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ARTICLE

Interpretation of Corporate Acquisition Contracts in Japan: A Legal Transplant through Contract Drafting

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Abstract

This article explores Japanese transactional lawyers' attempts to transplant American legal practice concerning corporate acquisition contracts into Japan. Despite their extensive efforts to disseminate legal concepts originating from the common law into the Japanese legal community, their transplantation attempts produced somewhat unexpected results by the promoters of the transplant. Faced with unfamiliar drafting styles and legal concepts, Japanese courts interpreted American-style corporate acquisition contracts in accordance with traditional Japanese-style contract interpretation. As a result, attempts by Japanese practitioners at transplantation were incomplete. This incompleteness is attributable to their inattention to the differences in approaches to contract interpretation between Japanese and New York courts. New York's approach is much more formalistic and literal than Japan's. If fully aware, however, they could have filled the gap by using functional substitutes for American techniques of controlling adjudicators' contract interpretation which would effectively operate under Japanese law. Japan's experience confirms that a widely supported view in comparative law scholarship that transplanted law does not necessarily operate in the recipient jurisdiction as it did in its host jurisdiction is applicable to the transplantation of contract drafting practices.

Keywords: Contract Interpretation; Contract Drafting; Comparative Contract Law; Japanese Law; Mergers and Acquisitions

Legal transplant through contract drafting

At the peak of the Japanese economy in the 1980s, Akio Morita, the then-chairman of Sony Corporation, analyzed the difference in approaches to contracting between American and Japanese lawyers. According to him, an American lawyer's role is anticipating legal problems, and consequently 'recommend provision after provision until the contract is as thick as a book and difficult to understand', while the essence of the Japanese approach eliminates the need to anticipate all possible problems and is summarized in a provision to the effect that 'in the event of disagreement, both parties to the contract agree to sit down together in good faith and work out their differences'.[1] At least in the field of corporate acquisitions, however, there is no longer such a sharp difference between American and Japanese contract drafting practices. Since around the late 1990s, Japanese business lawyers have transplanted American contract drafting practices into Japan and applied them to cross-border and domestic mergers and acquisitions involving Japanese companies.[2]

[1]Ronald Gilson, 'Value Creation by Business Lawyers: Legal Skills and Asset Pricing' (1984) 94 Yale Law Journal 239, 307–308.

[2]This phenomenon is not necessarily unique to Japan. For instance, American-style documentation started being used in cross-border M&A transactions between US and German companies by the turn of the century at the latest. See also Claire A

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This drastic shift in contract drafting practices, however, raised a new issue for Japanese judges to resolve disputes over corporate acquisition transactions through the construction of American-style contracts.[3] Without clear instructions from contract drafters, the Japanese courts have interpreted American-style contracts in accordance with traditional Japanese-style contract interpretation to-date. Japan's experience is an interesting phenomenon because legal transplants by private actors like transactional lawyers are a nearly undetected area in comparative law scholarship.[4]

The purpose of this article is twofold. First, it aims to add an example of a less extensively explored pattern of legal transplants to existing studies of legal transplantation. Second, it provides practical guidance on the interpretation of American-style corporate acquisition contracts to practitioners within the broad scope of non-common law jurisdictions by analysing Japan's experience.

The remainder of this article is organized as follows. The next part provides a brief overview of the existing academic literature on legal transplants and explains how this article relates to them. The third part details Japanese practitioners' attempts to transplant American contract drafting practice into Japan. It reveals that while the essence of American drafting style and a number of significant common law concepts were successfully transplanted into Japan, contract interpretation by Japanese adjudicators remains grounded in a traditional Japanese style. The fourth part discusses the results of such a twist. Most of the Japanese courts' holdings are perceived to be somewhat unexpected by the promoters of the transplant. The final part summarizes the discussions in this article and suggests some lessons to be drawn from Japan's experience.

Existing literature

Since Alan Watson published his seminal book *Legal Transplants* in 1974,[5] legal transplantation is one of the most favoured topics in comparative law scholarship.[6] A legal transplant generally refers to a phenomenon where a set of legal rules are transported from one jurisdiction (host jurisdiction) to another (recipient jurisdiction).[7] An early debate over legal transplants focused, somewhat abstractly, on the general possibility of transplanting and its usefulness as a means of legal reform. Alan Watson, who shared many examples on the reception of Roman law and the spread of English common law, claimed that legal rules can be easily separated from the society of their host jurisdiction; transplanting is a practical and less costly means of legal reform.[8] Pierre Legrand,[9] to the

Hill & Christopher King, 'How Do German Contracts Do as Much with Fewer Words?' (2004) 79 Chicago-Kent Law Review 889, 891.

[3]In common law jurisdictions, 'interpretation' and 'construction' are sometimes used distinctively. The word 'interpretation' refers to the process of determining the meaning that the parties themselves attached to contract language, whereas 'construction' refers to the process of determining the meaning and legal effect of a contract. See E Allan Farnsworth & Zachary Wolfe, *Farnsworth on Contracts*, vol 2 (4th edn, Wolters Kluwer 2019) para 7.08. Although the conceptual differences between those processes are recognized in Japanese legal scholarship (Tadao Hozumi, 'Hōritsu kōi no "kaishaku" no kōzō to kinō (2) [The Structure and Function of the "Interpretation" of Juristic Acts: Part 2]' (1961) 78 Hōgaku Kyōkai Zasshi 27), Japanese law does not draw a lexical distinction between the two processes and uses the same word, *kaishaku*, for both of them. In this article, therefore, the terms 'interpretation' and 'construction' are used interchangeably.

[4]While legal transplants through governmental channels (legislative or judicial processes) have been extensively studied, those through private actors were nearly undetected. A rare exception is Li-Wen Lin's study on multi-national companies' attempts to incorporate labour and environmental norms into their codes of vendor conduct. See Li-Wen Lin, 'Legal Transplants through Private Contracting: Codes of Vendor Conduct in Global Supply Chains as an Example' (2009) 57 American Journal of Comparative Law 711.

[5]Alan Watson, *Legal Transplants: An Approach to Comparative Law* (University Press of Virginia 1974).

[6]A thorough review of the legal transplant literature is far beyond the scope of this article. As an accessible survey of the literature, see Michele Graziadei, 'Comparative Law, Transplants, and Receptions', in Mathias Reimann & Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law* (2nd edn, Oxford University Press 2019) 442.

[7]Watson (n 5) 21.

[8]ibid ch 16; Alan Watson, 'Comparative Law and Legal Change' (1978) 37 Cambridge Law Journal 313, 313–321.

[9]Pierre Legrand, 'The impossibility of "Legal Transplants"' (1997) 4 Maastricht Journal of European and Comparative Law 111.

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contrary, argued that transplanted legal rules require interpretation in the recipient jurisdiction based on its own social, historical, and cultural context. Therefore, they are by no means the same rules as those in the host jurisdiction. In this sense, Pierre Legrand claims that 'legal transplants are impossible'.[10]

More recent studies, recognising that some sets of legal rules are easily separated from society and others are not,[11] have shifted their focus to the factors that determine the success or failure in individual transplantation attempts. Concerning Asian jurisdictions, for example, Curtis J Milhaupt and his co-authors extensively discussed a number of legal transplantation attempts from the United States to Japan. Hideki Kanda and Curtis J Milhaupt[12] examined the US occupation authority's attempt to transplant a corporate director's duty of loyalty shortly after World War II and found that it took almost 40 years before it began to be used by the Japanese courts. Their reasoning for such a long ignorance of the transplanted duty of loyalty clause by the Japanese judiciary was that (i) Japanese judges, educated and practised in the civil law system, were less comfortable with open-ended standards like the duty of loyalty. They preferred applying more specifically-tailored rules that existed before the transplantation of the duty of loyalty to directors' self-interested transactions[13] (the lack of what they call a 'micro-fit'); and (ii) during Japan's high economic growth, corporate directors had less incentive to divert company interests to themselves because maintaining their position was more valuable than imperilling it by stealing from the company (the lack of what they call a 'macro-fit'). Ronald J Gilson and Curtis J Milhaupt[14] explored a more recent corporate governance reform that gave large Japanese companies an option to adopt an American-style board structure that included three mandatory committees, namely a nomination committee, a remuneration committee, and an audit committee. Each of these committees consisted of a majority of outside directors. Their observations revealed that the companies which moved toward the American-style board structure were concentrated among those which were free from the traditional *keiretsu* corporate group structure and had a substantial number of foreign shareholders. They further observed that Japan transplanted some visible components of the American-style board structure, but not the complementary institutions that enhanced the effectiveness of the committee system, such as the allocation of authority between the full board and its committees and judicial review of board actions.[15] This article certainly forms an extension of those studies as an examination of a transplant attempt from the United States to Japan, but is distinguishable from them in that (i) it highlights the role of private actors – Japanese practicing lawyers – as promotors of transplantation, and (ii) it focuses on complementarity within the legal framework – contract interpretation and drafting – rather than complementarity between the legal system and the broader economic and social conditions.

