

VORTRAG / LECTURE

Calculation of Damages and “Lost Profits” under Japanese Law: A Comparison with German and United States Law

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I. THE JAPANESE CIVIL CODE AND ITS ORIGIN

The *samurai* class in Japan emerged and captured political power in 1192 when the *Minamoto Yoritomo* clan established its government in Kamakura.¹ The *samurai* class continued to maintain political power over the nation until 1868, when the Emperor was restored to power.² During the Kamakura era, *Hôjô Yasutoki*³ issued written laws in 1232 called *Jôei shikimoku*,⁴ which are said to be the first legislation promulgated by the *samurai* class.

* This paper is the edited version of a lecture presented at the Düsseldorf offices of the law firm Heuking Kühn Lüer Wojtek on 12 October 2010 by invitation of the German-Japanese Association of Jurists (DJJV).

1 *Minamoto Yoritomo* established its first *samurai* government in Kamakura in 1192 as the generalissimo (*shôgun*) for the subjugation of barbarians. Despite changes of warlords, the *samurai* class continued to maintain its political power until 1868, when the *Tokugawa shôgun* returned political power to the Emperor (the “Meiji Restoration”). The Kamakura government began in 1185 and discontinued in 1333.

2 *Tokugawa Yoshinobu*, the 15th *shôgun* of *Tokugawa*, accepted the advice of *Yamanouchi Yôdô*, lord of Tosa, now part of present Shikoku, and decided to return political power to the Emperor.

3 Born in 1183, died in 1242, he was the third *shikken* (appointed agent to exercise the power and role of *shôgun*).

4 It is officially called *Go-seibai shikimoku* and is comprised of 51 articles covering the succession of land property, punishment of crimes, statute of limitations, and other matters. It is

The Meiji Restoration in 1868 drastically changed the nation, and eventually the *samurai* not only lost political power but disappeared as a class. The four classes – samurai, farmer, craftsman, and merchant – were declared to be “equal.”

Gustave Boissonade,⁵ a French professor of law, came to Japan in 1873 to advise the Japanese government on the modernization of Japan’s legal system. He virtually completed drafting a Civil Code⁶ by 1888. But the government leaders⁷ started to consider the German system⁸ to be superior, and the “German school”⁹ gradually became dominant among legal scholars. This German ascendancy occurred not only in the legal field but also in medicine and various other fields. The Prussian-French War of 1870–1871, ending in Prussian victory, influenced Japanese leaders toward German technology and ideas for the then developing nation of Japan.

Despite the completion of the Civil Code draft by *Boissonade*, the Japanese government’s Civil Code Drafting Committee was formed in 1894. After its completion, the current Civil Code took effect in 1898.

Accordingly, the fundamental basis of the Japanese Civil Code was the German Civil Code, and those basic ideas still continue to this day.

II. DAMAGES CLAIMS AND LOST PROFITS UNDER THE JAPANESE CIVIL CODE

1. Introduction – Issues

The Civil Code lays down two important principles for damages claims. One refers to the content of damages claims: The claim for damages is to place the aggrieved party in a position as if the contract were fully performed. We can call this the “gap-filling” principle.¹⁰ The other principle is that compensation should cover “ordinary damage,” that is, damage within the scope of adequate causation; this cuts off damage incurred outside the usual course of events. However, if damage beyond the range of ordinary damage is

being discussed to what extent these laws may have influenced the contents of the Japanese civil law of today.

5 *Boissonade* was born 7 June 1825, and died 27 June 1910. He lived in Japan for 21 years, from 1873 to 1895.

6 The Civil Code he drafted was modeled after the French Civil Code and was adopted by the Japanese government but was revoked before implementation. It is therefore called the “Old Civil Code.”

7 *Ito Hirobumi* and *Saion-ji Kinmochi* were primarily involved in legislation policy.

8 The Old Civil Code was heavily criticized by English law scholars in Japan, as well.

9 Once the implementation of the Old Civil Code was waived, the drafting committee members used the first German Civil Code Draft as their main reference.

