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Internet Contracting and Standard Terms in the Global Electronic Age: Perspectives for Japan

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Internet Contracting and Standard Terms in the Global Electronic Age: Perspectives for Japan

An Address to the Students of Law of the Kansai-University, Osaka, Japan

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by

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Introductory Remarks

1. I have many people to thank for being able to address you today. First, I would like to thank Professors Kubo and Imanishi for inviting me here today. Then I would also like to thank Professor Takigawa for interpreting my remarks to you. I wish also to thank Professor Yamanaka, who has made Kansai University a part of my life. He and I met in Munich some years ago when we were both fellows of the Alexander von Humboldt Foundation studying German law. Thus the spirit of the Humboldt Foundation is behind this talk today.

2. Further, I would like to thank your University for inviting me here to be a visiting scholar.

3. Finally, I would like to preface my remarks with a disclaimer. I have relatively little knowledge of Japanese law and no knowledge of the Japanese language. I realize that what I can say about Japanese law is at best modest and tentative.

1. Introduction

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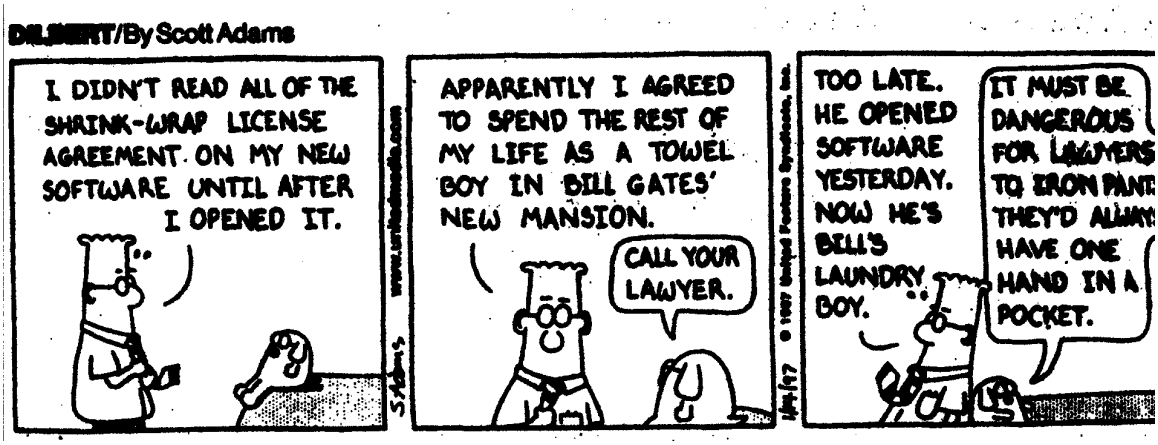
Here is what I would like to do today:

I hope to show you how your own everyday experiences raise significant domestic and international legal questions. I want to show you that a seemingly technical matter need not be boring, but can provide you with an example both of practical application of law internationally and of the benefits that knowledge of foreign law can bring in assisting in understanding and improving domestic law.

Your generation is the computer generation. I expect that all of you have used a personal computer. I expect that most of you have bought software for your computer or have used it to access the Internet. That means that just about everyone of you is probably subject to standard terms governing your use of software or of an Internet site.

Perhaps you do not remember agreeing to the terms. Probably, at sometime in your use of software or an Internet site you were asked, "do you agree to these terms?—if so click here." If you remember such a dialogue, do you remember whether you actually *read* the terms? If you actually read the terms, you must be a law student. Most people—myself included—do not read the terms. They just click to get on with their objective. They do not want to waste their time reading pages of tiny type, especially when they know that they cannot change that type.

But hold it. If you did not read the terms, did you agree to them? Isn't the basis for enforcing contracts, the parties' agreement to be bound? Moreover, if you did not agree to the terms, how do you know what conditions they impose on you? Let's put these two points graphically with a Dilbert cartoon by Scott Adams:



Here we see both of the issues. In this case, the supposed act by which Dilbert "agreed" to the terms was opening the software package, that is tearing open the plastic "shrink-wrap" wrapping. That's why it's called a "shrink-wrap license agreement."