Another striking stream of recent research is a systematic empirical investigation that tests whether the transplanted law operates in the recipient jurisdictions as it did in the host jurisdictions.

[10]ibid 114.

[11]Gunther Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences' (1998) 61 Modern Law Review 11, 17ff; Roger Cotterrell, 'Is There a Logic of Legal Transplants?', in David Nelken & Johannes Feest (eds), *Adapting Legal Cultures* (Hart Publishing 2001) 71, 80–84.

[12]Hideki Kanda & Curtis J Milhaupt, 'Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law' (2003) 51 American Journal of Comparative Law 887.

[13]Even before the transplantation of the duty of loyalty clause, the Japanese Commercial Code had imposed certain restrictions on directors' self-interested transactions such as (i) entering into business that competes with the company (art 264), and (ii) personally entering into transactions with the company (art 265) and required shareholder's approval for the amount of directors' remuneration (art 269).

[14]Ronald J Gilson & Curtis J Milhaupt, 'Choice as Regulatory Reform: The Case of Japanese Corporate Governance' (2005) 53 American Journal of Comparative Law 343.

[15]ibid 369–371. For Milhaupt's own synthesis of the two studies, see Curtis J Milhaupt, 'Historical Pathways of Reform: Foreign Law Transplants and Japanese Corporate Governance', in Klaus J Hopt et al (eds), *Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan, and the US* (Oxford University Press 2005) 53.

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Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard[16] classified the legal transplants that took place in 39 countries from the late 18th century to the early 20th century into receptive transplants and unreceptive transplants, and found that the countries which went through receptive transplants have more effective legal institutions measured by the legality index.[17] Receptive transplants in this context meant that the recipient jurisdiction reformed its own law by voluntarily transplanting a set of legal rules from the host jurisdiction, or the recipient jurisdiction had established familiarity with the legal system of the host jurisdiction before the formal transplants. On the other hand, unreceptive transplants meant that the transplants were imposed by an outside force such as an occupation and whose legal system the recipient jurisdiction had no familiarity with. Mathias Siems and David Cabrelli,[18] on the basis of an extensive analysis of ten hypothetical company law cases by legal experts from ten different jurisdictions, testified that the resolutions of the cases are sometimes different among jurisdictions that have the same or similar legal sources. In connection with these empirical studies, this article provides an example that illustrates that the transplanted legal concepts, as opposed to the intentions of the promotors of the transplantation, operated in the recipient jurisdiction somewhat differently than in the host jurisdiction.

Transplantation attempts

This part discusses Japanese transactional lawyers' attempts to transplant dispute resolution practices in corporate acquisition transactions from the United States. The first section discusses what have been successfully transplanted: contract drafting style and some common law legal concepts. The second section highlights what was *not* transplanted: contract interpretation. The third section argues that contract interpretation could have substantially been transplanted by using drafting techniques that could operate as functional substitutes for the non-transplanted aspect.

What was transplanted: drafting style and legal concepts

With the rapid increase in the number[19] and the complexity[20] of corporate acquisition transactions that involved Japanese companies in the late 1990s,[21] Japanese transactional lawyers transplanted the American style of drafting corporate acquisition contracts into Japan.[22] As a consequence, the current drafting standards of corporate acquisition contracts in Japan generally follows the

[16]Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, 'The Transplant Effect' (2003) 51 American Journal of Comparative Law 163.

[17]The legality index consists of survey data measuring the effectiveness of the judiciary, rule of law, the absence of corruption, low risk of contract repudiation, and low risk of government expropriation observed during 1980 to 1995. See ibid 183.

[18]Mathias Siems & David Cabrelli (eds), *Comparative Company Law: A Case-Based Approach* (Hart Publishing 2013).

[19]The chronological change in annual numbers of corporate acquisition transactions from 1985 to date in the Japanese market is available at MARR Online website <https://www.marr.jp/genre/graphdemiru> accessed 9 Sep 2020.

[20]For the institutional changes that are related to the Japanese M&A market around the turn of the century, Curtis J Milhaupt & Mark D West, 'Institutional Change and M&A in Japan: Diversity Through Deals', in Curtis J Milhaupt (ed), *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals* (Columbia University Press 2003) 295.

[21]Although it is not easy to verify exactly when the American-style drafting practice was accepted into Japanese legal practice, its spread is generally considered to have taken place in accordance with the increased complexity of corporate acquisition transactions in the late 1990s. A piece of indirect evidence is that *M&A hō taizen*, a pioneering practitioners' treatise on mergers and acquisitions law in Japan, was published in 2001. See Nishimura & Partners (ed), *M&A hō taizen* [*Corpus Juris M&A*] (Shōji Hōmu Kenkyūkai 2001).

[22]Japanese practitioners usually state that their drafting style follows 'western' contract drafting style. See eg Nishimura & Partners (n 21) 511; Sōichirō Fujiwara (ed), *M&A no keiyaku jitsumu* [*The Practice of M&A Contracts*] (Chūō Keizai 2010) 4–5; Ryūtarō Nakayama, 'Hyōmei hoshō jōkō no deforuto rūru ni kansuru ichi kōsatsu [A Thought on Default Rules regarding Representations and Warranties]', in Shinsaku Iwahara et al (eds), *Kaisha Kinyū Hō: Gekan* [*Corporations, Finance and Law, vol 2*] (Shōji Hōmu 2013) 1–2. As discussed below, however, their drafting style is American, neither German nor French.

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American practice both in terms of drafting style and the legal concepts used therein.[23] A glance at the widely known practitioner's treatises on corporate acquisition contracts in Japan confirms this fact.[24] They all agree that a standard share purchase agreement consists of (i) an agreement to sell shares, (ii) payment and price adjustment, (iii) closing, (iv) representations and warranties (*hyōmei oyobi hoshō*), (v) covenants (*seiyaku*), (vi) conditions precedent (*zentei jōken*), (vii) indemnification (*hoshō*), (viii) termination and cancellation, and (ix) miscellaneous clauses.[25] These components essentially accord with those of the Model Stock Purchase Agreement prepared by the Mergers and Acquisitions Committee of the American Bar Association.[26]

Japanese practitioners now are fully aware that they are using key legal concepts that were implanted from common law, and that these concepts are not necessarily familiar to the Japanese legal community, including judges. For instance, in explaining the concepts of 'representation' (*hyōmei*) and 'warranty' (*hoshō*), the treatises explicitly state that they were imported from common law concepts[27] and that there is no equivalent in Japanese law.[28] Similarly, the treatises always describe the meaning of 'covenant', 'condition precedent', and 'indemnification' in common law jurisdictions. To date, however, contract drafters continue to use those less familiar legal concepts in corporate acquisition contracts because their intended economic functions and legal effects are somewhat different from those attached to similar legal concepts codified in the Japanese Civil Code.[29] Such agreements, even though they use legal concepts unfamiliar to Japanese judges, are perceived to be valid and enforceable in accordance with the parties' intention under the 'principle of private autonomy'.[30]

As opposed to Japanese practitioners' close attention to the differences in individual legal concepts between common law and Japanese law, they appear much less conscious of the general

[23]While the drafting style is vaguely referred to as 'western', the individual concepts used in corporate acquisition contracts are expressly explained as imported from common law. See eg, Fujiwara (n 22) 5; Nakayama (n 22) 1–2. Doubtless the heavy reliance by Japanese drafting practice on common law concepts and American drafting style is at least partially attributable to the fact that the vast majority of leading M&A practitioners have the experience of being educated in US law schools and/or seconded to US law firms (Legal education abroad has significant influence on the channel of legal transplants. See Holger Spamann, 'Contemporary Legal Transplants: Legal Families and Diffusion of (Corporate) Law' [2009] BYU Law Review 1813, 1849–1851). As Japanese judges are directly recruited from new graduates of the judicial training programme (*shihō shūshū*) organized by the Supreme Court of Japan, it takes time for transactional lawyers' experiences to be shared with judges through actual disputes in Japan.

