

Comparison of “Lost Profit” for Damage Calculation under Japanese Law with German and United States Law

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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 Kamakura² and the class continued to maintain the political power over the nation until 1868, when the Emperor was restored to power³. During the Kamakura era, Houjou Yasutoki⁴ issued written laws called “Jouei-shikimoku”⁵ in 1232, which is to be said the first legislation promulgated by the samurai class.

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”⁶.

Prof. Gustave Boissonade⁷, a French professor of law, came to Japan in 1873 to advise the Japanese government on modernization of Japan’s legal system. He virtually completed drafting a Civil Code⁸ by 1888. But the government leaders⁹ started to consider the German system¹⁰ to be superior and the “German school”¹¹ gradually became dominant among legal scholars. This German ascendancy occurred not only in the legal field, but also in medicine and other various 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 Prof. Boissonade, the Japanese Government’s Civil Code Drafting Committee was formed in 1894 and completed the current Civil Code which took effect in 1898.

Accordingly the fundamental basis of the Japanese Civil Code was the German Civil Code and those basic ideas still maintain.

Damage Claim and Lost Profit under the Japanese Civil Code

1. Introduction — Issues

The Civil Code provides two important principles for damage claim. One is what the contents of damage claim would be, i.e., damage claim should place the aggrieved party into the position as if a contract was fully performed. We can call this “filling in gap” principle¹². Another principle is that the damage claim should be to the extent of “ordinary damage”. Ordinary damage should be within adequate

causation, which cuts off the chain of events beyond the events arising naturally. However, if there is damage beyond ordinary damage, and if foreseeable by the breaching party, such damage can be claimed as special damage¹³.

The ordinary or special damage dichotomy is a little academic. In practice foreseeability is the more important issue in determining the amount of damage. Among various types of damage claims, “lost profit” is an important issue in business contract disputes. If the contract was fully performed, certain profit would be expected. Upon breach by one party, the typical “lost profit” issue arises. The loss could be (1) resale profit anticipated from a third party (“resale profit”), (2) value of the contract products if duly delivered (“use merit”), or (3) lost opportunity by a business of the use of the contract products resulting in loss of anticipated business profit (“business profit”). No special damage rule applies to lost profit discussed above and in most cases lost profits are considered ordinary damages.

I would like to analyze and discuss the calculation of lost profits in this paper, because breach of a commercial contract usually triggers the issue of lost profit. Lost profits of business entities tend to be large. The term “profit” is widely used but a single legal definition is never attempted.

2. Accounting Definitions

For accounting purposes, “gross profit” (or gross margin) means the profit obtained by deducting cost of production from the sales amount. Sales amount is also called turnover. In the event that a business entity is a trading company, cost of production can be cost of purchase or acquisition. Secondly, there is a concept called “business operating profit”. This is the profit after deducting SGA¹⁴ from gross margin. SGA includes most expenses such as salaries, office rent, traveling cost and so on. 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 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.

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 the company could be

experiencing heavy financial burdens, for example.

3. Legal Definition of Profit

Five categories of profits according to accounting usage of the word “profit” are shown below:

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

When damages are claimed for lost profits, the category of profit is not necessarily properly defined in many legal writings. Lost profit in the context of a damage claim does not always fit the profit concept of accounting rules. The “lost profit” needs to be considered and defined for application to the particular case. The lost profit damage claim should be defined in the context of “filling in gap” principle discussed above. For example, when a party to the contract is in 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 manufacturer can calculate the difference of the status of the company’s worth if the contract had been fully performed timely and the condition of the manufacturer because the operations were stopped or delayed by the other party’s breach. The aggrieved party needs to be put into the position as if the component had been delivered on the due date. This is the “filling in gap” principle to satisfy the claim 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 for the filling in gap theory. The company has employees’ salary expense every month, and the company pays office rent every month and it can not decrease salary or office 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 for the period. These are some considerations for the calculation of damages.

The “lost profit” has to be the averaged turnover minus averaged cost of

production, minus only variable costs such as outside contractors. The company's salaries and rent can not be deducted because they can not be decreased for that default period in proportion to non-operation of manufacturing facilities of the company.

