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Japanese Law Explained

Terminating a Japanese Distributor: Legal Risks Commonly Overlooked by Foreign Companies

When foreign companies enter the Japanese market, one of the most common strategies is to appoint a local distributor or sales agent. This approach allows companies to quickly establish a presence without building their own sales infrastructure. However, many foreign companies later discover that terminating a Japanese distributor relationship can be more complicated than expected. Understanding the legal and practical risks is essential before entering into a distribution agreement in Japan.

1. The Common Assumption: "We can terminate according to the termination clause in our contract"

In many foreign jurisdictions, a company can terminate its relationship with a distributor or sales agent if;

- The agreement includes a termination clause and
- The contract term expires or a party notifies the other of its intent to terminate the relationship.

Foreign companies often assume the same rules apply while operating in Japan; however, courts sometimes rule differently when applying the principle of good faith from the Civil Code.

2. The Role of Good Faith Under Japanese Law

Distribution agreements in Japan are generally governed by the Civil Code. Although the Civil Code respects freedom to contract, Japanese courts also apply the principle of good faith. This means that even if a contract formally allows termination, a court may still scrutinize how a party exercises this right.

Courts may consider factors such as:

- The length of the business relationship;
- The degree of economic dependence on the supplier;
- Whether the distributor made significant investments with respect to its relationship to the supplier;
- Whether the supplier gave sufficient advance notice;

- Whether there was any financial compensation provided for the termination; and
- Whether the supplier provided any advanced explanation or engaged in any prior negotiations.

If a court deems that termination was unfair with respect of these factors, the distributor may seek damages against the supplier.

3. A Typical Dispute Scenario

A foreign manufacturer appoints a Japanese distributor. The distributor invests in building a market presence, including hiring sales staff, marketing and developing customer relationships. After many years of cooperation, the manufacturer decides to terminate the relationship or appoint a new distributor. The distributor claims that the termination caused significant losses and was unreasonable.

Even when the contract technically permits termination, disputes may arise if the distributor’s reliance on the relationship was substantial.

4. Key Points

(1) Provide Adequate Notice
After forming a relationship with a Japanese distributor or sales agent, companies should provide notice of its intent to terminate as soon as possible. Usually, longer notice periods reduce the risk of disputes.

(2) Take Precautions When Creating the Agreement
A company should have clear contractual terms that set the conditions on when a party may terminate the agreement, as well as make the contract non-exclusive and limit a distributor’s investments to help manage the parties’ expectations.

(3) Avoid Sudden Market Restructuring
Although sometimes unavoidable, when possible, a company should avoid any sudden or abrupt changes terminating the relationship between it and its distributors or agents. Companies should carefully consider and notify as soon as possible any distributor or agent of its decision to terminate especially when the relationship has lasted for many years.

5. Conclusion

Japan does not have a specific statute governing distribution agreements generally. In principle, termination depends on the contract; however, the long-term nature of many Japanese business relationships means that termination may still raise legal and practical challenges. Foreign companies planning on doing business in Japan should address their termination strategy and contract terms including notice periods and transition planning before structuring their distribution agreements.

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