[24]Fujiwara (n 22) pt 2; Yoshihito Shibata et al, *M&A jitsumu no kiso* [*The Foundations of M&A Practice*] (Shōji Hōmu 2015) para 2.2.2; Mori, Hamada & Matsumoto (ed), *M&A hō taikei* [*Comprehensive Analysis of M&A Law of Japan*] (Yūhikaku 2015) pt 1, ch 4; Kōji Toshima et al, *M&A keiyaku* [*M&A Contract*] (Shōji Hōmu 2018); Nishimura & Asahi (ed), *M&A hō taizen: ge* [*Corpus Juris M&A, vol 2*] (rev edn, Shōji Hōmu 2019) pt 2, ch 3.

[25]In miscellaneous clauses, some common-law-specific clauses are intentionally omitted. They include a 'no third-party rights' clause, a 'jury trial waiver' clause and an 'enforcement of contract' clause. As discussed below, however, a merger or integration clause is intentionally included in corporate acquisition agreements despite the absence of the parol evidence rule in Japanese law.

[26]Murray Perelman (ed), *Model Stock Purchase Agreement with Commentary* (2nd edn, American Bar Association 2010).

[27]In the common law, misrepresentation is a cause of action in tort law, and breach of an express warranty is a cause of action in contract law. For the historical development of those concepts in the United States, see Glenn D West & W Benton Lewis Jr, 'Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?' (2009) 64 Business Lawyer 999.

[28]Practitioners' treatises explain that the concepts of 'representation' and 'warranty' are used in drafting practice to achieve the same legal effect under Japanese law as contemplated under common law. See Fujiwara (n 22) 147–148; Shibata et al (n 24) 103; Mori, Hamada & Matsumoto (n 24) 228; Toshima et al (n 24) 73; Nishimura & Asahi (n 24) 173–174.

[29]For example, liability arising from breach of a representation or warranty is argued to be distinguished from liability arising from breach of a seller's warranty against defects, which is provided in Articles 562 to 564 (or former Article 570) of the Japanese Civil Code, in that (i) the scope of representations and warranties is not limited to the defects in the shares themselves but includes various matters relating to the sold company, (ii) a buyer's inspection duty, which is provided in Article 526 of the Japanese Commercial Code, is contemplated to be excluded, and (iii) the scope of indemnification is not limited to a buyer's reliance damages. See Mori, Hamada & Matsumoto (n 24) 228; Toshima et al (n 24) 73.

[30]Nakayama (n 22) 2; Fujiwara (n 22) 148.

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differences in contract interpretation approaches between Japanese law and common law jurisdictions (and the more nuanced differences among common law jurisdictions).[31] First, they usually describe their drafting style as 'western' despite the fact that it is actually an American style.[32] Such a vague description reflects the lack of accuracy to the variety of contract interpretation approaches amongst the major legal families as will be briefly discussed in the next section. Second, to the author's knowledge, none of the practitioners' treatises explains the American technique of controlling the adjudicator's contract interpretation through a choice of law clause as detailed below, and other drafting techniques.[33] Their comments on a choice of law clause, assuming that it is usually relevant to international transactions only, briefly deal with the validity of choice under Japanese law,[34] the applicability of the law of the target company to such issues as the procedures to assign shares, and some technical issues relating to conflict of laws.[35]

Such inattention to contract interpretation by the practitioners (at least on the face of drafted contracts)[36] has created a curious situation whereby American-style contracts are interpreted by adjudicators in accordance with Japanese-style contract interpretation.[37] Since the results of legal disputes over commercial transactions are determined by a combination of (i) how the terms and conditions of the transaction are drafted on the face of the contract, and (ii) how those terms are interpreted by adjudicators, the transplantation of contract drafting style and language turns out to be incomplete only in so far as the transplantation of dispute resolution practices concerning corporate acquisition transactions that prevail in the United States is incomplete.

Before we turn to the results of such incomplete transplantation attempts, the next section explores the features of contract interpretation under Japanese law and how they differ from those of the interpretation approach the Japanese contract drafters have implicitly assumed the adjudicators should follow.

What was not transplanted: contract interpretation approach

This section discusses whether the contracting parties can expect that American-style corporate acquisition contracts will be interpreted by Japanese courts in the same manner as the American courts without any contractual device. If there were no significant differences between default contract interpretation approaches in the United States and those in Japan, the contracting parties' expectation would be satisfied without any further efforts by contract drafters. In reality, however, there are significant differences in contract interpretation approach between these two jurisdictions.

[31]See the next section.

[32]See note 22 above.

[33]In American practice, for example, drafting techniques that confine the sources of contract interpretation to the text of the agreement include (i) 'whereas' or 'purpose' clauses that describe the parties' business plan and transaction, (ii) definition clauses that ascribe particular meanings to words and terms that may vary from their plain meaning, and (iii) appendices that provide any document the parties desire a court to consider in interpreting the contract's text. See Ronald Gilson et al, 'Text and Context: Contract Interpretation as Contract Design' (2014) 100 Cornell Law Review 23, 58–59.

[34]Hō no tekiyō ni kansuru tsūsoku hō [Act on General Rules for Application of Laws], Act no 78 of 21 June 2006, art 7.

[35]Fujiwara (n 22) 277–280; Toshima (n 24) 190. Compare Lou R King et al, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions,* vol 2 (Law Journal Press 2017) para 15A.01; Stephen I Glover et al (eds), *M&A Practice Guide* (LexisNexis 2017) para 15.11.

[36]Practitioners sometimes argue that contractual language in corporate acquisition agreements such as a warranty clause should be interpreted literally on their publications. See eg Akira Ehira, 'Hyōmei hoshō no igi to kashi tanpo sekinin tono kankei [The Meaning of Representations and Warranties and Their Relationship with the Warranty against Defects]', in Masao Yanaga et al (eds), *Gendai kigyō-hō kinyū-hō no kadai* [*The Issues in Modern Enterprise Law and Financial Regulations*] (Koubundou Publishers 2004) 87–88. To the author's knowledge, however, explicit instructions to adjudicators about how interpret a contract are yet to emerge in contract drafting practice.

[37]See 'Transplantation results' part below.

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Differences in contract interpretation approach in various jurisdictions

Comparative law scholarship has revealed that the way contracts are interpreted by adjudicators varies depending upon in what jurisdictions the disputes over the contracts are brought. Konrad Zweigert and Hein Kötz argue that the three major legal families adopt different approaches to contract interpretation.[38] French courts tend to consider that the primary role of interpretation is to discover the common intention of the parties. When no such common intention is found, they then ascertain the hypothetical intention of the parties.[39] Such an approach to contract interpretation that emphasizes the parties' true mental state is called 'subjectivism' or the 'subjective theory' of contract interpretation.[40] On the other hand, German jurists generally regard the construction of contracts as the process of ascertaining the meaning of the words chosen by the parties in accordance with the understanding of a reasonable person in the position and circumstances of the addressee, and accept the divergence of the given meaning from the parties' hidden intention.[41] They are also more receptive to judges reading terms into contracts that were omitted by the contract parties under the concept of 'constructive interpretation'.[42] Such an interpretational approach that prioritizes the external expression of the intention over the internal mental state of the parties is called 'objectivism' or the 'objective theory' of contract interpretation.[43] Common law judges, although they share the emphasis on the external expression rather than the subjective intention of the parties with the German approach, 'try to stick to the wording of documents as long as possible and only exceptionally admit witness evidence to prove that the written agreement has been amplified or modified'.[44] Such an interpretation approach that places a heavy weight on written documents is called 'formalism' or 'textualism'.[45]

Among the common law jurisdictions, however, the Unites States exhibits a more nuanced variation in contract interpretation because contract law issues are governed by state contract law.[46] Geoffrey P Miller,[47] after an extensive examination of case law in New York and California, concluded as follows:

> New York judges are formalists. Especially in commercial cases, they have little tolerance for attempts to re-write contracts to make them fairer or more equitable, and they look to the written agreement as the definitive source of interpretation. California judges, on the other hand, more willingly reform or reject contracts in the service of morality or public policy; they place less emphasis on the written agreement of the parties and seek instead to identify the contours of their commercial relationship within a broader context framed by principles of reason, equity and substantial justice.[48]

[38]Konrad Zweigert & Hein Kötz, *Introduction to Comparative Law* (Tony Weir tr, 3rd edn, Oxford University Press 1998) ch 30.

