From around 1996 a company incorporated in the United States, A, which sold gaming machines and game consoles, began looking for a manufacturer that could develop a device (hereinafter, the “Device”) that would automatically arrange the tiles used in a game of Chinese dominos called “pai gow,” which had been taken up by casinos in the United States and other countries. The manufacturer sought would also develop tiles to be used exclusively in the Device (hereinafter the Device and the tiles are referred to collectively as the “Products”). On 23 April 1997 A commissioned Y (Defendant, Intermediate Appellant, Final Appellee), through B, to look for a manufacturer that would develop and supply the Products to A. Upon receiving this commission, around May 1997 Y sounded out X (Plaintiff, Intermediate Appellee, Final Appellant) about whether or not X would be able to develop the Products. Forming the opinion that it could do so, X decided that if an order were placed to develop and manufacture the Products, X would accept the order. Around June 1997, X received a visit from a group that included C (A’s representative officer), D (the manager from Y assigned to the project), and the representative officer of B. X started on the development of the Products after a number of issues were confirmed, including that the costs of developing the Products would ultimately
be borne by A's side, that the goal was a transaction involving at least one thousand Devices, and that because the Devices would be used in casinos, they would need to be durable enough to allow for continuous operation over a long period of time.

On 6 August 1997, X completed Prototype 1 of the Device, which X showed to C and D. X, C and D agreed on the continuation of the Device’s development. X was asked by C and D to submit a quotation for the Products’ development costs. Believing Y to be the immediate other party in the transaction for the Products, on 18 August 1997 X submitted a quotation to Y that set out the Products’ development costs. In response, whilst D made a verbal promise to X that Y would pay the development costs by the end of September that year, D did not heed X’s request to execute a contract with Y concerning the development of the Products. On 24 August however, D did deliver a letter to X entitled “Confirmation of Payment of Pai Gow Development Costs,” which stated that Y would pay ¥9.6 million as the development costs on 8 December 1997.

X then produced the Device’s Prototype 2, which was also approved by D. It was again agreed to continue with the Device’s development, and in addition C asked X to improve the stability and durability of this Prototype 2. However, since D had not taken a clear stance on the issue of executing a contract with X, through the mediation of B’s representative officer, X’s representative officer held talks with E, Y’s executive managing director. E indicated the view that as matters had progressed to the current extent, even Y had no alternative to bringing a deal involving the Products to fruition. Trusting that a contract would be executed with Y, X decided to continue with the Products’ development. Subsequently however, D indicated that he could not give a firm commitment to X for the purchase of 1,000 Devices, and nor could D issue an actual order form. It was at this point that X needed finance from its banks in order to continue the development and manufacture of the Products. On the grounds of this additional reason for needing a formal order from Y, X asked Y to issue a written order. In response, on or around 26 December 1997, D proposed to X that Y would place an order with X for two hundred Devices, and made a verbal promise that Y would place a formal order for the Devices. On 21 January 1998, Y prepared and delivered to X a letter with the heading “Order Form” (hereinafter, the “Order Form”). Whilst the Order Form stated that Y was placing an order for one hundred Devices and that a formal contract of sale would be prepared on a later date, it did not stipulate a specific delivery date.

In March 1998, X exhibited two Prototype 3 Devices at a trade show in Las Vegas, where they were favorably received. After obtaining D’s approval, the Device was ready for mass production. However Y did not present X with a delivery schedule, on the grounds however that no concrete order had been placed by C. Accordingly, on 4 June 1998, X informed Y that unless there was some prospect of the
execution of a contract for the Products, X could not expend any more time or expenditure on developing the Products than it already had so far. In response, on 16 June 1998, Y sent a letter to X with the heading “Transaction for Fully Automatic Pai Gow” (hereinafter, the “Presentation of Terms”), in which Y proposed placing an order for thirty Devices each month for ten months between July 1998 and April 1999, for ¥300,000 per unit. Negotiations subsequently proceeded between X and Y over terms including the prices of the Device.

