

Certain Issues relating to International Conflict of Laws in Cross-Border Business Activities (summary)

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1. Introduction

Set forth below are three cases which I and my partners encountered while practicing law in Tokyo. Case 1 and Case 3 demonstrate some of the necessities for development and application of law arising from changes in society, and Case 2 presents international conflict of laws issues connected with refinance of the construction of a large vessel.

This report responds to the legal issues faced by those who are subjected to laws of multiple jurisdictions in respect of their cross-border business activities. I hope it will offer an opportunity to examine certain issues relating to international conflict of laws and international civil procedures, in light of a better understanding of the practical issues affecting cross-border business activities.

2. Three Cases

For each of the three cases a summary is given below with respect to (1) facts, (2) challenges arising under international conflict of laws or international civil procedures, and (3) the solution elected.

Case 1 Jurisdiction of Japanese Courts over a Foreign Corporation Doing Cross-Border Business, and Limitations to Applying Foreign Law by Fundamental Japanese Law of Contract

A Japanese company (the “Distributor”) is engaged in distribution of products designed and produced by a U.S. company (the “Producer”), under the Producer’s trademark, in accordance with an Exclusive Distributorship Agreement between the two companies (the “Distributorship Agreement”). The term of the Distributorship Agreement is ten years automatically renewable unless notice is given otherwise by either party, and the laws of the State of New York govern the agreement. The Distributorship Agreement includes a clause to the effect that the Producer shall not assume any liability to pay for any damages which the Distributor may suffer due to termination of the Distributorship Agreement upon ex-

piration of its term (the “Exoneration Clause”).

The Distributor was established solely for the business contemplated in the Distributorship Agreement, and now has 20 stores throughout Japan with 100 employees. A few months prior to expiration of the ten-year term, the Distributor, to its surprise, received from the Producer a notice rejecting renewal of the Distributorship Agreement. The Producer plans to establish a subsidiary in Japan and, immediately after termination of the Distributor’s business, to have the subsidiary sell the same products as were sold by the Distributor in the Japanese market.

The Distributor came to our law firm because it will suffer substantial damages if it ceases doing business. The following are issues we considered when determining whether the Distributor had a case for damages despite the Exoneration Clause.

The Exoneration Clause is literally valid under New York law. Accordingly, the Distributor will fail before a New York court unless, pursuant to the U.S. rules of private international law, the New York court applies the public order or good morals doctrine of Article 90 of the Japanese Civil Code to protect the Distributor.

In similar situations, Japanese courts have applied principles of Japanese contract law to grant compensation for damages to distributor.⁽¹⁾ If a lawsuit were to be filed with a Japanese court, the primary question under Japan’s private international law would be: would it be possible for the Distributor to recover damages before a Japanese court through application of the Japanese rules of public order or good morals to the Producer, a U.S. company?

Issues we considered in an attempt to help the Distributor recover damages before a Japanese court included:⁽²⁾

- (1) Will the Japanese court exercise jurisdiction over the Producer?
- (2) Will the Japanese court apply the Japanese public order or good morals doctrine despite the governing law clause? Will the Japanese court accept the argument to the effect that the Producer, which has gained benefits from the sale of its products in Japan, should not be exempted from Japan’s fundamental rules of contract law and that the freedom under the Japanese rules of international conflict of laws to choose the law of contract shall be so limited?
- (3) Would the result of applying New York law to deny protection to the Distributor be invalidated by application of the public order doctrine within the meaning of the Japanese rules on international conflict of laws?

We noted that the Producer is a company doing business globally and should, and must be willing to, comply with the rules and laws of Japan or any other country in which it carries out its business, either directly or indirectly through its subsidiaries or its business partners such as joint venture companies, licensees, or distributors. Given this, is it reasonable for the Japanese court to determine that (1) it does not have jurisdiction over the Producer due to lack of substantial contacts with Japan, or (2) the Producer should be permitted to escape the application of fundamental rules of Japanese law because New York law was chosen as the governing law of contract, or (3) the result of applying New York law to deny protection to the Distributor is not contradictory with the public order doctrine within the meaning of Japan's rules on international conflict of law?

Due to the difficulties of these issues, which were not expected to be resolved quickly enough to keep the business alive in Japan, the matter was resolved by sale of business to the Producer.

Case 2 *Dépeçage* and Agreement to Change Governing Law

A Japanese shipping company (the "Original Party") has a shipbuilding contract with a Japanese shipbuilder (the "Shipbuilder"), which contract is governed by Japanese law. A re-finance project was proposed to reduce the Original Party's finance costs, where a U.K. bank's subsidiary (the "Finance Subsidiary") would agree to replace the Original Party by novation of the shipbuilding contract by which the Finance Subsidiary would succeed to the latter's rights and obligations under the shipbuilding contract and, upon delivery of the ship, the Finance Subsidiary would lease the ship to the Original Party. A question arose on what law should govern the novation contract.