[39]ibid 402.

[40]Steven J Burton, *Elements of Contract Interpretation* (Oxford University Press 2009) para 1.3.3; Jan M Smits, *Contract Law: A Comparative Introduction* (2nd edn, Edward Elgar 2017) 123.

[41]Zweigert & Kötz (n 38) 404.

[42]Bundesgerichtshof [BGH] [Federal Court of Justice] 18 December 1954, 16 BGHZ 71.

[43]Smits (n 40) 123–124.

[44]Zweigert & Kötz (n 38) 406. Steven Burton, therefore, distinguishes 'literalism' and 'objectivism'. In his usage, literalism refers to the contract interpretation approach which holds that the literal meaning of the contract's governing word or phrase determines the parties' rights, duties and powers, while objectivism refers to the approach which looks for the parties' intention as expressed in the contract document as a whole and its objective context. See Burton (n 40) paras 1.1 and 1.3.

[45]American debates over contract interpretation focus on the issue of whether adjudicators should take into account evidence other than the documents encompassing the parties' final agreement on the disputed transaction. Thus, the phrase 'contextualism' is generally used in contrast to the common law's traditional approach of formalism or textualism.

[46]*Erie Railroad v Tompkins* 304 US 64 (1938).

[47]Geoffrey P Miller, 'Bargains Bicoastal: New Light on Contract Theory' (2010) 31 Cardozo Law Review 1475.

[48]ibid 1478.

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Such a nuanced variety of contract interpretation in the United States gives us a clue about which contract interpretation approach the American parties to corporate acquisition transactions generally expect adjudicators to adopt. In this connection, after analysing 412 corporate acquisition agreements filed with the Securities and Exchange Commission in 2002, Theodore Eisenberg and Geoffrey P Miller[49] found that 132 contracts (32 per cent) are governed by Delaware law,[50] 70 (17 per cent) New York law, and 50 (12 per cent) California law.[51] Their empirical study also revealed a significant degree of deviation of choice of law from the target company's place of incorporation. Despite practitioners' general recognition that the target company's state of incorporation is generally chosen as the governing law of corporate acquisition contracts,[52] New York, in many cases, successfully managed to account for the parties' choice of law as opposed to the target company's state of incorporation (28 out of 157 Delaware incorporations and 31 out of 226 incorporations in states other than Delaware, New York and California).[53] New York's success in attracting corporate acquisition contracts as the state of governing law can be seen as prima facie evidence supporting American parties' preference for a formalistic and literalistic approach to contract interpretation.[54]

With this information in hand, the next subsection briefly describes the history of contract interpretation in Japan. It clarifies that the default contract interpretation approach in Japan is an objectivist approach, and neither the Japanese legislature nor judiciary has seriously examined the textualist interpretation approach that prevails in New York law.

A brief history of contract interpretation in Japan[55]

The history of contract interpretation in Japan dates back to the enactment of the Japanese Old Civil Code (*kyū minpō*)[56] in 1890.[57] The Old Civil Code, drafted by Gustave Émile Boissonade de Fontarabie, a French law professor, required the courts to search for the real intention of the parties in contract interpretation. Similar to Article 1156 of the *French Civil Code* (*Code civil*), Article 356 of the Property Section of the Japanese Old Civil Code provided, 'In interpreting an agreement, the court must seek what the common intention of the contracting parties was, rather than pay attention to the literal meaning of the terms used by the parties'. Article 356 and other provisions

[49]Theodore Eisenberg & Geoffrey Miller, 'Ex Ante Choice of Law and Forum: An Empirical Analysis of Corporate Merger Agreements' (2006) 59 Vanderbilt Law Review 1975.

[50]As Delaware is by far the most favoured state of incorporation among US public companies (168 out of 412 (41 per cent) of the target companies in Eisenberg and Miller's sample), Delaware's high ratio is, at least partially, attributable to the fact that the target company's state of incorporation is chosen as the governing law of merger contracts. As mentioned below, it is a fact that Delaware loses a substantial number of contracts that should catch our attention.

[51]Eisenberg & Miller (n 49) 1987, table 2.

[52]King et al (n 35) para 15A.01.

[53]Eisenberg & Miller (n 49) 1990, table 3B.

[54]Miller (n 47) 1478. Note, however, that empirical study on choice of law clauses in international commercial contracts which were referred to arbitration by the International Chamber of Commerce shows that Swiss law as well as English law are the preferred choice of parties to international commercial contracts. See Gilles Cuniberti, 'The International Markets for Contracts: The Most Attractive Contract Laws' (2014) 34 Northwestern Journal of International Law and Business 455. Similar to New York law, English law is known for its very formalistic approach to contract interpretation, whereas Swiss law is much less formalistic and offers a variety of doctrines that enable courts to rewrite contracts to make them more equitable and fair. See ibid 503–505.

[55]For an overview of the history of the 'theory' of contract interpretation in Japan, see Osamu Morita, 'Keiyaku no kaishaku: ippan junsoku wo chūshin ni (sono ichi) [The Interpretation of Contracts: Focus on the General Principles, Part 1]' (2016) 430 Hōgaku Kyōshitsu 50, 56–61.

[56]Minpō [Civil Code], Act No 28 of 21 April 1890.

[57]The Japanese Old Civil Code was drafted by French law professor Gustave Émile Boissonade de Fontarabie and enacted in 1890. Prior to its scheduled enforcement in 1893, however, its enforcement was suspended for four years primarily due to strong objections to its overly 'westernised' content, and it was finally replaced by the current Japanese Civil Code in 1898. The political conflict over the enforcement of the Japanese Old Civil Code is known as the 'Quarrel over the Civil Code' in Japanese legal history.

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regarding the principles of contract interpretation[58] in the Japanese Old Civil Code were drafted by Gustave Émile Boissonade based on Articles 1156 to 1164 of the *French Civil Code* and with reference to the *Italian Civil Code* (*Codice civile*) so that they become more logical and clearer than the provisions in the *French Civil Code*.[59] Accordingly, they were strongly influenced by the subjectivist approach to contract interpretation. Although all of those provisions were deleted[60] in the process of drafting the current *Japanese Civil Code* (*meiji minpō*),[61] the main goal of contract interpretation continued to be regarded as seeking the contracting parties' true intentions even after the enactment of the current Civil Code in 1896.[62]

The shift to objectivism from the theory of contract interpretation in Japan only began in the 1920s.[63] In the absence of express provisions regarding contract interpretation in the Civil Code and under the strong influence of German legal theory under the *German Civil Code* (*Bürgerliches Gesetzbuch*),[64] Sakae Wagatsuma, the most influential civil law professor in Japan at the time, formulated the operation of contract interpretation as follows: (i) the interpretation of contracts requires ascertaining the objective meaning of the parties' expressions when they are made. Parties' true internal intentions should never affect their terms; (ii) in interpreting contract terms, the interpreter should refer to (a) the parties' purpose of contracting, (b) customs, (c) statutory default rules, and (d) the principle of good faith; and (iii) the circumstances under which a contract is drafted should be taken into consideration as part of the parties' expressions.[65] More crucially, judges needed to consider a wide range of sources for contract interpretation, including customs, statutory default rules and all other relevant circumstances.[66] This gave judges a wide discretion to amend the parties' agreement under the name of 'contract interpretation'.[67] Although Sakae Wagatsuma's formula of contract interpretation has been heavily criticized by academic commentators since the mid-1950s,[68] it was affirmatively accepted by Japanese courts[69]

[58]Articles 357 to 360 of the Property Section of the Japanese Old Civil Code stipulated individual principles of contract interpretation, most of which have been included in the French Civil Code to date, such as interpreting individual terms so as to give effect to the entire contract and harmonising apparently conflicting terms so as to fit the subject matter of the contract.