Duty of mitigation on the part of the aggrieved party is applicable to lost profit damages. Only lost profits which could be realized by exercising due care by reasonable management will be allowed. In other words, lost profit based on "filling in gap" is conditional on proper exercise of the mitigation duty.

The profit as discussed above falls under none of the profit accounting rules such as (a) to (e) above. We should not over-compensate or under-compensate by wrongly applying the concept of profit.

Profit has to be the gross profit minus variable costs. Variable costs mean the costs which can be promptly saved by decisions of management without breaching contracts and without creating unreasonable difficulties. You can not 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 lost profit of a damage claim.

Comparative Points

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

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

The measure of damages: the difference between the market price at the time and place for vender and the unpaid contract price.....less expenses saved in consequence of the buyer's breach.....

If 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 the "filling in gap" theory and mitigation duty. The second paragraph provides a basis for lost profit claim 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 it is entrusted to case law. White and Summers¹⁵ takes the view to the effect that gross margin deducted by variable costs should be the profit including reasonable overhead.

The famous English case of *Hadley vs. Baxendale*, Court of Exchequer, 1854, held that lost profit should consider consequential damages. Plaintiffs, who operated a mill, sued defendants, who were common carriers, for breach of a contract of carriage. The delivery of a crank shaft was delayed five (5) days.

This precedent is fully followed by United States Courts. The case is famous for upholding “lost profit” as damage, and the court used foreseeability to award the lost profit claim to the aggrieved party. This case was cited and discussed at the time the Japanese Civil Code Drafting Committee was working.

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

The March 1, 2001 Federal Ordinary Civil Court Judgment of Germany -Bundesgerichtshof- seems in line with the view, i.e., 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 universal and common among Japan, Germany and United States.

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 distributor is entitled to claim lost profit for the period wrongfully terminated.

< SGA items for distributor >

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|---|-----|
| 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 sales of products, and the distributor therefore becomes unable to sell, the distributor is likely to save the costs of 2), 3), 5). These are marked (V) above for “variable cost”. (F) are the costs which are usually not affected immediately by the decrease of sales and are very difficult to be decreased by management within a year or so. The “fixed cost” are 6), 7), 11), 12) and 13). Those above marked (D) are costs which might be or might not be decreased by the stoppage of sales of the products. If decreased, 1), 4), 8), 9) and 10) are not proportionately decreased in accordance with the sales volume amount.

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
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Comparison

Gross profit	500
Gross profit minus variable costs 2), 3) 5)	485
Gross profit minus SGA	150

Mitigation duty on the side of the aggrieved party does not necessarily justify the full deduction of SGA items of (D) 1), 4), 8), 9) 10) to determine damages. Each item of SGA has to be analyzed, so that we can reasonably decide if deduction from gross profit is justified. In most cases, management has discretion to reduce (D) items such as 1), 4), 8), 9), 10). But the law should not impose unreasonable burden on the aggrieved party. 485 above should be, generally speaking, the appropriate amount of lost profit. If the lack of proper termination notice is for a year period, the lost profit should be 485. If six months, 242.5

Conclusion

I am not explaining accounting rules or accounting analysis, but addressing what the results of the legal outcome should be in defining “lost profit”. For lawyers and judges, this area is not frequently discussed. Once determination is made to award a damage claim, the amount to be compensated is a great concern to clients and collectively to society and the nation. The possibility of obtaining adequate damages motivates plaintiffs to initiate lawsuits. Attached are a summary of recent court cases in Japan which indicate that the courts are divided on the issue of “lost profit”.

(This paper is the edited version of my speech in Dusseldorf, Germany on October, 12 2010 at German Japanese Jurist Association)

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² Minamoto Yoritomo established its first samurai government in Kamakura in 1192, being the generalissimo (shogun) for the subjugation of barbarians. Despite changes of warlords, the samurai class continued to maintain its political power until 1868, when the Tokugawa shogun returned political power to Emperor (the "Meiji Restoration"). The Kamakura Government began in 1185 and discontinued in 1333.

³ Tokugawa Yoshinobu, the 15th Shogun of Tokugawa, accepted advice of Yamanouchi Youdou, lord of Tosa, part of present Shikoku Island, and decided to return political power to the Emperor.