A *license agreement* is simply a form of contract. It is a contract that sets out the terms of use of intellectual or other property. Licenses that always have the same terms—and most do—are

called *standard terms license agreements*. Software and Internet license agreements are almost invariably standard terms licenses.

2. Why standard terms are used.

Standard terms are universal and not just in Internet and software contracts. In most countries the vast majority of written contracts use standard terms. The parties to contracts generally do not individually negotiate the terms of their contracts other than the most basic elements such as price and quantify..

Standard terms are especially important for software and for information obtained on the Internet. That is because software and information can easily be copied. If I could buy a copy of Microsoft Windows and could make copies for all of my friends, Microsoft would lose many sales. Thus Microsoft requires that I agree not to make copies. Because I agree to that limitation, it is willing to license to me a copy of Windows for my own use for ¥50,000. A company that wanted to license Windows for thousands of employees would have to pay much more. Because for licensed products, what you can do with the product determines the value, one sometimes says that in such cases the license is *the* product.

The use of standard terms is not limited to software and information. It is common in contracts of all types. Standard terms are convenient, because they help spell out the parties' relationships. They may be less common in Japan, because written contracts may be less common here and relationships are sometimes understood in the context of social norms. But in the mass societies of Europe and America, and on the Internet, where contracting parties usually do not know each other, standard terms are used to spell out the parties' mutual obligations. Contract law alone purposely does not provide all the answers.

The general rule of contract law is *freedom of contract*. This means that the parties should be free to agree on the contract that they want to have. They should be able to agree on how to allocate responsibilities and liabilities. For example, they may wish to agree who bears the cost of shipping the goods. For an apartment rental, they may want to agree on who bears certain costs associated with the rental, such as heating. Contract law leaves many issues completely ungoverned.

But even when contract law provides solutions to legal questions, often it permits the parties to change that solution. Most contract law is what is called *default law*. That is, the law applies unless the parties agree otherwise. A good example in American contract law is that in a sale of goods, unless the parties otherwise agree, the buyer must pay the cost of shipping and, if the goods or damaged or lost underway, the buyer bears that risk and must accept that loss. However, since this rule is a default rule, the parties may agree otherwise.

3. Why standard terms are regulated.

The Dilbert cartoon well illustrates why standard terms are regulated. The basic issues are two: (1) when should one party be deemed to have "agreed" to the terms, whether read or not? and, (2) what limitations, if any, should there be on the fairness of the terms.

Agreement. Typically where standard terms are used, parties are asked to submit to them unread or, if read, not necessarily understood. Often, even when parties do read them, the party using them does not allow any changes. While ideally the party asked to submit to the terms may seek another supplier who does not insist on such terms, that may not always be practically possible. The legal question then is, if the party had no choice to change the terms, when should that party be deemed to have agreed to them? How much knowledge of the existence of the terms and what opportunity to read them should the party subjected to them have? Laws that regulate this question are sometimes called *incorporation* controls.

Fairness. A problem of unfairness can arise because only party writes the standard terms or because one party has disproportionate bargaining power. Typically a party who writes standard terms drafts them in such a way as to resolve all possible issues in its favor. For example, suppose you borrow ¥12,000,000 and agree to repay the money with interest in twelve monthly payments due on the first of each month. You sign a standard term agreement in which the lender has provided that for each day you are late in making any payment, you must pay an additional ¥100,000. Laws that control the fairness of the terms are sometimes called *content controls*.

4. Standard terms as an international issue

So long as countries have different laws, whenever people cross borders there is a risk that they will bring their own conceptions about what is lawful with them. They may then engage abroad in conduct that while perfectly permissibly, is prohibited abroad. For as long as parties have engaged in international transactions, this risk of illegal standard terms has been there. What is different today is that the Internet means that you do not even have to leave your home to engage in international transactions.[1] If, for example, you download software from a Microsoft website and you click your agreement to a Microsoft license, is that license enforceable if it contains terms permissible under American law but prohibited under Japanese law?

So far as I know, Microsoft has not found its license under attack here. But I do know that in Germany—thanks to the German law regulating standard terms—Microsoft was required to drop many of the terms in its standard license for Windows.