10 Damage causes the decrease of the entire assets of the aggrieved party. The portion of such decrease has to be recovered through the operation of law. The damages claim is a monetary claim for the amount to fill in the decreased portion, and not more than that.

incurred and this damage was foreseeable by the breaching party, such damage can be claimed as special damage.¹¹

The distinction between ordinary and special damage is rather academic. In practice, foreseeability is crucial in determining the amount of damages. Among other types of damage, “lost profit” is an important issue in business contract disputes. If the contract was fully performed, certain profits could be expected. Upon breach by one party, the typical “lost profit” issue arises. The loss could be (1) profit anticipated from resale to a third party (“resale profit”), (2) value of the products as stipulated in the contract if duly delivered (“use merit”), or (3) lost opportunity by a business of the use of the products as stipulated in the contract resulting in the loss of anticipated business profit (“business profit”). The special damage discussed above does not apply to lost profit, which is considered ordinary damage.

In this paper I would like to analyze and discuss the calculation of lost profits because breach of a commercial contract usually triggers the problem of compensation for lost profit. Business entities tend to incur large losses of profit. The term “profit” is widely used, but there is no uniform legal definition.

2. *Accounting Definitions*

For accounting purposes, “gross profit” (or gross margin) means the profit obtained by deducting the cost of production from the sales amount, which is also called turnover. In the case of a trading company, the cost of production is the cost of purchase or acquisition. Secondly, there is a concept called “business operating profit.” This is the profit after deducting costs for sales and general administration (SGA) from gross margin. SGA includes most expenses, such as salaries, office rent, traveling cost, and so on.¹² If financial costs or gains are added to the business operating profit, the result is called “ordinary profit” (or loss). Other concepts of profit are “pre-tax profit” (or loss) and “after-tax profit” (or loss). This is the profit after adjusting for extraordinary gain or loss over the ordinary profit. For example, if factory land is sold and the company gained a certain profit, this is considered extraordinary gain and is not included in turnover (sales) or SGA in case of loss. Since this transaction does not occur in the ordinary course of business, it is classified under the heading of “extraordinary gain or loss” in the profit and loss statement. Pre-tax profit will become after-tax profit after deduction of taxes due.

11 Special damage is exceptionally recoverable when it can be proved that the damage could be foreseen, while ordinary damage does not require foreseeability. However, the distinction is not of much help as the concept of ordinary damage is controversial.

12 For instance, SGA also covers executive compensation, factory operation costs, transportation, communication costs, and energy.

The accounting system enables the company to calculate the tax payable to the government, and enables the business to assess whether or not it is viable. When operating profits are realized but ordinary loss results, for example, the company could be experiencing heavy financial burdens. Thus, usage of the term “profit” in accounting includes the following five categories:

- (a) gross profit (margin)
- (b) business operating profit
- (c) ordinary profit
- (d) pre-tax profit
- (e) after-tax profit

3. *Legal Definition of Profit*

In many legal writings there is no clear definition of which category profit belongs to when damages for lost profits are claimed. Lost profit in this context does not always fit the profit concept of accounting rules. The scope of “lost profit” needs to be considered and defined in application to the particular case and in accordance with the “gap-filling” principle mentioned above. For example, when one party to the contract is a manufacturing business, and the other party to the contract did not deliver components of manufacturing machines on the due date, the manufacturer may have to stop operations until the components are delivered and installed. The loss to the manufacturer is the difference between the hypothetical value of the company if the contract had been fully performed in a timely manner and the present state when operations are stopped or delayed due to the other party’s breach. The aggrieved party needs to be put in a position as if the component had been delivered on the due date. This is the “gap-filling” principle that applies to claims for damages. First, we need to determine the turnover for the period during which operations stopped. Usually, turnover for this period will be fictitiously determined by using the average turnover of the period of the past year. If that turnover is, say, US\$ one million, should the lost profit be US\$ one million? No, that would not be a proper determination under the gap-filling theory. The company incurs expenses for employees’ salaries every month, the company pays rent for the offices every month, and it cannot reduce either salaries or rent despite the non-operation of the factory for the delay period. The company may use outside contractors to transport manufactured products to customers on a day-to-day basis, and when factory operations stop because there are no products, the company may be able to avoid hiring outside transport contractors during this period. All these factors have to be taken into consideration in the calculation of damages.