[59]Toyohiro Nomura, 'Hōritsu kōi no kaishaku [The Interpretation of Juristic Acts]', in Eiichi Hoshino (ed), *Minpō kōza* [*Civil Law Lecture Series*], vol 1 (Yūhikaku 1984) 291, 298–99; Masami Okino, 'Keiyaku no kaishaku ni kansuru ichi kōsatsu (1) [A Thought on the Interpretation of Contracts: Part 1]' (1992) 109 Hōgaku Kyōkai Zasshi 245, 266.

[60]Although the reasons for deletion are not clearly stated in the literature concerning the legislative process of the current Japanese Civil Code, academic commentators point out that the legislative policy of the first draft of the German Civil Code omitting the individual principles of contract interpretation from the Code's provisions was likely to have had a strong influence on the drafting process of the current Japanese Civil Code. See Okino (n 59) 280–281.

[61]Minpō [Civil Code], Act No 89 of 27 April 1896.

[62]Masami Okino, 'Keiyaku no kaishaku ni kansuru ichi kōsatsu (2) [A Thought on the Interpretation of Contracts: Part 2]' (1992) 109 Hōgaku Kyōkai Zasshi 495, 497–498.

[63]ibid 500.

[64]Sakae Wagatsuma and other civil law scholars in Japan at the time heavily relied on the German literature. See Nomura (n 59) 303–304.

[65]Sakae Wagatsuma, *Shintei minpō sōsoku* [*New Revised Civil Law General Provisions*] (Iwanami Shoten 1965) para 286.

[66]Okino (n 62) 503.

[67]Keizō Yamamoto, 'Hojūteki keiyaku kaishaku (5) [Constructive Contract Interpretation: Part 5]' (1986) 120 [3] Hōgaku Ronsō 1, 16.

[68]Okino (n 62) 514–533.

[69]See eg Daishin'in [Great Court of Judicature] 2 June 1921, 27 Daishin'in Minji Hanketsuroku [Daihan Minroku] 1038 (the contractual language 'delivery at Shiogama railway station' should be read to mean the seller is required to deliver the goods at the Siogama railway station before the receipt of payment if Shiogama's local custom is taken into account); Yamaguchi Chihō Saibansho Hagi Shibu [Yamaguchi Distirct Court, Hagi Branch] 10 August 1966, 199 Hanrei Taimuzu [Hanta] 180 (the contractual language providing that (i) A donates to B the property that A built on B's land and simultaneously (ii) B leases the property to A should be read to mean B leases his land to A and attaches a security interest on A's building if the parties' purpose of contracting is taken into account); Tōkyō Chihō Saibansho [Tokyo District Court] 6 July 1964, 391 Hanrei Jihō [Hanji] 27 (the printed contractual language that automatically terminates a lease contract without any notice in the case of a tenant's delay in paying rent should be read as non-binding sample language). The contract

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and has been regarded as the prevailing view of contract interpretation among Japanese judges to date.[70]

Despite the Japanese courts' general acceptance of the objectivist approach to contract interpretation, the Japanese government attempted to create new provisions regarding contract interpretation its recent complete overhaul of the Civil Code.[71] Its interim proposal of amendments to the Civil Code, published in 2013, included the following provisions regarding the principles of contract interpretation:[72]

Interim Proposal #29: Interpretation of Contracts

1. If the parties share a common understanding of the terms of a contract, the contract terms shall be interpreted in accordance with their common understanding.
2. If the parties' common understanding of the terms of the contract is not clear, the contract terms shall be interpreted, in light of the ordinary meaning of the language and other expressions the parties used therein and all other circumstances relating thereto, in accordance with the meaning the parties would have reasonably understood.
3. If any matter remains unresolved by 1 or 2 above, the contract terms shall be interpreted in accordance with the terms the parties would have agreed to [under the same circumstances as the contract was made].[73]

As is suggested from its language, the proposal was strongly oriented towards the revival of subjectivism which existed in the Japanese Old Civil Code.[74] Item 1 was construed to signify that the proposal followed the will theory of contracts and that priority should be placed on the parties' subjective intentions in interpreting contract terms. Item 2 reduced the sources of meaning to the parties' reasonable understanding. It also rejected the traditional objectivist view that required the consideration of customs, statutory default rules, and the principle of good faith. Lastly, Item 3 expressly accepted judges' authority to supply missing contract terms. However, again, it reduced the source of supply to the parties' hypothetical intentions.

While the Civil Law Committee was deliberating, however, strong objections arose against the proposal.[75] Amongst these objections, the business community objected to Item 1 because it may

interpretation which the Tokyo District Court adopted in its 1964 decision is known as '*reibun kaishaku*', meaning sample language construction, and considered an example of the application of the principle of good faith. See Nomura (n 59) 324.

[70]Shintarō Katō, 'Keiyaku no kaishaku ni okeru sukiru [Skills in Contract Interpretation]', in Masanobu Katō et al (eds), *Nijū ichi seiki hanrei keiyaku-hō no saizensen* [*The Frontiers of Case Law in Contracts in the 21st Century*] (Hanrei Times 2006) 60–63.

[71]The Property Section of the Civil Code enacted in 1896 continued to be used with only minor amendments over one hundred years. The government decided to initiate a process of complete overhaul in 2006 and established the Civil Law Committee within the Legislative Council (*hōsei shingikai*) to amend the Civil Code in 2009. After five years of deliberation, the Legislative Council submitted its final proposal of amendments to the government in 2015. The final bill of amendments passed the Diet in 2017 as Act No 44 of 2017. The amendments came into effect as of 1 April 2020.

[72]The government explains the reason for the proposal as follows: 'In disputes over contracts, the first task is to clarify what was agreed through contract interpretation. The Civil Code does not have any provisions regarding contract interpretation; however, in light of the important role which contract interpretation plays in clarifying the legal relationship which is built upon contracts, it shall be clarified by the Code provisions what principles should apply to contract interpretation. 1 to 3 of [Interim Proposal #29] attempts to newly provide the basic principles of contract interpretation'. See Hōmushō Minjikyoku Sanjikanshitsu [Ministry of Justice, Civil Affairs Bureau, Councellors' Office], 'Minpō (saiken kankei) no kaisei ni kansuru chūkan shian no hosoku setsumei [Supplementary Explanation on the Interim Proposal to the Amendment of the Civil Code (Obligation Section)]' (Apr 2013) 360 <http://www.moj.go.jp/content/000112247.pdf> accessed 7 Jul 2021.

[73]The bracketed part is not clearly written in the original Japanese draft, but from its context, it is strongly inferred that it is intended to be included.

[74]Osamu Morita, 'Keiyaku no kaishaku: ippan junsoku wo chūshin ni (sono ni) [The Interpretation of Contracts: Focus on the General Principles, Part 2]' (2016) 431 Hōgaku Kyōshitsu 60, 62–64.

[75]ibid 64–66.

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give adjudicators an excuse to rewrite disputed contractual language in accordance with the adjudicators' own sense of fairness or equality under the guise of the parties' common understanding. On the other hand, the Japanese judiciary opposed Item 2 for fear that it may reduce their discretion to freely evaluate evidence and in turn, affect their findings. Finally, there was concern from practicing lawyers and the business community that Item 3 may allow judges actively to modify written terms in the contract through the findings of the parties' hypothetical intentions. In the end, the proposal failed to obtain consensus in the Civil Law Committee and was removed from the government's final bill.

As seen from the history of contract interpretation above, objectivism remains the default contract interpretation approach in Japan. Despite recent legislative attempts to revive subjectivist contract interpretation, Japanese judges still prefer an objectivist approach. This history also indicates that neither the Japanese legislature nor Japanese judiciary has seriously explored the textualist interpretation approach that prevails in New York.[76] As such, without any statutory mandate that would change their default contract interpretation approach, it was, and still is, difficult to expect Japanese judges to interpret American-style corporate acquisition contracts in the same manner as New York judges do. The next section, therefore, details the differences between Japanese and New York contract interpretation approaches at the doctrinal level and how the incomplete transplants as described in the previous section could be addressed through contract drafting.