What all of this means is that you—as Internet site users and providers—in the future need

[1] While here in Osaka, using my eBay United States auction identifier, I bid on an auction at the eBay Germany site, sent payment from here, and requested shipment to the United States. The total cost, including shipment, was $8, i.e., less than ¥1000. Which law applies?

practically to be aware of the laws that regulate standard terms whether in Japan or elsewhere. You may be subject to them.

5. Laws governing standard terms

Today most countries in the industrialized world have special laws that limit unfair standard terms. I am going to talk in some detail about such laws in Japan, the United States, Germany and the European Union. In these countries, and many others, however, even before these special laws were adopted, courts under general provisions of contract law sometimes refused to enforce standard terms either because the party to be subject to them did not agree to them or because the terms were unfair.

In *Japan*, until recently, there was no specific law that limited use of standard terms. Since 2001 there has been such a law: The Consumer Contract Act. Before then, control of standard terms in Japan was largely by way of courts using general contract law as a basis to deny enforcement of certain terms and by way of administrative agencies and statutes requiring use of particular terms.

Germany, on the other hand, adopted an extensive law regulating the use of standard terms already in 1976. It was called the *AGB-Gesetz* (after the German term for standard terms, *Allgemeine Geschaeftsbedingungen*). In the 1980s Korea adopted a law based on the German law.[2] In 2002 the German special statute became part of the German Civil Code (§§ 305-310.). The original German statute of 1976, however, was based on case law going back to the early part of the 20th century that had applied general clauses of the German Civil Code, such as the good morals clause of section 143 and the good-faith clause (*Treu und Glauben*) of section 242.

The German statute favorably impressed the *European Union*. In 1993 the European Union introduced its Unfair Terms Directive. Like other European Union Directives, the Unfair Terms Directive is not directly applicable law. It is, instead, an instruction to Member States to adopt laws that follows the terms of the directive. All fifteen Member States have done so. When the European Union is enlarged in a year, then all twenty-five Member States will have such laws.

In the *United States* the law professor who wrote the Uniform Commercial Code was familiar with the German court practice based on the general clauses of the German Civil Code. He inserted into the American law comparable general clauses with the expectation that they would be used to control standard terms. They have been so used.

Although the issues arising in standard terms have been similar, the laws of each country

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[2] *See generally* Don-Hoon Kim, Koreanisches AGB-Gesetz—unter Beruecksichtigung einer Rechtsvergleichung mit dem deutschen AGB-Gesetz, Diss. Koeln 1988; Jae-Hyun Lee, Grundfrage des Rechts der Allgemeinen Geschaeftsbedingungen—Ein Rechtsvergleich zwischen Deutschland und Korea, Diss. Goettingen 1990.

differ. There are several reasons why you should be aware of these differences. In the first instance, as someone doing business on the Internet, standard terms that you use or that you agree to may be subject to foreign laws. Looking beyond that immediately practical purpose, as a citizen of Japan, you want to understand Japanese law. By seeing how other countries handle these issues, you will be better able to see how present-day Japanese law treats them. Moreover, through study of foreign solutions, you may find approaches that would help in improving future Japanese law.

Each of these laws faces the same set of competing interests. There is, as we have seen, the *policy interest in freedom of contract*. In general, parties should be free to do what they wish. On the other hand, however, the *principle of contractual justice* requires that freedom of contract be limited. But yet another principle of legal system—namely the *principle of legal certainty*—requires that whatever rules are imposed are clear and easy to follow. Parties should be able to rely on the law to guide their behavior.

I do not plan to give you detailed descriptions of the four laws; you would forget all of the details soon enough. Instead I want to concentrate on consideration of four principal issues addressed in all four of the laws. Each of the laws treats each of these issues somewhat differently. Two of these issues are necessarily addressed in every statute no matter what it governs, namely *scope* and *enforcement*. By scope I mean simply what the statute is intended to govern. By enforcement I mean what measures does the statute provide to insure that it is complied with. The other two issues I plan to talk about are how these specific laws treat the two issues of standard terms already alluded to, namely, *agreement*, i.e., when do the terms become part of the contract (*incorporation control*) and second, *fairness*, that is when are they subject to control for unfairness (*content control*).