The “lost profit” is the averaged turnover minus averaged cost of production minus variable costs such as outside contractors. The company’s salaries and rent cannot be deducted because they cannot be decreased in proportion to non-operation of manufacturing facilities of the company for the default period.

The aggrieved party is under a duty of mitigation as regards lost profit. Compensation will only be awarded for lost profits that were incurred exercising due care and reasonable management. In other words, lost profit based on “gap-filling” is conditional on proper exercise of the mitigation duty.

Profit as specified above falls under none of the accounting concepts of profit listed under 2. (a) to (e). We should be careful not to over-compensate or under-compensate by wrongly applying the concept of profit. Profit has to be defined as gross profit minus variable costs. Variable costs mean the costs that can promptly be saved by decisions of management without breaching contracts and without creating unreasonable difficulties. You cannot deduct SGA entirely or any part of fixed costs among SGA. You can only deduct variable costs among SGA. That is the definition of legal profit I generally apply in order to delineate the legal concept of lost profit in the context of claims for damages.

III. COMPARATIVE POINTS

Uniform Commercial Code (“UCC”) of the United States reads:

U.S. UCC §2-708 Seller’s Damages for Non-acceptance or Repudiation.

(1) (...) the measure of damages (...) is the difference between the contract price and the market price at the time and place for tender (...), but less expenses saved in consequence of the buyer’s breach (...).

(2) If the measure of damages provided in subsection (1) is inadequate to put the seller in as good a position as performance would have done then the measure of damages is the profit (including reasonable overhead) which the seller would have made from full performance by the buyer, (...).

The first paragraph stipulates one aspect of the “gap-filling” theory application and mitigation duty. The second paragraph provides a basis for lost profit claims and defines profit to be compensated as the profit including reasonable overhead. This does not mean gross profit or operating profit. Reasonable overhead includes reasonable SGA. What is “reasonable” is not defined but is entrusted to case law. White and Summers¹³ take the view that gross margin deducted by variable costs should be the profit including reasonable overhead.

In the famous English case of *Hadley vs. Baxendale*,¹⁴ it was held that in calculating lost profits consequential damage should be taken into consideration. In this case, the plaintiffs – who operated a mill – sued the defendants – who were common carriers – for breach of a contract of carriage because the delivery of a crank shaft was delayed for five days.

13 J.J. WHITE/R.S. SUMMERS, Uniform Commercial Code (6th ed., St. Paul 2010) 366-387, hornbook of American law, widely used in the United States as Uniform Commercial Code commentary.

14 9 Exch. 341, 156 Eng. Rep. 145 (1854)

This precedent is fully followed by United States courts. The case is famous for upholding “lost profit” as damage. The court used the foreseeability test to award compensation for lost profit to the aggrieved party. This case was cited and discussed while the Japanese Civil Code Drafting Committee was working more than 100 years ago.

In this respect, British law (and United States common law) does not differ from Japanese law. English courts at that time were influenced in turn by Continental European case law and adopted European legal theories of lost profit to include consequential damage.

The 2001 judgment of the German Federal Court of Justice (*Bundesgerichtshof*)¹⁵ seems in line with the view that lost profit is gross profit minus variable cost. German courts also have decided cases similar to my discussion here. In other words, the lost profit calculations are common among Japan, Germany, and United States.

IV. APPLICATION OF THEORY – VARIABLE COSTS AND FIXED COSTS

We can apply the lost profit theory to the case of a wrongful termination of a distributorship agreement. The aggrieved party, the distributor, is entitled to claim lost profit for the period wrongfully terminated.

SGA items for distributor

1)	sales promotion	(D)
2)	sales commission	(V)
3)	packing, transportation, storage	(V)
4)	advertisement and publicity	(D)
5)	allowance for bad debts	(V)
6)	directors' compensation	(F)
7)	salaries and employees' other compensation	(F)
8)	telecommunication and traveling cost	(D)
9)	treatment expenses	(D)
10)	wear and tear	(D)
11)	depreciation cost	(F)
12)	rent	(F)
13)	research and development	(F)

In the event that a supplier wrongfully stops the sale of products, and the distributor therefore becomes unable to sell, the distributor is likely to save the costs listed in 2), 3), and 5). These are marked (V) above for “variable cost.” (F) are the costs that are usually not affected immediately by the decrease of sales and are very difficult to be reduced by management within a year or so. The “fixed costs” are listed in 6), 7), 11), 12), and 13).