What could have been transplanted: functional substitutes

Compared with New York's formalistic contract interpretation, the Japanese objective approach has two outstanding features: they have a broader evidential base and a wide discretion to intervene, with the parties' agreement. Those gaps, however, could have been bridged if appropriate contract drafting techniques were used.

Parol evidence rule

Common law courts administer a parol evidence rule, a principle that determines the scope of what is to be interpreted. If the parties' final and complete agreement is reduced to writing – in legal jargon it is called 'integrated' – then the evidence of prior negotiations – called 'extrinsic evidence' – is not admitted.[77] Although its actual operation varies from state to state and in different jurisdictions,[78] New York courts are known to take a 'hard' position[79] in its application.[80] In *WWW Associates v Giancontieri*,[81] the New York State Court of Appeals explains the parol evidence rule as follows.

> A familiar and eminently sensible proposition of law is that, when parties set down their agreement in a clear, complete document, their writing should as a rule be enforced according to its terms. Evidence outside the four corners of the document as to what was really intended but unstated or misstated is generally inadmissible to add to or vary the writing.[82]

[76]Exceptions are found in purely academic discussions. For example, Seiichi Ochiai, referring to American debates between textualism and contextualism, suggested the potential of adopting a textualist interpretation approach in commercial transactions under Japanese law. See Seiichi Ochiai, 'Shōnin kan torihiki no tokushoku to kaishaku [The Features and Interpretation of Commercial Transactions]', in Hideki Kanda (ed), *Shijō torihiki to sofuto rō* [*Soft Law and Commerce*] (Yūhikaku 2009) 113.

[77]See generally Farnsworth & Wolfe (n 3) para 7.03.

[78]Eric A Posner, 'The Parol Evidence Rule, the Plain Meaning Rule and the Principles of Contractual Interpretation' (1998) 146 University of Pennsylvania Law Review 533, 538–540.

[79]Eric Posner distinguishes 'hard' and 'soft' positions in American courts' application of the parol evidence rule. Under the 'hard' position, the court generally excludes extrinsic evidence and relies entirely on the writing, while under the 'soft' position, the court looks into both the writing and the extrinsic evidence. See ibid 534.

[80]Miller (n 47) 1506–1507.

[81]566 NE 2d 639 (NY 1990).

[82]ibid 642.

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In deciding whether the contract is integrated, the courts will determine whether the written document prima facie contains the engagements of the parties;[83] a merger or integration clause[84] is treated as almost conclusive evidence for an integration.[85] This is a result of American contracting parties, making use of New York's jurisdiction, being able to control the scope of evidence regarding their contract disputes by combining a choice of law clause and a standard merger clause. This is only possible because New York permits the contracting parties to a transaction involving USD250,000 or more, regardless of its 'reasonable relationship' with New York State, to designate New York law as the governing law of the transaction.[86] If they choose New York law as the governing law and include a standard integration clause in their written final agreement, they can ensure the application of the most formalistic version of the parol evidence rule.

On the contrary, Japanese law does not have any specific rule on the scope of evidence in disputes over contract interpretation. Following general principles of evidence in civil disputes, Japanese courts may take into account all the evidence that are submitted to the court so long as its procedural rules are complied with.[87] The general admissibility of evidence, however, does not deny contracting parties control over the scope of interpretation by adjudicators because the parties may consent to the restriction of the scope of admissible evidence in prior anticipation of disputes (*shōko seigen keiyaku*); Japanese courts would then adhere to parties' consent and dismiss any evidence that is submitted in breach of such an agreement.[88] Theoretically, therefore, if it can be shown that the contracting parties have clearly agreed on their final written contract being the sole evidence in their potential disputes, the outcome would be effectively similar to that of the most formalistic version of the parol evidence rule could be obtained under Japanese law.[89] Thus, such an agreement can be employed as a functional substitute for the combination of standard integration clause and a choice of law clause in American drafting practice. Japanese contract drafters would then have functionally transplanted even the hard version of the parol evidence rule into Japan.

Intervention by adjudicators

Another distinctive feature of the New York courts' approach to contract interpretation is their restrictive attitude towards intervention with the agreement of commercial private parties. In *Greenfield v Philles Records*,[90] the New York State Court of Appeals held that 'if the agreement on its face is reasonably susceptible of only one meaning, a court is not free to alter the contract to reflect its personal notions of fairness and equity'.[91] Similarly, in *Breed v Insurance Co of*

[83]See eg *Morgan Stanley High Yield Securities Inc v Seven Circle Gaming Corp* 269 F Supp 2d 206 (SDNY 2003); *Municipal Capital Appreciation Partners I LP v Page* 181 F Supp 2d 379 (SDNY 2002).

[84]A merger or integration clause is used to show that a written agreement is completely integrated and typically reads: 'This writing contains the entire agreement of the parties and there are no promises, understandings, or agreements of any kind pertaining to this contract other than stated herein'. See Farnsworth & Wolfe (n 3) para 7.07.

[85]See eg *Jarecki v Shung Moo Louie* 745 NE 2d 1006 (NY 2001); *Primex International Corp v Wal-Mart Stores* 89 NY 2d 594, 1997 NY LEXIS 320.

[86]NY Gen Oblig Law, sec 5-1401.

[87]Minji soshōhō [Code of Civil Procedure], Act No 109 of 26 June 1998, art 247. See also Makoto Itō, *Minji soshō hō* [*Civil Procedure*] (6th edn, Yūhikaku 2018) 366; Kōji Shindō, *Shin Minji Soshō hō* [*New Civil Procedure*] (6th edn, Koubundou Publishers 2019) 596. Even evidence collected by a party in violation of law can be admitted in civil courts under Japanese law. See Daishin'in [Great Court of Judicature] 2 July 1943, 22 Daishin'in Minji Hanreishū [Daihan Minshū] 574 (a stolen diary is admitted as evidence).

[88]Tōkyō Chihō Saibansho [Tokyo District Court] 28 March 1967, 208 Hanrei Taimuzu [Hanta] 127 (oral testimony is not admitted as evidence of consent if a land lease contract requires a written consent for the tenant's renovation of his building on the leased land).

[89]As discussed in the next part, careful drafting of contractual language, not a mere copy of a standard integration clause, would be required to successfully convey the parties' intention of limiting the scope of evidence to the court.

[90]98 NY 2d 562 (NY 2002).

[91]ibid 570–571. See also *Teichman by Teichman v Community Hospital* 87 NY 2d 514 (NY 1996).

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North America,[92] it held that the 'court may not make or vary the contract […] to accomplish its notions of abstract justice or moral obligation'.[93] Similar to their control over the scope of evidence, American contract parties can incorporate those restrictive attitudes towards contract interpretation by designating New York law as the governing law of their contract.

In contrast, as discussed in the previous section, the default rule of Japanese contract interpretation gives adjudicators a wide discretion to interpret the contract terms in light of a broader evidential base. This allows them to utilize 'constructive interpretation' to modify the written terms of the contract. As Japan only has a single law of contracts, a choice of law clause would not be such an effective contractual device to control intervention by adjudicators as it is in the United States. If the contract parties desire to exclude intervention by adjudicators under Japanese law, they would need a specific contract clause that prohibits adjudicators from supplying any contract terms or modifying any express terms in relying on the sources outside the four corners of a written document.[94]

As discussed above, however, those less visible elements in American contract drafting practice were not successfully transplanted into Japan through their functional equivalents under Japanese law. Such an incomplete transplantation attempt, therefore, produced 'unintended' results for the drafters of Japanese corporate acquisition contracts. With this in mind, the next part outlines Japanese courts' struggles with American-style contracts.

Transplantation results

Japanese practitioners' attempts to transplant American contract drafting practice produced results somewhat 'unexpected' by their promoters. They are (i) Japanese courts' intervention in written contract terms, and (ii) admission of evidence other than the final written contracts. This part explores those scenarios in turn.

