

Litigation - Japan

Supreme Court: warranty against defects in contaminated land transaction

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September 28 2010

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Summary

On June 1 2010 the Supreme Court made a potentially historic decision regarding a seller's warranty under Paragraph 570 of the Civil Code. The case related to certain defects in relation to the sale and purchase of a parcel of land that contained a substance later deemed to be a pollutant (ie, fluorine). The decision clearly contrasts with a Tokyo High Court decision of September 25 2008. The Supreme Court decision will have a significant effect not only on transactions regarding contaminated land, but also on the interpretation of the term 'latent defect' in Paragraph 570,⁽¹⁾ which is one of the most significant provisions of the code regarding contractual liabilities.

Facts

On March 15 1991 the final appellee (ie, the buyer, the plaintiff and the original appellant) purchased the land in question, located in Tokyo, from the final appellant (ie, the seller, the defendant and the original appellee) for approximately Y2.3 billion. On April 2 1992 the final appellant transferred the land to the final appellee. However, the land was contaminated with fluorine, which was not regarded as a pollutant under Japanese law at that time.

After the sale and transfer of the land, the hazardous nature of fluorine gradually came to be better understood. On March 28 2001 the environmental standard for soil contamination, formulated in accordance with the Basic Environment Law (91/1993), was revised to add fluorine to the list of regulated pollutants.

In addition, the Tokyo metropolitan government enacted an environmental regulation on December 22 2000, which it began to enforce on April 1 2001. The regulation requires a person planning to change the use of an area of land in excess of 3,000 square metres to notify the governor of Tokyo. The regulation allows the governor, if he or she suspects that the soil may be contaminated, to order the notifier to (i) conduct research to determine whether the land is contaminated, and (ii) report the results of such research. If a regulated pollutant, such as fluorine, is found to be present in the land in excess of a predetermined level, the notifier must take countermeasures.

In the present case, since the land was contaminated with fluorine, the final appellee was required to take countermeasures in accordance with the regulation.

The final appellee filed the lawsuit against the final appellant with the Tokyo District Court, seeking approximately Y460 million in damages in relation to the contamination.

Tokyo High Court decision

The Tokyo High Court reversed the district court decision, which had dismissed all of the final appellee's claims, and awarded almost the entire amount of damages sought by the final appellee.

The high court held that:

- a latent defect existed in the land, as it was contaminated with fluorine;
- it was unnecessary to consider whether fluorine was generally recognised as a pollutant when the parties entered into the contract for sale of the land; and
- the statute of limitations regarding the final appellee's claim based on the seller's warranty against defects had not expired, since the date of commencement of the statute of limitations should actually have been the date on which the hazardous nature of fluorine became clear - that is, March 28 2001, being the date on which the environmental standard for soil contamination was officially revised.⁽²⁾

Supreme Court decision

The Supreme Court reversed the decision and dismissed all of the final appellee's claims. The Supreme Court held that:

- when determining whether a latent defect exists in the subject matter of a sale, it is necessary to determine the nature and quality of the subject matter that the parties had expected - in light of conventional wisdom and generally recognised facts - when they entered into the contract regarding such sale;
- given that fluorine was not generally recognised as a pollutant when the parties entered into the contract, the parties could not have stipulated that the land be free from fluorine; and
- thus, a latent defect did not exist in the land.

Comment

The Supreme Court decision clearly differs from that of the Tokyo High Court with regard to the interpretation of the term 'latent defect'. The high court considered that a latent defect exists if the subject matter of a sale lacked - in hindsight - the nature or quality which would have been generally expected in the same (or materially similar) subject matter. In contrast, the Supreme Court's view is that a latent defect exists in the subject matter of a sale only when such subject matter lacked the nature or qualities which were (or should have been) expected by the parties when entering into the relevant contract. Such a difference will inevitably lead to contradictory conclusions.

Even before the Supreme Court's adoption of a conflicting position, many legal practitioners and scholars had criticised the high court decision. Based on the following rationale, it can be concluded that the lower court ruled on the basis of an erroneous interpretation of the term 'latent defect'.

First, the seller's warranty against defects is generally regarded as a type of contractual liability. Thus, it is important to determine the nature and quality of the subject matter that the parties expected when they entered into such contract.

Second, if the high court interpretation of 'latent defect' were correct, a seller would be subject to contingent liabilities in relation to all unknown and unexpected substances found in the subject matter of the sale long after having entered into the contract for sale (including those which were considered harmless at the time of the sale, but were subsequently found to be hazardous due to developments in technology, as in the case of fluorine). This liability issue is particularly serious with respect to land transactions, as some risk of soil contamination will inevitably remain in land that has previously been used for manufacturing or similar purposes, and countermeasures against soil contamination are usually extremely costly. As a result, sellers would be unable to sell their land without fear of incurring considerable contingent liabilities resulting from land contamination. This, in turn, would result in inefficiencies in the sale and purchase of real property, with further consequences for the stable development of the economy.

The Supreme Court's decision seems reasonable and is likely to be supported by legal practitioners and scholars.

In addition to the judicial interpretations described above, the term 'latent defect' has recently been under review in the Legislative Council of the Ministry of Justice. Under a revision of the Civil Code proposed by the Legislative Council, the concept of 'latent defect' would be defined; whereas it remains undefined at present. The proposed definition is consistent with the Supreme Court decision, in that it emphasises the nature and quality of the subject matter that the parties had expected, in light of the agreement in question and the intent and purpose thereof, at the time of entering into the contract.

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Endnotes

(1) Article 570 states: "If there is any latent defect in the subject matter of a sale, the provisions of Article 566 shall apply *mutatis mutandis*; provided, however, that this shall not apply in cases of compulsory auction." Article 566(1) states: "In cases where the subject matter of the sale is encumbered with or for the purpose of a superficies, an emphyteusis, an easement, a right of retention or a pledge, if the buyer does not know the same and cannot achieve the purpose of the contract on account thereof, the buyer may cancel the contract. In such cases, if the contract cannot be cancelled, the buyer may only demand compensation for damages."

(2) According to Supreme Court precedent, a claim based on a vendor's warranty against defects shall be extinguished if not exercised for 10 years from the handover, unless there are exceptional circumstances. In this case, the Tokyo High Court acknowledged the exceptional circumstances (ie, that fluorine was generally recognised as a pollutant on March 28 2001 and therefore, before such date, the plaintiff could not have justifiably filed the complaint), and delayed the commencement date of the statute of limitations.

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