¹⁵ Federal Court of Justice, 1 March 2001, NJW-RR 2011, 985.

Those marked (D) above are costs that might or might not be decreased by the stoppage of sales of the products. If decreased, 1), 4), 8), 9), and 10) are not reduced in proportion to the amount of sales volume.

Hypothetical example

Turnover		1,000
Manufacturing cost		<u>500</u>
Gross profit		500
SGA		<u>350</u>
1) sales promotion		5
2) sales commission		4
3) packing, transportation, storage		8
4) advertisement and publicity		20
5) allowance for bad debts		3
6) directors' compensation		20
7) salaries and employees' other compensation		200
8) telecommunication and traveling cost		2
9) treatment expenses		2
10) wear and tear		1
11) depreciation cost		5
12) rent		50
13) research and development		30
Operating net profit (income)		150
– ordinary profit covering interest, dividends exchange gain and loss, and extraordinary gain and loss are omitted –		
Pre-tax net profit		100
<i>Comparison</i>		
Gross profit		500
Gross profit minus variable costs 2), 3), 5)		485
Gross profit minus SGA		150

Due to the mitigation duty of the aggrieved party, it is not necessarily justified to fully deduct SGA items (D) as stated in 1), 4), 8), 9), and 10) when assessing damages. Each item of SGA has to be analyzed in order to decide if deduction from gross profit is justified. In most cases, management has discretion to reduce items (D) such as 1), 4), 8), 9), and 10). But the law should not impose an unreasonable burden on the aggrieved

party. Generally speaking, the appropriate amount of lost profit should be 485 as indicated above. That is, if proper termination notice is not given for a period of one year, the lost profit should amount to 485; if it is not given for six months, it would amount to 242.50.

V. CONCLUSION

My analysis focused on the legal definition of “lost profit” and its desired effects; I did not address accounting rules. The definition of lost profit is rarely an issue with lawyers and judges. However, once a claim for damages is made, the amount to be compensated is of great concern to clients as well as to society and the nation at large. The possibility of obtaining adequate damages is an important incentive to plaintiffs to initiate lawsuits. As the summary of recent court cases in the appendix shows, Japanese courts are divided on the issue of “lost profit.”

APPENDIX – TABLE OF CASES (see p. 231 – 235)

Court Cases Defining Lost Profits in Japan

Classification:

- No. 1 Calculation based on gross profit
- No. 2 Calculation based on gross profit minus variable costs
- No. 3 Calculation based on net profit

Court Cases Defining Lost Profits in Japan

No. 1 : Calculation based on gross profit

<i>Court precedent</i>	<i>Status</i>	<i>Facts</i>	<i>Plaintiff's assertion</i>	<i>Defendant's assertion</i>	<i>The basis of the calculation of lost profits as determined by the court</i>	<i>Definition of the terms by the court</i>
Tokyo District Court June 9, 2009 Hei 20 (wa) No. 8895	Not appealed	The Defendant was a director of the Plaintiff corporation who resigned and began working for a competitor of the Plaintiff. The Defendant then began providing services to the Plaintiff's clients. The Plaintiff claimed that the Defendant breached the Defendant's non-compete obligations and claimed lost profits as damages.	Plaintiff asserted that the calculation of lost profits should be based on gross profits.	Defendant generally denied the Plaintiff's assertions.	The calculation of the Plaintiff's lost profits was based on the gross profits of the immediately preceding fiscal year.	There is no definition of gross profit in the judgment.
Tokyo High Court February 26, 1981 Sho 52 (ne) No. 1940	Not appealed	Defendant supplier refused to sell goods to the Plaintiff distributor because the Defendant felt there was a possibility that the Plaintiff would not pay for the goods. The Plaintiff sued for breach of contract and requested the court to calculate its lost profits based on the difference between sales and purchase price of the products.	Plaintiff asserted that the calculation of lost profits should be based on gross profits.	Defendant's assertions are not mentioned in the judgment.	The calculation of the Plaintiff's lost profits was based on the difference between sales and purchase price (i.e., gross profits).	The judgment stated that gross profits are the amount of profits after the deduction of material purchases from the sales amount.