Modification of written contract terms by Japanese courts

Faced with unfamiliar legal concepts, Japanese courts attempted to interpret them in line with the default rules under Japanese contract law. Such attempts have often been criticized by practitioners for unexpectedly modifying written contract terms.[95] This section discusses two important cases. One relates to a buyer's knowledge of a seller's breach of representations and warranties, and the other to the materiality of accuracy in disclosed information.

The first case is the Tokyo District Court decision on 17 January 2006,[96] where the Japanese court upheld a buyer's indemnity claim made on the grounds of a seller's breach of warranty in a corporate acquisition agreement in Japan. The target consumer finance company did not, in

[92] 46 NY 2d 351 (NY 1978).

[93] ibid 355.

[94] Another possible means to avoid unexpected judicial intervention would be to agree to have disputes over contract interpretation referred to arbitration before panels of experienced Japanese transactional lawyers. At least in domestic corporate acquisition transactions, however, arbitration is very rarely used in Japan. The annual number of cases referred to the Japan Commercial Arbitration Association never exceeded 20 during the five-year period from 2015 to 2019, and 82% of them were international disputes (see The Japan Commercial Arbitration Association, 'Arbitration – Performance' <https://www.jcaa.or.jp/arbitration/performance.html> accessed 9 Sep 2020). Japanese practitioners' reasoning for the rare use of arbitration is, among others, that (i) there is still a limited number of Japanese experts in mergers and acquisitions law and (ii) arbitration generally involves higher costs than litigation. See Fujiwara (n 22) 282; Toshima et al (n 24) 191. Curiously, even in the United States, arbitration is much less frequently chosen than litigation as a dispute resolution method by large corporate parties. See Theodore Eisenberg & Geoffrey P Miller, 'The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly Held Companies' (2007) 56 DePaul Law Review 335.

[95] See eg Shigeru Kaneda, 'Hyōmei hoshō wo meguru jitsumu jō no sho kadai (ge) [Various Issues in Practice on Representations and Warranties: Part 2]' (2006) 1772 Kinyū Hōmu Jijō 36, 39–40.

[96] 1920 Hanrei Jihō [Hanji] 136.

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breach of Japanese GAAP, recognize a certain bad debt allowance to avoid reporting losses in fiscal 2002. On 18 December 2003, the plaintiff, after two due diligence investigations on the target company, entered into a stock purchase agreement with the defendants to purchase all the company's shares held by the defendants, based on the target company's balance sheet as at the end of October 2003. The stock purchase agreement included the defendants' representations and warranties to the effect that (i) the target company's financial statements were all in compliance with Japanese GAAP, (ii) the balance of all its loan claims as at the end of October 2003 was accurately recorded, and (iii) all the materials and information provided to the plaintiff during its due diligence investigations were true and accurate. The defendants had agreed in the stock purchase agreement that they would indemnify all reasonable costs actually incurred by the plaintiff arising from, or in connection with, a breach of warranties by the defendants. The plaintiff claimed that the target company's failure to recognize the bad debt allowance was in breach of the defendants' warranties and required that they indemnify the amount thereof.

Despite the stock purchase agreement being silent on the buyer's awareness of the sellers' breach at the time of the contract's execution, the Tokyo District Court assumed that if the buyer were aware of the sellers' breach, he would not be able to claim against the sellers, and then held that 'if the plaintiff's ignorance of the defendants' breach of representations and warranties were attributable to his gross negligence, fairness would require that he be deemed to be aware of it and the defendants, as the case may be, should not be liable for their breach of representations and warranties'. Subsequently, the court undertook a detailed fact-finding exercise on the process of the buyer's due diligence investigations.[97]

Japanese contract drafters were surprised at the Tokyo District Court's unexpected intervention in a contract term when it imposed a subjective requirement to an indemnity claim. As discussed in the first section of the previous part, drafters expected that the contract terms would be interpreted by Japanese courts in the same manner as done by New York courts: a purchaser's knowledge is held to be irrelevant in relation to an indemnity claim under New York law.[98] As discussed in the second section of the previous part, however, the Japanese version of objective contract interpretation explicitly requires that adjudicators refer to statutory default rules. Like other civil law jurisdictions,[99] a buyer's damage claim against a seller's breach of contract is made pursuant to Article 415 of the Civil Code,[100] which sets out a debtor's liability for non-performance of contractual obligations and the non-performance must be attributable to the seller.[101] However, it is accepted that in assessing the attributability of non-performance, Japanese courts take into account not only a debtor's contribution but also a creditor's contribution to the non-performance.[102] The Tokyo District Court's requirement of a buyer's ignorance of a seller's breach in its decision on 17 January 2006 is nothing but the reflection of such a statutory default rule on the court's interpretation of disputed contract terms.[103] To avoid the court's 'objective' interpretation, the contract must have provided a clause instructing the court not to interpret the indemnity provisions in the same manner as it has done for the liability under Article 415 of the Civil Code.

[97]As the Tokyo District Court concluded that the plaintiff was not grossly negligent in his ignorance of the defendants' breach, the court's holding is *obiter dictum*.

[98]*CBS Inc v Ziff-Davis Publishing Co* 553 NE 2d 997 (NY 1990).

[99]Smits (n 40) ch 12.

[100]Civil Code, art 415.

[101]As a consequence of the recent overhaul of the Civil Code (above n 71), Article 415 was amended to clarify that a debtor can defend against a creditor's damage claim by proving that non-performance is not attributable to the debtor.

[102]See eg Daishin'in [Great Court of Judicature] 9 February 1920, 11 Hōgaku 715 (in a sale of land, the seller obstructed the buyer's land survey by bringing together tenants who objected to the sale); Sapporo Kōtō Saibansho [Sapporo High Court] 5 February 1965, 25 Saikō Saibansho Minji Hanreishū [Minshū] 1501 (as a result of the buyer's instructions, the seller failed to supply the agreed amount of sulphur ore).

[103]Mika Takahashi, '*Hyōmei hoshō jōkō ihan ni kansuru zakkan* [Some Thoughts on a Breach of Representations and Warranties]' (2009) 76 Rikkyō Hōgaku 122, 154–160.

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The second case is the Tokyo District Court decision on 26 July 2007.[104] In that case, the plaintiff purchased from the defendant all the shares of the target company, which ran many *izakaya* restaurants.[105] As the target company had recorded large losses in recent years, it was agreed that the target company would restructure its finances and business before the share purchase, and the defendant delivered to the plaintiff a document recording all the shut-down costs in each restaurant. In the stock purchase agreement, the defendant represented and warranted to the plaintiff that, among other things; (i) the target company's financial statements were accurate in all material respects; (ii) except as disclosed to the plaintiff, the company's assets were all free and clear of any security interests; and (iii) all the information, documents, and materials disclosed to the plaintiff contained true and accurate information only and did not omit any material information. The defendant agreed to indemnify the plaintiff against all losses arising from, or in connection with, any inaccuracy in its representations and warranties. The defendant's indemnity obligation was not qualified by materiality. After the purchase, the plaintiff found some undisclosed shut-down costs, bank pledges on the company's receivables and uncollectible accounts in some restaurants and claimed against the defendant for indemnity on the grounds of breach of warranties.

The Tokyo District Court upheld only part of the plaintiff's claim, holding as follows:

> It is extremely difficult to disclose, completely and without any error, information relating to the assets and liabilities of the target company… and it is not necessary to obtain the target company's information in full detail in evaluating the company's value and its future potential. It is, therefore, unrealistic to require that every item one can think of be disclosed or be represented as accurate; accordingly, the subjects thereof shall obviously be limited. Concretely speaking, [this court understands that every representation and warranty clause in the disputed agreement] warrants that there is no *material* difference or error in the items that would affect [the purchaser's] decision to purchase the company or its calculation of the amount of the purchase price, and [the indemnity clause in the disputed agreement] indicates that [the seller] accepts the purchaser's damage claim if the warranties turn out to be breached… (emphasis added)

The court then determined whether the disputed inaccuracy of the seller's warranty concerned such a *material* fact.