Contractual rights and obligations of the Original Party under shipbuilding contracts can cease to exist only in accordance with governing law, meaning the novation contract must be governed by Japanese law. However, since the Finance Subsidiary requested that other provisions, including representations and warranties for the benefit of the Finance Subsidiary, be governed by English law, *Dépeçage* was now required. In drafting the agreement, it became important to clearly divide the agreement into two parts: the novation to be governed by Japanese law, and the remaining part to be governed by English law. Special attention was paid to ensure that the agreement was so divided in two.

Being a subsidiary of a U.K. bank and having no expertise in the shipping business, the

Finance Subsidiary sought an option to elect further novation to the Original Party's subsidiary to secure extinction of and release from all its obligations under the shipbuilding contract if and when it becomes uncomfortable for it to stay in its contracted position. Parties to the novation contract and further novation contract concerning the shipbuilding contract are shown in Exhibit 1. The Finance Subsidiary further requested that future extinction of its contractual obligations and creation of new obligations on part of the Original Party's subsidiary by further novation be established against third parties in advance, at the time of the novation contract. Having looked into whether and how the request could be satisfied, we concluded that the extinction of such contractual obligations and the creation of such new obligations could not be established against third parties until the further novation does actually occur. With a view to overcoming this difficulty under Japanese law, the parties decided to change the governing law of the shipbuilding contract from Japanese law to English law. Thus the *Dépeçage* became unnecessary.

This raises several questions. What law should govern in determining the validity of an agreement to change the governing law of the shipbuilding contract from Japanese law to English law? As for legal opinions to be obtained to confirm the validity of such an agreement, which jurisdictions are relevant? Is the validity of such an agreement determined under the rules for international conflict of laws of the jurisdiction of the court that will decide this issue? Or can the parties to the agreement to change the governing law choose the governing law of such an agreement? The latter position was taken in drafting this particular agreement. The agreement to change the governing law from Japanese law to English law consisted of two parts, namely (i) the agreement to withdraw the choice of Japanese law as governing law and (ii) the agreement to choose English law as the new governing law.

The governing law provisions in the decided-upon agreement to change the governing law of the contract are set out below:

“Article 2 ...Clause 19 (d) of the Shipbuilding Contract shall be amended to read as follows:

“This Contract shall be construed and the relations between the Parties determined in accordance with the laws of England.”

“Article 5 This Agreement shall be governed by and construed in accordance with Japanese law but in accordance with Article 2 of the Shipbuilding Contract as amended by this Agreement shall be governed and construed in accordance with English law.”

As a result of the agreement, legal opinions of both Japanese law and English law were obtained for the refinance transactions.

Case 3 Recognition under Japanese Law of a Foreign Legal Entity Organized for Public Interests

International Finance Facility for Immunisation Company (“IFFIm”) is a limited liability company established under English law and registered as charitable organization in England. IFFIm plans to offer its bonds for sale in Japan. The proceeds will be applied to vaccines and immunisation for infants, in accordance with the schedules made by the Global Alliance for Vaccines and Immunisation (“GAVI”) for the purpose of achieving the goal of the UN Millennium Declaration No. 4: reducing the infant death rate by two thirds by 2015. The bonds will be issued according to the World Bank’s assessment of the availability of future funds which a number of countries have committed to provide to IFFIm in coming years. IFFIm will repay its bonds using those future funds.

Is IFFIm a foreign legal entity recognized and authorized by Japanese law? Under Japanese law a foreign legal entity is recognized and authorized only if it falls under the category of “a foreign corporation” or “a legal entity recognized and authorized by a treaty,” both provided for in Article 35, Paragraph 1 of the Civil Code. Japanese law provides for no government action or court order for the recognition and authorization of a foreign legal entity, and therefore the meaning of the above provisions must be clarified. Otherwise a foreign legal entity, particularly one organized for public interest purposes, would encounter the fundamental practical question of whether it is recognized as such and authorized to engage in its activities in Japan.

“A foreign corporation” in said Article 35, Paragraph 1 clearly includes a business corporation for profit. Does it also include a foreign corporation established for public interest purposes? By the 2006 amendment to the Civil Code, the term “a foreign corporation” now in Article 35, Paragraph 1 replaced the term “a business corporation” in former Article 36, Paragraph 1. Prior to the 2006 amendment, Article 36, Paragraph 1 had been generally interpreted to exclude foreign corporations organized for the public interest, because public interests in a foreign country are not necessarily recognized as public interests in Japan. However, this reasoning is less persuasive under the present Japanese law. Japanese corporation law now permits a Japanese corporation to do non-profit activities. In addi-

tion, as a result of the comprehensive changes in 2006 to the laws relating to legal entities, Japanese law no longer requires “public interests” to be recognized by the Japanese government for purposes of organizing a legal entity under Japanese law. Japan now allows its people to organize a legal entity for any purposes they choose, subject to the implicit condition that it is not against the public order or good morals of Japan.