⁴ Born in 1183, died in 1242. The third Shikken (Appointed Agent to exercise the power and role of Shogun)

⁵ It is officially called "Goseibai-Shikimoku", comprised of 51 articles covering the succession of land property, punishment of crimes, statute of limitations and others.

⁶ Meiji Government took the policy to treat four classes as equal.

⁷ 7 June 1825- 27 June 1910. He lived in Japan for 21 years from 1873 to 1895.

⁸ 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".

⁹ Ito Hirobumi and Saionji Kinmochi were involved in legislation policy.

¹⁰ Old Civil Code was heavily criticized by English law scholars in Japan.

¹¹ 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.

¹² Damage causes the decrease of the entire assets of an aggrieved party. The portion of such decrease has to be recovered through the operation of law. Damage claim is the amount of monetary claim to fill in such decreased portion, and not more than that.

¹³ Special or ordinary is a very academic distinction. Special damages are exceptionally recoverable only when foreseeability is proved, while ordinary damage requires no foreseeability. But arguments on what constitutes ordinary damage would make such distinction fruitless.

¹⁴ Sales and general administration. This covers most business expenses including salaries, executive compensation, factory operation costs, transportation, communication cost, energy cost and so forth.

¹⁵ James J. White and Roberts S. Summers "Uniform Commercial Code" Sixth Edition, (Page 366-387), horn book of American law, widely used in the United States as Uniform Commercial Code commentary.

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COURT CASES DEFINING LOST PROFITS IN JAPAN

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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

No.1: Calculation based on gross profit

	Court precedent	Status	Facts	Plaintiff's Assertion	Defendant's Assertion	The basis of the calculation of lost profits as determined by the Court	Definition of the terms by the Court
a	Tokyo District Court June 9, 2009 Hei 20(wa) No. 8895	Not appealed	Defendant was a director of the Plaintiff corporation. The Defendant resigned and began working for a competitor of the Plaintiff. Defendant began providing services to the Plaintiff's clients. 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 judgement.
b	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 that there was a possibility that the Plaintiff would not pay for the goods. Plaintiff sued for breach of contract and requested the court to calculate its lost profits based on the difference between the sale 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 the sales price and purchase price (i.e., gross profits).	The judgment stated that the definition of gross profits is the amount of profits after the deduction of material purchases from the sales amount.

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

	Court precedent	Status	Facts	Plaintiff's Assertion	Defendant's Assertion	The basis of the calculation of lost profits as determined by the Court	Definition of the terms by the Court
a	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 seem to be the same as the meanings ascribed to them under accounting rules
b	Tokyo District Court December 12, 2006 Hei 15(wa)No. 18743	Under appeal	Defendant was a director of the Plaintiff corporation and subsequently resigned and incorporated a company to compete with Plaintiff. 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 Defendant's act or not, therefore such "fixed expense" should not cut off from the 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 an 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 judgement stated that whether payroll costs are variable depends on the amount of sales
c	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" of the judgement is the amount after cutting off the variable cost such as material cost or freight cost from the gross profit.
d	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 refuse to enter into a business relationship with Plaintiff. Plaintiff filed for a preliminary injunction to enjoin the Defendant from spreading rumor's 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 the gross profit.

No.3: Calculation based on net profit

	Court precedent	Status	Facts	Plaintiff's assertion	Defendant's assertion	The basis of the calculation of lost profits as determined by the Court	Definition of the terms by the Court
a	Tokyo District Court June 16, 2009 Hei 19 (wa) No. 16291	Not appealed	Plaintiff franchisee sued the Defendant franchisor in 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, depreciation expenses from gross profits.	The meaning of gross profits, variable costs and fixed costs seem to be the same as the meanings ascribed to them under accounting rules
b	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 judgement.	The calculation of the Plaintiff's lost profits are 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 seem to be the same as the meanings ascribed to them under accounting rules
c	Chiba District Court Matsudo branch July 16, 2009 Hei 20 (yo) No. 6	Under appeal	Plaintiff was s 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 preliminary injunction and claimed that the Defendant breached his duty of non-compete obligations and claimed lost profits as damages.	Plaintiff claimed that the calculation of lost profits should be based on gross 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 the amount after cutting off the variable cost (the definition is in the right block) from the gross profit.	"Variable costs" is defined in the judgment as including fixed costs, such as payroll costs (e.g., the remuneration of directors)..