This decision was also criticized by commentators for ignoring the contract drafter's intentional determination of the scope of representations and warranties.[106] Drafters expressly indicate whether only 'material' facts are represented to be accurate or any facts, including immaterial facts, are represented to be accurate by the adjective 'material' in contract clauses. They argue that the court's understanding that only material facts can be represented to be accurate would impede an indemnity's function as a post-closing price adjustment. The court's departure from the contract drafter's expectation, again, is likely to come from its attempt to interpret the share purchase agreement in line with Japanese default rules on contract law. Japanese law recognizes the concept of a seller's duty of disclosure during contract negotiations on the grounds of the principle of good faith,[107] and the scope of such disclosure is held by the Japanese Supreme Court to be 'information that would affect a party's decision whether to enter into the contract' with the other party.[108] As the

[104] 1268 Hanrei Taimuzu [Hanta] 192.

[105] An *izakaya* restaurant is the Japanese style drinking place which serves alcoholic drinks and snacks. It is comparable to a pub in the UK or a tapas bar in Spain.

[106] See eg Nakayama (n 22) 12–15.

[107] In the sale of a closely-held company, a court denied the seller's duty to voluntarily disclose information to the buyer, but expressly affirmed its duty to cooperate with the buyer's due diligence investigation. See Ōsaka Chihō Saibansho [Osaka District Court] 11 July 2008, 2017 Hanrei Jihō [Hanji] 154.

[108] Saikō Saibansho [Supreme Court] 22 April 2011, 65 Saikō Saibansho Minji Hanreishū [Minshū] 1405. Before the Japanese Supreme Court decision, many Japanese lower court decisions had upheld the buyer's claim made on the grounds of the seller's breach of the duty of disclosure in sales of real property and financial instruments since the mid-1970s.

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Japanese version of objectivist contract interpretation requires that adjudicators refer to the principle of good faith, it is no wonder that courts were inclined to limit the scope of information to be represented as being accurate, in implicitly relying on the cases which have formed the scope of information subject to a seller's duty of disclosure. To avoid a court's default interpretation like this, again, the contract drafter should have instructed the court to understand that any term unqualified by the adjective 'material' must be read to include any trivial matter.

Admission and exclusion of extrinsic evidence

Japanese courts are not so clear on their interpretation of a merger clause included in a Japanese law governed contract.[109] The contrast between the following two cases, however, indicates that potentially a merger clause, if it is appropriately drafted, would operate even under Japanese law in essentially the same manner as it does under New York law.

In the Tokyo District Court decision on 13 December 1995,[110] the parties to a stock purchase agreement disputed the existence of their side agreement requiring that the seller buy back the shares upon the target company's liquidation. Their stock purchase agreement provided the following merger clause:

> The parties agree that the terms of this agreement, including any document referred to in this agreement, are the final expression between the parties to this agreement with respect to the subject matter of this agreement, and they shall not be rebutted by any other prior or simultaneous agreements. The parties further intend that the agreement constitutes a complete and exclusive statement of the terms of this agreement and no extrinsic evidence shall be presented in the judicial, administrative or any other legal proceedings contemplated in this agreement.

Even under Japanese law, it is clear from the language of this clause that the parties intended to exclude any extrinsic evidence from the court in a dispute over contract terms. With respect to the interpretation of the merger clause, the Tokyo District Court held that the merger clause prohibits the court 'from altering or supplying meaning to each term by extrinsic evidence other than the written agreement, and it requires the court to ascertain the parties' intention in reliance solely on the language of each term'. The holding indicates that the court regarded the merger clause as an agreement to limit the admissible evidence (*shōko seigen keiyaku*), which is construed to be fully effective under Japanese law.[111]

The Tokyo District Court decision on 25 December 2006,[112] in contrast, did not attach such a legal effect to a merger clause. In the case, although not a dispute over a corporate acquisition agreement, the parties disputed whether the plaintiff had agreed to award the defendant most favoured treatment in patent license fees in their patent license agreement regarding LCD panels. Their final license agreement provided no express most favoured treatment clause, and it included the following simple merger clause:

> This Agreement constitutes the entire understanding and agreement of the Parties with respect to the subject matter hereof and supersedes all prior agreements, express or implied, and oral or written.

In advance of the execution of the final agreement, however, the plaintiff had sent the defendant a letter stating, 'In case that [the plaintiff] concludes a license agreement with [other LCD

[109] Akio Hoshi, 'Kanzen gōi jōkō no igi to kaishaku [The Meaning and Interpretation of an Entire Agreement Clause]', in Naoki Koizumi & Yoshiyuki Tamura (eds), *Nijū ichi seiki no chiteki zaisan-hō: Nakayama Nobuhiro sensei koki kinen ronbunshū* [*Intellectual Property Law in the 21st Century: Festschrift for Professor Nobuhiro Nakayama in Celebration for His 70th Birthday*] (Koubundou Publishers 2015) 988, 999–1000.

[110] 938 Hanrei Taimuzu [Hanta] 160.

[111] See note 88 and accompanying text.

[112] 1964 Hanrei Jihō [Hanji] 106.

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manufacturers] on more favourable conditions than those offered to [the defendant], the [plaintiff] would necessarily inform [the defendant] and rearrange the current License Agreement.' Despite the merger clause, the Tokyo District Court did not exclude the letter from evidence. Instead, it regarded the merger clause in their final agreement as a factor denying the formation between the parties of an agreement on most favoured treatment. This case illustrates the Japanese courts' usual approach to contract disputes; all evidence will be considered so long as they are relevant.[113]

The difference between the two cases in their interpretation of a merger clause suggests that potentially even the hard version of the parol evidence rule could be transplanted into Japan. This can be done through appropriate contract drafting that functionally substitutes the combination of a standard merger clause and a parol evidence rule under New York law. Case law has demonstrated that simple merger clauses would not suffice for the Japanese courts' default approach to the scope of evidence to change. Nonetheless, the Japanese courts would pay sufficient attention to the parties' clear indication of their preference for the scope of evidence.

Conclusion

This article has undertaken an extensive exploration of Japanese transactional lawyers' attempts to transplant American legal practice concerning corporate acquisition contracts into Japan. The discussion has shown that their attempts, however, produced somewhat unexpected results by the promoters of the transplant. Faced with unfamiliar drafting styles and legal concepts, Japanese courts interpreted American-style contracts in accordance with Japanese-style contract interpretation. As a result, Japanese practitioners' transplantation attempts were incomplete. This incompleteness is attributable to their inattention to the differences in approaches to contract interpretation between Japanese and New York courts. New York's approach is much more formalistic and literalistic than Japan's. If fully aware, however, they could have fulfilled the gap by using functional substitutes for American techniques of controlling adjudicators' contract interpretation which would effectively operate under Japanese law.

Japan's experience confirms that a widely supported view in comparative law scholarship that the transplanted law does not necessarily operate in the recipient jurisdiction as it did in its host jurisdiction is applicable to the transplantation of contract drafting practice. It also provides some important lessons for legal practice and legal scholarship in other jurisdictions as well. First, in transplanting legal concepts or legal practices from other jurisdictions, it is important to recognize their appropriateness for local practice. Simply copying and pasting the host jurisdiction's practice would not succeed in many cases. As discussed in this article, however, recognising the existence of a practice which has been taken for granted in a local jurisdiction, such as contract interpretation, is much harder than understanding the meanings of unfamiliar legal concepts in other jurisdictions. In this regard, legal scholarship would be useful to clarify these less obvious differences. Second, purely technical contract terms do matter. In practice, significantly less attention is given to technical contract terms such as a choice of law clauses, dispute resolution clauses, and merger clauses. As discussed in this article, however, such provisions can be a decisive factor in the choice of the contract interpretation approach. From time to time, they may greatly affect the results of contractual disputes. In this respect, it is contract drafters who have control over the choice of the contract interpretation approach[114] which could bring mutual benefits to the contracting parties through contract drafting.

[113] See note 87 and accompanying text.

[114] Such a legal regime is strongly advocated by Alan Schwartz and Robert Scott. See Alan Schwartz & Robert E Scott, 'Contract Theory and the Limits of Contract Law' (2003) 113 Yale Law Journal 541; Alan Schwartz & Robert E Scott, 'Contract Interpretation Redux' (2010) 119 Yale Law Journal 926.

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