6. The scope of standard terms laws

Every statute needs to deal with the scope of its application. In the area of standard terms laws, there are two different basic approaches to scope. Some laws apply only consumer contracts, but apply to all consumer contracts without regard to whether the contracts use standard terms or not. Other laws apply to all contracts—even non-consumer contracts—but only when they use standard terms.

The European Union Unfair Terms Directive is limited to consumer contracts. Originally, it was to have applied to all terms in all consumer contracts. Thanks, however, to lobbying from Germany, it does not apply to individually negotiated terms. As a result, its practical effect is largely limited to standard terms. The Japanese Consumer Contract Act likewise applies only to consumer contracts, but it does not exclude from its coverage individually-negotiated terms. I will address in a moment why Germany sought such a limitation in the European Union Directive.

Both the German and the American laws are not limited to consumer contracts. They apply

to all contracts, even those made by large businesses such as Sony and Mitsubishi. While the American law is not limited to standard terms, the German law originally was. As with the European Directive, however, almost all terms subject to control are found in standard terms agreements.

. The choice of scope reflects different conceptions of what the danger is that the law combats and how best to deal with it. Where the focus is on the consumer, the principal evil sought to be combated is the effect of the different bargaining powers of the parties. Where the focus is on contracts generally, the evil sought to be combated is the one-sided nature of the drafting process..

When American and Japanese laws focus on protecting the individual consumer even where terms are not standard and are separately negotiated, they show a preference for the interest of contract justice. When German law and, to a lesser extent, European Union law, rule out application of the law to separately negotiated terms and review only standard terms, they are making a choice to favor the policy interest of freedom of contract and the legal system interest in legal certainty. By accepting the validity of the parties' separately negotiated choice of terms, they avoid interfering in freedom of the parties to chose. By ruling out examination of the individual contract, they permit an abstract definition of which terms are unlawful. That abstract definition makes application of the law easier.

7. Incorporation controls

Long before there were special statutes regulating standard terms, courts refused to enforce unfair terms by finding that these terms had never become part of the contract or by construing them against the draftsman. Courts might find that there had been no agreement because the terms were never provided to the party charged with knowing them, or because the party could not or did not read them.

In today's computer world this question of agreement comes up in a variety of contexts. The issues are similar to the non-computer world: namely, what responsibility does the party using standard terms have to call the other party's attention to the terms and to obtain its explicit assent? What constitutes assent? In the days of packaged software, the license was prominently displayed on the box and agreement was said to come from tearing open the plastic shrink-wrap. More common these days is the request that the user click-here to show agreement. Some such sites require the user to scroll through the whole page before clicking; some merely make the license terms available by hyper-link. Today one also encounters websites that assert that your use of the site—without any clicking—constitutes acceptance of its terms (so-called *browse-wrap*).

Of the four jurisdictions that we are discussing, only the German system has an explicit control on when standard terms become part of the contract. What is now section 305 of the Civil Code requires that standard terms become part of the contract only if the party using them "expressly

draw the other party's attention to them" and provides "the possibility of obtaining knowledge of their content," *and* "the other party agrees that they are to apply." Even where these provisions are followed, section 305c provides that *surprising* terms do not become part of the contract. Surprising terms are defined as terms that the other party should not have reason to reckon with. An example frequently given is a clause that binds the buyer of a good such as an automobile to a service contract for the good's maintenance.

Unfair terms laws in Japan, the European Union, and the United States do not have such explicit controls on incorporation of f terms into contracts. In Japan the Consumer Contract Act as initially proposed was to have included several provisions treating incorporation issues. There was to have been a general provision similar to that of the Germany law that would have permitted a consumer to avoid a contract if a business failed to explain material terms. But thanks to business opposition this proposal was dropped and a declaratory clause with no consequences substituted.[3] There were also to be provisions, again similar to the German law, that would have struck down surprising terms and provided that standard terms be construed against the drafter.[4] In the European Union addition of such a control to the Directive has been discussed, but so far, has been ruled out by limitations arising from the original Directive language.

