* (1889) 14 PD 64.

92) *Attorney General for Belize v Belize Telecom Ltd* [2009] 1 WLR 1988.

93) *Ibid* at 1993-5.

94) *Yam Seng* case (note 79) at 132-143.

95) *Marks & Spencer Plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 72 at 31 where it was held that Lord Hoffmann's analysis "could obscure the fact that construing the words used and implying additional words are different processes governed by different rules".

96) Justice Leggatt suggested that "the same conclusion is reached if the traditional tests for the implication of a term are used" (*Yam Seng* case at 137), however, he did not state detailed analysis of such approach.

According to the above mentioned cases subsequent to Yam Seng case, it is at least certain that the Supreme Court and the Court of Appeal intend to limit the applicability of good faith duty in general contracts (including relational contracts).

V. Conclusion

Under Japanese law, the principle of good faith is most fundamental rule overruling contract and any other civil relationship. In England, to the contrary, the good faith is not a general principle but may be applied to only limited situations under certain specific contracts.

In the above mentioned Yam Seng case, Justice Leggatt attempted to establish and expand the implied duty of good faith as a general obligation in ordinary contracts. He stated that “In refusing…to recognise any such general obligation of good faith, this jurisdiction would appear to be swimming against the tide… There can be little doubt that the penetration of this principle into English law and the pressures towards a more unified European law of contract in which the principle plays a significant role will continue to increase.” However, the Supreme Court and the Court of Appeal are likely to limit the applicability of the ratio in Yam Seng case. As a practicing lawyer, I stand by the recent courts’ attitude towards Yam Seng case, i.e. the general duty of good faith shall not be recognized under English law. This is because under English law, what “good faith” is meant is too unclear. According to Yam Seng case, the duty includes at least the requirement of honesty, but the meaning of honesty can be quite broad.⁹⁷⁾

97) In *Bristol Groundschool v Intelligent Data Capture* (note 80), the judge (Spearman QC) stated that good faith extends at least the requirement of honesty and that the relevant test is whether the conduct complained of “would be regarded as commercially acceptable by reasonable and honest people in the particular context involved”. The test does not seem to clarify the meaning of honesty since the test itself includes “honest people”.

In Japan, rules under the principle of good faith create stability and certainty of trade relations in the market. Specific rules have been established by plenty of cases. Even if an appropriate case law cannot be found, it is not difficult to predict a rule to be applied by courts in the relevant issue. This is because, firstly, most good faith rules have been existed at least as a social norm for long years, which are familiar to Japanese people. Secondly, good faith is a simple concept based on common sense, which means that you shall act in a manner not to harm the other people taking account of their reasonable expectation. From this view point, it can be said that reasonable commercial expectation is protected by application of the principle of good faith.

In England, however, since there are only a few cases concerning this duty, in what situation and how it is applied has yet been clearly defined. Moreover, the good faith is rather against traditional ethos of individualism embodied in English law, whereby the parties are free to pursue their own self-interest provided they do not act in breach of a term of the contract.⁹⁸⁾ In such circumstances, the recognition of a general duty of good faith could ruin the primary merit of English law as the governing law of contract. To deal with unjust and unfairness, English law have various specific rules which contents and requirements have already been established. Indeed, Yam Seng case could reach the same conclusions without deciding a breach of the good faith duty.⁹⁹⁾

[End]

98) McKendrick, *Contract Law*, 9th ed (Palgrave 2011), 221-2.

99) In Yam Seng case, the judge also found a repudiatory breach of an express term (see note 83).