This problem of interpretation may be resolved by a broad reading of “a legal entity recognized and authorized by a treaty” in Article 35, Paragraph 1 of the Civil Code. The Financial Service Agency of Japan (the “Japanese FSA”) accepted the filing of IFFIm’s Securities Registration Statement in its capacity as “a sovereign or other similar issuer” as provided in the Japanese securities regulations. From this treatment it is understood that the Japanese FSA recognized IFFIm as falling under “a legal entity recognized and authorized by a treaty” as provided in Article 35, Paragraph 1 of the Civil Code of Japan.

3. Supplementary Comments

In case 1, neither New York law, which would resolve the case in accordance with the literal language of the contract, nor Japanese law, which would hesitate to apply the Japanese public order or good morals doctrine to compensate the Distributor, seems to offer a fair and reasonable solution to Case 1.

Case 2 shows how deeply international conflict of laws affects actual cross-border transactions. Lawyers working on cross-border transactions, including cross-border investments and M&A, must be equipped with the ability to discuss international conflict of laws issues with lawyers in other jurisdictions. Legal education should prepare lawyers to do so.

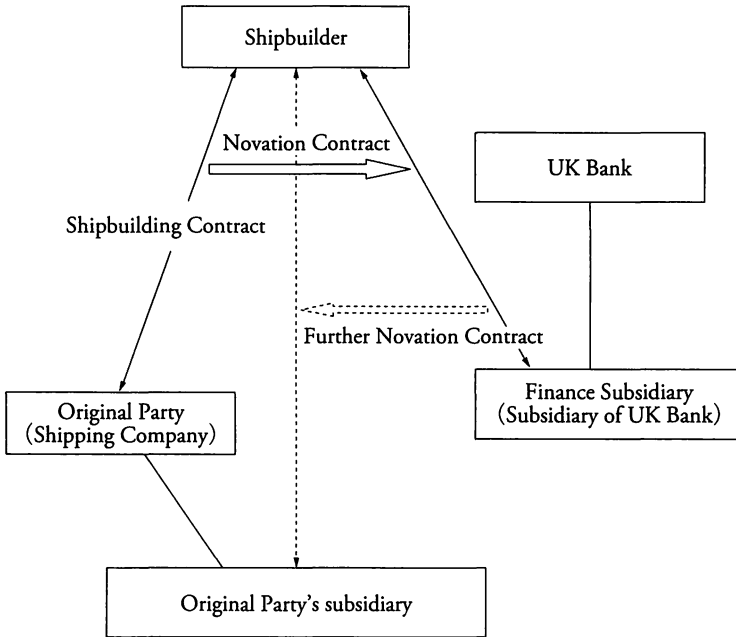
Case 3 indicates that the rules for recognition and authorization of foreign legal entities should be re-examined in light of the increasing internationalization of activities of legal entities. Given Japanese rules of international conflict of laws permitting the application of the laws of other jurisdictions, it would be reasonable to conclude that legal entities recognized by foreign law should in principle be recognized and authorized under Japanese law.

Cross-border business activities of corporations are increasing, and individuals are traveling, buying goods and services, working, making investments and receiving education in countries other than their home countries. This increasing internationalization is intensified by widespread technology which has improved cross-border communication and information dissemination. Under those circumstances, corporations doing cross-border

business will increasingly wish to elect laws, courts, or arbitrators at their choice so as to clarify those which they shall be subject to. At the same time, however, the notion that laws are designed to accomplish an objective in an individual jurisdiction will intensify the pressure on those engaged in cross-border business activities to comply with the compulsory laws of each jurisdiction in which they act.

How will the principles of international conflict of laws and international civil procedure respond to these changes?

Exhibit 1 Parties to Novation Contract and Further Novation Contract concerning Shipbuilding Contract



- (1) In most cases, the distributorship agreements at issue seem to have contained neither a specific period of contract, nor a clause providing for the producer's liability upon termination of contract. In those cases, Japanese courts granted compensation for damages to distributors through application of the "good faith principle" as provided in Article 1, Paragraph 2 of the Civil Code. But in cases where distributorship agreements have a provision similar to the Exoneration Clause, distributors would have to argue that under the circumstances in the specific case the provision is invalid as it is in violation of the "public order or good morals doctrine" as

set out in Article 90 of the Civil Code.

- (2) For the purpose of examining these issues, it is assumed that if the Japanese public order or good morals doctrine were applied to the Exoneration Clause, it would be possible to persuade the Japanese court to decide that based upon the facts of Case 1, the Exoneration Clause is in violation of the Japanese public order or good morals doctrine and is accordingly invalid.