While unfair terms laws in the United States do not have a control on incorporation, historically courts applying general contract law of assent have required that users at least receive knowledge of the existence of such terms before the contract is concluded. A recent court decision seeming to hold otherwise has been much disputed. American contract law generally has long construed contract terms against the drafter and especially so terms in standard terms contracts (which sometimes are also know as contracts of adhesion.) Moreover the general content control of American law that we will discuss next takes into account whether a party has had a chance to read the terms through a doctrine called "procedural unconscionability". In general, however, in American law, parties are held to have agreed to standard terms if they had an opportunity to know that the terms existed; parties need not have actually read them nor have had their attention called to them

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[3] So Zentaro Kitagawa, *Chapter 1, Contract Law in General* §1.18[3][b], in 2 Zentaro Kitagawa (ed.), Doing Business in Japan 1-236 (2002). As adopted Article 3 of Chapter 1 of the Consumer Contract Act provides "Businesses drafting clauses of a consumer contract shall strive to make the rights and duties of consumers and such other things set forth in the consumer contract clear and plain to consumers and, in order to deepen consumer understanding when consumers are solicited to enter consumer contracts, to provide necessary information on consumer rights and duties and such other things set forth in the consumer contract."

[4] Conversation with Professor Hiroyuki Kubo.

8. Content controls

The laws in Japan, Germany, the European Union and the United States all control the content of standard terms, but take rather different approaches to doing so. The most apparent difference in these approaches is the mix they have of general statutory clauses prohibiting unfair terms, specific statutory clauses prohibiting particular types of terms as unfair ("black lists"), specific statutory clauses prohibiting particular types of terms as unfair in particular circumstances to be judged by a court ("gray lists") and statutory clauses mandating particular standard terms. A still more fundamental issue of approach is the extent to which the respective laws seek to provide abstract definitions that heighten legal certainty.

General clauses. All four jurisdictions use general clauses. You probably know that general clauses are statutory provisions that invite courts to engage in weighing particular circumstances. The "good faith" provisions of the Japanese and German Civil Codes and of the American Uniform Commercial Code are examples of general clauses. General clauses are necessary because the law cannot provide in advance solutions to all issues that might arise. Thus, even where black and gray lists are used, general clauses are needed to supplement them.

The American general clause is section 2-302 of the Uniform Commercial Code and is the most permissive clause: it strikes down a standard term only if the term is "unconscionable." Unconscionability requires more than mere unfairness. The European Union provision is less permissive and provides for striking down terms that are merely unfair. Article 3 provides that a contract terms shall be regarded as unfair "if contrary to the requirement of good faith, it cause a significant imbalance in the parties' rights and obligations." The Japanese clause is similar. Article 10 of the Consumer Contract Act strikes down clauses that "impair the interests of consumers one-sidedly against the fundamental principle [of good faith]". By its terms the Japanese general clause is limited to a control on terms that alter the default provisions provided by substantive law. The German clause, Section 307(1) of the Civil Code, likewise provides that provisions in standard terms are invalid if "contrary to the requirement of good faith, they place the contractual partner of the user at an unreasonable disadvantage." What makes the German provision different, however, is it then go on to specify particular instances when an "unreasonable disadvantage" is to be presumed. Thus, one sees that while the Japanese, EU and German provisions all similarly seek to provide more solicitude for the interest of contractual justice than does the American, the German provision seeks also to pay closer attention to the issue of legal certainty.

Prohibited lists. All of the laws concerned to a greater or lesser extent in addition to the use of a general clause specifically prohibit some terms. In some lists, the terms given are simply prohibited outright. These are called black lists. In other lists, the terms listed are not prohibited outright, but only if they are found to meet certain criteria. The terms are to be evaluated in

particular cases and either approved or disapproved based on the circumstances of the particular case. The principal reason for having such lists is to give greater legal certainty to the application of the law. These lists help do that in at least two ways. By naming explicitly prohibited clauses, they make clear that certain clauses are prohibited outright (black list) and other clauses may be prohibited (gray list). Moreover, these lists help increase legal certainty in another way by making concrete the prohibition of the general clause; they serve as examples of the kinds of terms that should be prohibited. They are starting points for reasoning by analogy.