No. 2 : Calculation based on gross profit minus variable costs

<i>Court precedent</i>	<i>Status</i>	<i>Facts</i>	<i>Plaintiff's assertion</i>	<i>Defendant's assertion</i>	<i>The basis of the calculation of lost profits as determined by the court</i>	<i>Definition of the terms by the court</i>
Osaka District Court May 21, 2009 Hei 20 (wa) No. 6081	Not appealed	Plaintiff sued Defendant alleging infringement of its trademark and claimed lost profits as damages.	Plaintiff asserted that the calculation of lost profits should be based on gross profits.	Defendant asserted that variable costs should be deducted from gross profits. However, the Defendant did not assert that fixed costs should be deducted from gross profits.	The calculation of the Plaintiff's lost profits was based on the amount after deducting variable costs such as sales commissions or transportation costs from gross profits.	The meaning of gross profits, variable costs, and fixed costs seems to be the same as the meaning ascribed to them under accounting rules.
Tokyo District Court December 12, 2006 Hei 15 (wa) No. 18743	Under appeal	Defendant was a director of the Plaintiff corporation who subsequently resigned and incorporated a company to compete with the Plaintiff. The Defendant subsequently hired Plaintiff's employees and began providing services to Plaintiff's clients. Plaintiff claimed that the Defendant was in breach of his duties as a director and claimed lost profits arising out of Defendant's actions.	Plaintiff asserted that the "fixed expense" continues to accrue whether Plaintiff's sales decreased because of the Defendant's conduct or not, therefore such "fixed expense" should not be cut off from gross profit.	Defendant asserted that fixed expenses should not be included in calculating gross profits.	The calculation of the Plaintiff's lost profit was based on the amount after deducting all expenses from gross profits, except for fixed expenses.	The judgment defines "fixed expenses" as expenses, such as depreciation or rent, incurred regardless of the Plaintiff's amount of sales. Payroll costs of the Plaintiff were not included in "fixed expenses." The judgment stated that whether payroll costs are variable depends on the amount of sales.

Nagoya District Court April 28, 2005 Hei 16 (wa) No. 1307	Under appeal	Plaintiff sued Defendant alleging infringement of its patent and claimed lost profits as damages.	Plaintiff claimed that the calculation of lost profits should be based on marginal profits.	Defendant claimed that fixed costs should be deducted from gross profits like variable costs.	The calculation of the Plaintiff's lost profits was based on marginal profits.	The definition of "marginal profit" in the judgment is the amount after deducting variable cost such as material cost or freight cost from gross profit.
Tokyo High Court March 7, 1989 Sho 63 (ne) No. 1431	Not appealed	Plaintiff prepared to enter into business with a customer. However, the Plaintiff's customer was told by Defendant that Plaintiff did not have good credit and, as a result, the customer refused to enter into a business relationship with Plaintiff. Plaintiff filed for a preliminary injunction to enjoin the Defendant from spreading rumours about the Plaintiff's credit and claimed lost profits as damages.	Plaintiff claimed that the calculation of lost profits should be based on marginal profits.	Defendant's assertions were not mentioned in the judgment.	The calculation of the Plaintiff's lost profits was based on marginal profits.	The judgment defines "marginal profits" as the amount after cutting off the variable cost such as material costs or freight cost from gross profit.

