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Special Newsflash Japan – COVID-19 (2020/03) – Effect on Commercial Contracts

COVID-19 now forces domestic and foreign companies to assess if the performance of their ongoing contracts is still possible or cancellation needed, together with the various legal consequences arising therefrom. In this newsflash, we have addressed the following four imminent questions under Japanese law.

Q1: Do I have a cancellation right due to COVID-19 based on my contract?

This first depends on the provision(s) in the contract concerned. Many contracts stipulate cancellation rights of the party ordering goods or services in case of non-performance of a contractual obligation or in case of performance delays by the service provider/supplier. The service provider/supplier, on the other hand, is usually not entitled to cancel the contract in such case and may also be subject to damage compensation obligations vis-à-vis the party that ordered goods or services.

To balance the interests between the parties, international trade contracts often contain so-called *force majeure* clauses, stipulating that non-performance due to an unforeseeable or uncontrollable external event (sometimes also referred to as “act of god”) may trigger special legal rights and consequences as further defined in the contract. These can range from a one-sided extension of deadlines, or an adjustment of the contract, to liability exclusion or a right of cancellation for both parties of the contract. Depending on the wording of such clause COVID-19 may fall under the scope of *force majeure*.

Force majeure clauses often include specific examples of unforeseeable or uncontrollable events, such as natural disasters, strikes, riots, war, governmental measures or embargos etc., but often do not mention “infectious diseases” etc. specifically. If not expressly listed in the wording, diseases typically do not constitute a *force majeure* event, unless being covered by other listed events, such as “governmental measures” taken as a consequence of a disease, e.g. an order for all citizens to stay at home. Only if the *force majeure* wording includes terms, such as “infectious diseases”, “epidemics” etc., COVID-19 can be deemed to fall under the scope of the *force majeure* with the legal consequences described in the contract. Please note though that even if the *force majeure* clause expressly mentions “infectious disease” but does not define the threshold criteria, the legal consequences may not be triggered until the spread of the disease has reached a level that hinders the performance, for example in the case of lack of personnel due to high infection rates. This needs to be reviewed on a case by case basis.

If nothing in particular is stipulated in the contract, the general provisions of the applicable law apply. In this respect, please refer to Q3 below.

Q2: Does it make a difference at what time the contract was concluded?

Yes. *Force majeure* clauses do not apply to events that have already materialized prior to conclusion of the contract. Therefore, for contracts concluded after January 2020, and in particular after the WHO announcement dated 30 January 2020 declaring COVID-19 as a “Public Health Emergency of International Concern”, the parties may be deemed to have been aware of the risk of COVID-19 and thus concluded the contract deliberately, as the developing situation and the risks were already publicly known. In this case, the parties are in principle not permitted to exercise rights based on a *force majeure* clause stipulated in the contract unless the incident falls under another category of *force majeure*.

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Q3: What are the legal consequences under the law, if the contract does not contain a *force majeure* clause?

If no *force majeure* clause is included in the contract, or a *force majeure* clause is not applicable, the parties must refer to the statutory regulations provided under the applicable laws.

- Japan, Germany and many other European countries have enacted the *UN Convention on the International Sale of Goods (CISG)*. CISG is applicable to international commercial sales and purchase contracts, i.e. when the purchaser and seller have their seat in two different membership states, unless it has been explicitly excluded. If applicable, CISG (Article 79) provides for a *force majeure* clause, stipulating the exemption of a party from liability for non-performance due to reasons beyond its control which could not reasonably have been expected to be taken into account. Based thereon, damage compensation claims against such party may be excluded.

If the CISG is excluded, the Japanese Civil Code does not include any specific provisions related to the cancellation of contracts based on *force majeure*, so that the general provisions related to non-performance apply.

- Under the current Japanese Civil Code, the ordering party of a purchase agreement, service agreement or works agreement is entitled to cancel unilaterally if (i) the supplier is in delay with the delivery and also does not fulfill its obligations within an additional grace period determined by the ordering party (or refuses performance), (ii) the supplier is in delay with the delivery and the purpose of the agreement can no longer be achieved, or (iii) the performance has become impossible. In all these cases, the cancellation requires in addition that the failure to perform is attributable to the supplier.

In case of a cancellation by the ordering party based on the above, the supplier principally loses its entitlement to the purchase price, service fees, etc., and has to refund any already received amounts to the extent delivery or services have not yet been made or provided. If there is any damage caused by such non-performance due to the supplier's fault, e.g. because it has failed to take adequate measures to ensure its production/delivery/procurement capacity, the supplier may be required to pay damage compensation to the ordering party. The scope of the compensation will depend on the situation of the individual case.

Under the amended Civil Code which will be applicable to agreements executed on or after 1 April 2020, the ordering party also has a cancellation right when the performance has become impossible and the impossibility is not attributable to either party. In such case, the supplier will be released from its delivery/supply obligations, but loses its right to the purchase price/service fees.

With respect to the above, it needs to be considered that under Japanese law, an impossibility of the performance due to COVID-19 only applies in exceptional cases. One example could be, e.g., the implementation of import or export restrictions for an unforeseeable term. Increased production costs, the requirement to change vendors, etc. however usually do not constitute an impossibility for the supplier/service provider, which principally has to make all reasonable efforts to deliver the goods or services ordered. Therefore, in order to avoid such risk of default liabilities, it is recommended that the supplier/service provider: (i) timely informs its customers of the status of any performance delay due to COVID-19 and/or a forecast of its performance; (ii) considers the possibility of achieving procurement by other means; (iii) proposes to its customers any other similar or replacement products/services which may be procured earlier; and (iv) considers any other possible correspondence with its customers.

Q4: How should *force majeure* clauses be (re-)designed in the present situation?

In light of the current situation, taking into account COVID-19, companies should first review the existing *force majeure* clauses, if any, in their contracts. If in doubt about the scope of application of such clause, confirmation of the practical and legal consequences arising from COVID-19 should be sought with the contractual partner, as the COVID-19 event is already materializing and no longer unforeseeable as such.

For new contracts, inclusion of a *force majeure* clauses listing "infectious diseases", "epidemics" or "local disease outbreaks" in general and COVID-19 in particular can be nevertheless recommendable. This will automatically result in a discussion by the parties of the specific criteria triggering such event and the legal consequences resulting therefrom, which should all be addressed in detail in the contract as such scenario has at least become a not too remote possibility. In order to define the threshold criteria for a COVID-19 driven *force majeure* event, it is recommendable to use official warnings by governmental or international authorities, such as a WHO declaration of COVID-19 as a "public health emergency of international concern" or an official (travel) warning by the Japanese Ministry of Health etc. Moreover, the legal consequences should be thoroughly considered and negotiated by the parties to find a balanced solution alleviating their risks and burdens.

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