Of the four statutes that we are presently discussing, the American has the shortest black list: just one item.[5] A contractual disclaimer of liability for personal injuries caused by defective goods is not allowed. The German statute, on the other hand, has the longest black and gray lists. It may not be surprising then that the American law provides the least legal certainty, while the German law provides the most. Moreover, the American law provides the least rigorous review of standard terms, while the German provides the most rigorous. The Japanese Consumer Contract Act and the European Union Unfair Terms Directive fall somewhere in between. The Japanese law has only black lists, both of which are relatively short (Articles 8 and 9). As the law was initially proposed, the lists were considerably longer, but a number of terms were dropped from the Act as adopted.[6] The European Union law has only a gray list. This may be because it had to accommodate many existing laws.

Mandatory terms. Instead of prohibiting terms, another way of avoiding unfair terms is to require the use of specific approved terms. To some extent this is done in all four of the jurisdictions that we have been discussing. It is particularly common in certain regulated industries such as banking and insurance. In every jurisdiction these requirements come from outside the laws controlling contract terms. Until recently use of mandatory terms was Japan's only real tool to deal with unfair standard terms. The principal source of such mandatory terms was administrative guidance。Lately the European Union has taken to dealing with some persistent problems of unfair terms with legislation that requires mandatory terms. A good example is the Guarantees Directive that requires specific minimum terms for warranties.

9. Enforcement

All laws face the issue of enforcement. Generally laws that are not enforced, are laws that are not observed. Laws that are not observed are worthless as laws. The four jurisdictions that we are looking at take markedly different approaches to enforcement. In Japan and the United States

[5] That is the only prohibition in the general contract law. There are, however, other prohibitions in specialty laws, for example, prohibitions against usury.

[6] Conversation with Professor Hiroyuki Kubo.

enforcement is largely *reactive*. In the European Union and in Germany enforcement is supposed to be *proactive*. Reactive enforcement means simply a response to an illegal use; proactive enforcement is concerned with taking affirmative use to prevent illegal use..

In both Japan and the United States the principal method of enforcement is to treat the particular clause (or possibly the entire contract) as void. Thus if the contract contains a provision that impermissibly limits contract liability, if the buyer sues the seller and the seller seeks to avoid liability relying on the clause, the court will strike the clause down and not limit liability. The problem with this reactive approach is, however, that until the day of judgment comes, parties will continue to use the prohibited clause not only in this contract, but in other as well. The parties to the contract may assume that the clause is valid and will have no chance to challenge it in court. Challenges can come only if a triggering event, such as a suit for breach of contract, occurs. Moreover, even if a court finds such a clause unlawful, there is nothing that prevents a party from modifying it only slightly and trying its luck with a new and improved clause with other parties. Article 9(2) of the Japanese Consumer Contract Act encourages overreaching by providing that if the use of the terms requires excessive interest, the court should merely reduce the claim to that which is lawful and not strike the clause down altogether.

In the European Union, including Germany, the goal of unfair terms legislation is seen to be farther-reaching than remedying an individual instance of contract injustice. The goal is to stamp out the practice of use of unfair terms. To that end both the laws of the European Union and of Germany provide for what is called proactive enforcement. In the European Union, for example, in all lawsuits involving consumer standard terms contracts, courts are to examine the contracts for possibly impermissible terms on their own motion without waiting for a consumer to object. In Germany, both individuals and consumer organizations acting on behalf of consumers have extensive rights to sue before the party using the terms seeks to enforce them. In the case of successful suits, the party that used the terms is prohibited from using them or similar terms in any future contracts.

Proactive enforcement is not entirely unknown in Japan, although it is not a feature of the Consumer Contract Act. In Japan, the Consumer Life Centers, while they have no legal standing to do so, nevertheless do from time-to-time send letter calling on users of standard terms to modify them. Sometimes, they do.[7]

While the European Union has not stamped out the use of unfair terms altogether, I believe that it may have been successfully in proactively reducing their use. I have at least one personal anecdotal experience that confirms that. When I wrote an article on standard terms contracting, the university that published the article, i.e., a non-profit publisher devoted to advancing learning,

[7] Conversation with Professor Hiroyuki Kubo.

wanted me to agree to what I found to be onerous standard terms. When I proposed alternatives, I said, let me use the standard terms of two European for profit publishers. The terms of the profit-making publishers were more reasonable, I suspect, because of the influence of the law.

Goseicho arigatou gozaimasita

御清聴、有難うございました