No. 3 : Calculation based on net profit

<i>Court precedent</i>	<i>Status</i>	<i>Facts</i>	<i>Plaintiff's assertion</i>	<i>Defendant's assertion</i>	<i>The basis of the calculation of lost profits as determined by the court</i>	<i>Definition of the terms by the court</i>
Tokyo District Court June 16, 2009 Hei 19 (wa) No. 16291	Not appealed	Plaintiff franchisee sued the Defendant franchisor for breach of contract. Plaintiff claimed that the Plaintiff was forced to close because the Defendant used outdated material and was in breach of the franchise contract.	Plaintiff asserted that fixed costs should not be deducted from gross profits to calculate lost profits.	Defendant asserted that fixed costs should be deducted from gross profits like variable costs.	The calculation of the Plaintiff's lost profits are to be based on net profits after deducting variable costs and fixed costs, such as payroll costs, rent, and depreciation expenses, from gross profits.	The meaning of gross profits, variable costs, and fixed costs seems to be the same as the meaning ascribed to them under accounting rules.
Tokyo District Court January 20, 2009 Hei 19 (wa) No. 1590	Not appealed	Plaintiff was a shareholder of Company A in which the Defendant was a director. The Defendant resigned and incorporated a company to compete with Company A. After incorporating the company, the Defendant hired Company A's employees and began providing services to the clients of Company A. Plaintiff sued Defendant, alleging that Defendant breached his non-compete obligations and claimed lost profits as damages.	Plaintiff claimed that the calculation of lost profits should be based on the gross profit.	Defendant's claim is unclear in this judgment.	The calculation of the Plaintiff's lost profits is to be based on net profits, after deducting fixed costs (in this case, payroll costs) from gross profits.	The meaning of gross profits, variable costs, and fixed costs seems to be the same as under accounting rules.

<p>Chiba District Court Matsudo branch July 16, 2009 Hei 20 (yo) No. 6</p>	<p>Under appeal</p>	<p>Plaintiff was a shareholder of Company A in which Defendant was a director. The Defendant resigned and incorporated a company to compete with Company A. After incorporating the company, the Defendant hired Company A's employees and began providing services to the clients of Company A. The Plaintiff filed for a preliminary injunction and claimed that the Defendant breached his non-compete obligations and claimed lost profits as damages.</p>	<p>Plaintiff claimed that the calculation of lost profits should be based on gross profits.</p>	<p>Defendant asserted that fixed costs should be deducted from gross profits, like variable costs.</p>	<p>The calculation of the Plaintiff's lost profits is to be based on the amount after cutting off the variable cost from the gross profit.</p>	<p>"Variable costs" is defined in the judgment as including fixed costs, such as payroll costs (e.g., the remuneration of directors).</p>
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ABSTRACT

In the context of damages claims, the critical point is whether adequate compensation for losses can be obtained. A key issue is the amount of damages awarded, which is closely related to the question of how damages are calculated. As far as commercial contracts are concerned, compensation for lost profits is of major importance. However, the legal scope of the term “profit” remains largely unclear. While in the field of accounting several categories of profit can be identified – i.e., gross profit, business operating profit, ordinary profit, pre-tax profit, and after-tax profit – none of these apply when assessing damages for lost profits. The paper analyzes the losses incurred by an enterprise in cases of breach of contract in accordance with basic principles of the law of damages. Profit is thus defined as gross profit minus variable costs. A comparative analysis of US law and German law shows that this formula is commonly applied in Japan, the US, and Germany. The issues involved are further illustrated by the discussion of a hypothetical example. The analysis is rounded off by a summary of recent Japanese court decisions on the issue of lost profits.

(The Editors)

ZUSAMMENFASSUNG

Der angemessene Ersatz von Schäden ist zentrales Anliegen des Schadensersatzrechts. Die Höhe des Schadensersatzes ist dabei eng mit der Frage der Schadensberechnung verbunden. Im Wirtschaftsbereich ist besonders der Ersatz entgangenen Gewinns von Bedeutung. Die rechtliche Definition des Begriffs „Gewinn“ ist jedoch weitgehend unklar. Die aus dem Bilanzwesen bekannten Klassifizierungen von Gewinnen sind für diese Zwecke nicht anwendbar. In Übereinstimmung mit grundlegenden Prinzipien des Schadensrechts werden die Schäden eines Unternehmens bei Vertragsverletzung einer Analyse unterzogen. Der Autor gelangt zu dem Ergebnis, dass Gewinn rechtlich als Bruttogewinn abzüglich variabler Kosten zu definieren sei. Ein Vergleich mit dem Uniform Commercial Code sowie englischer, U.S.-amerikanischer und deutscher Rechtsprechung zeigt, dass diese Formel in allen genannten Rechtsordnungen Anwendung findet. Die Ergebnisse werden ferner anhand eines Beispiels weiter verdeutlicht. Abgerundet wird die Analyse durch einen Überblick über neuere japanische Entscheidungen, die sich mit der Berechnung des entgangenen Gewinns auseinandersetzen.

(Die Red.)