In July 1998 X manufactured thirty Devices (hereinafter, the “July Delivery”), which it delivered to the location designated by Y. With respect to the Products’ actual distribution path, X, Y, A and B agreed that X would sell the Products via B to Y, who would then sell the Products to A. On 1 July 1998, these four companies finally agreed in writing on the terms of the transaction, including prices and the dates of payment. On the basis of this agreement X and Y agreed in addition that a contract would be exchanged between these four companies (hereinafter, the “4-Party Contract”). These four companies subsequently held discussions on the specific provisions of the 4-Party Contract, leading to a completion of a draft document by 17 August 1998.

On 17 August 1998, D, C and the manager from X assigned to the project came to B’s office for the execution of the 4-Party Contract. C however suddenly demanded changes to the specifications, including for the Devices that had already been manufactured, including lowering the position at which the Device was mounted on a table by about five centimeters, and widening the slot where the tiles were inserted. As a result, the 4-Party Contract was not executed that day. In X’s judgment, in order to meet C’s demands, changes would be required to the Devices’ internal structure, which meant that modifications would have to be made right from the Devices’ basic design. X therefore rejected these demands at further negotiations held on 18 August, but C argued that unless the specifications were changed, the Devices would not pass muster as a product. D also indicated the stance that a consideration of the specifications in line with these demands was unavoidable. X’s representative officer broke off the negotiations in anger over C’s stance. Starting from 19 August however, X’s manager conducted inquiries with the object of complying with these demands, and negotiations continued with Y and B towards the execution of the 4-Party Contract.

X subsequently implored Y to provide cash for the Products X had already delivered, so that X could settle some bills. D got C to consent to payment of the purchase price of the July Delivery, and at the same time, instead of Y acting as the agent for this payment, D asked F, who had an interest in the transaction, to act as such agent between C and X. D obtained F’s agreement, so C instructed X to issue a shipping statement and invoice made out to F. On 14 September 1998, F paid ¥10 million to X, which was the amount that X needed to settle the above bills. However, since X did not consent to F
becoming a party to the transaction for the July Delivery, on 18 September X demanded that Y pay the development costs and the price of the Products already delivered, on the premise of the execution of a basic agreement pursuant to the Order Form. X also gave notice that if payment were not made, X would cancel the contract of sale for the Products and the basic agreement, on the grounds of Y’s default. Subsequently, negotiations between X and Y conducted on the premise of the 4-Party Contract finally broke down. X sued Y for damages, claiming that as a result of Y’s rejection of the transaction it had sustained losses totaling over ¥159.37 million, including the development costs and lost profits. X’s principal claim was based on Y’s default under the basic agreement between X and Y, and in the alternative X claimed that Y was in breach of the good faith principle applicable to the execution of a contract.

The court at first instance (Tokyo District Court, 28 October 2002) denied that the basic agreement had been executed, and dismissed X’s principal claim. However, the court stated that since Y had “betrayed the confidence it had conveyed” to X “that the execution of the basic agreement was a certainty,” Y’s act “constituted an extreme breach of the good faith principle in the execution of a contract.” Furthermore, since as of 17 August 1998 “the situation” was that “a draft of the basic agreement had been finalized and that all that remained was for the parties to sign and seal it, in the claim for damages pursuant to the good faith principle, it would be logical to allow damages to be awarded within the scope of the binding effect that would probably have arisen from the basic agreement, had that contract been executed.” The Tokyo District Court therefore upheld X’s claim for damages in an amount of slightly over ¥132.19 million, including lost profits.

By contrast, as well as dismissing X’s principal claim, the lower court (Tokyo High Court, 26 January 2005) also dismissed X’s alternative claim, for the following reasons. The 4-Party Contract was not executed because A’s representative officer C demanded new improvements to the Devices at too late a juncture. Since Y’s position was that so long as C would not agree to purchase Products Y could not execute a contract with X for the purchase of those Products, even if Y did not, in the end, execute the basic agreement in question with X, this could not be considered to constitute a breach of the good faith principle. Furthermore, C’s acts could not be seen as acts carried out by Y. The cause of the failure to execute the 4-Party Contract was X’s giving notice of cancellation to Y because X was unhappy about F’s designation as the purchaser for the July Delivery, which caused X to believe that Y did not intend to sign the 4-Party Contract. However, F was no more than the purchaser in only the contract of sale for the July Delivery, and since X also received payment of ¥10 million from F, Y’s response could not be especially described as a breach of the good faith principle.

X petitioned for acceptance of a final appeal. X’s reasoning was that since Y’s action in breaking off the
negotiations took place in the final stage of the execution of a contract, X’s expectation that a contract would be executed warranted protection.

[Summary of Decision]
The Supreme Court ruled as follows before reversing the decision of the lower court and remanding the case. “According to the facts described above, when X indicated reluctance to continue with development unless a contract were executed with Y on the development and manufacture of the Products, in order to get X to continue with the Products’ development, on or around 26 December 1997 Y proposed to X that it would place an order for two hundred Devices on the condition that Y be the party to the contract with X, notwithstanding that no concrete order for the Products had been received from A. Y promised verbally that it would place a formal order for these Devices, and on 21 January 1998, it issued the Order Form which contained an order for one hundred Devices. Then on 16 June that year it sent the Presentation of Terms, in which Y proposed placing an order for thirty Devices each month for ten months. As a result, X invested considerable expense in developing the Products, including ordering the parts required to manufacture one hundred Devices and the tiles exclusively for those Devices, and completing two metal molds required to manufacture those tiles. X also proceeded with the work, including improvements, in order to produce the July Delivery, which it delivered to Y.

In view of these facts, X is rightly described as having reasonable grounds for a strong expectation, as a result of these actions by Y, that the basic agreement in question would be executed with Y or, alternatively, a similar contract for the ongoing manufacture and sale of the Products. X is rightly described as having relied on these acts carried out by Y when it invested considerable expenditure in order to develop and manufacture the Products as described above.

That being the case, even if Y were, on the one hand, in the position described by the lower court, notwithstanding the quite reasonable possibility that in the end no contract would be executed between Y and A given the absence of any concrete order for the Products from A, it cannot be denied that as a result of Y actions described above, Y caused X to develop and manufacture the Products, because Y caused X to hold the undue expectation that either the basic agreement in question or the 4-Party Contract would be executed. On the basis of these facts, whilst it may be said that both X and Y should have naturally foreseen the possibility that in the end no contract might be executed, given the details of these actions carried out by Y, it is rightly said to be only natural that X went so far as to develop and manufacture the Products as a result of these actions. Y should be described as having come to commit each of the acts described above with the full recognition that as a result of such acts X would be led to develop and manufacture the Products. It follows that in its relations vis-à-vis X, Y is rightly
described as being in breach of its duty of care under the good faith principle at the preparatory stage of a contract, and therefore as liable for compensation to X for losses arising in X as a result. Whilst the breakdown in the 4-Party Contract negotiations was triggered by C’s demands for new improvements, and whilst negotiations for the execution of the 4-Party Contract ultimately broke down in the course of subsequent exchanges between X and Y, the chief cause for the breakdown in these negotiations ought to be described as the untimely demand for improvements made by C, A’s representative officer, who had commissioned Y to search for a manufacturer that would develop the Products and who instructed Y on the Products' development from start to finish. Even if X were also responsible to some small degree for the breakdown in these negotiations, the circumstances prior to such breakdown in negotiations are such that Y may not evade its responsibility as described above.”

“The lower court, which at odds with the foregoing held that Y was not in breach of such duty of care, committed an error in law that clearly prejudiced its ruling,” which therefore cannot escape reversal. The Supreme Court remanded the case to the lower court “to again conduct an exhaustive examination of the losses caused to X, and the value thereof, as a result of Y’s breach of its duty of care.”

[Keywords]