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New York Law Considerations for Japanese Companies Facing Supply Chain Disruptions Due to the COVID-19 Pandemic

Client Advisories

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March 18, 2020 - As the COVID-19 virus continues to spread, Japanese companies may experience difficulties obtaining parts and materials from their suppliers. This, in turn, may put Japanese sellers at risk of missing delivery obligations to their own customers, including those in the United States. For Japanese sellers facing this situation, we highlight certain issues to consider under New York law.

Force Majeure

A Japanese seller at risk of missing a delivery obligation may be able to invoke the doctrine of force majeure to excuse or delay its performance. Force majeure – which means literally, a superior force – refers to an event beyond the control of the parties that prevents the performance of a contract. *See Beardslee v. Inflection Energy, LLC*, 25 N.Y.3d 150, 154 (2015). A force majeure event is typically an "Act of God," such as an earthquake or a flood, or a human event, such as a war or a riot. Japanese sellers seeking to invoke force majeure based on the COVID-19 pandemic should consider the following issues.

1. Whether the Contract Has a Force Majeure Clause

A Japanese seller seeking to assert a force majeure defense should first check to see if there is a force majeure clause in the contract. Unlike Japan and certain U.S. jurisdictions, such as California, New York has not codified force majeure (other than in its Uniform Commercial Code – see below), and New York courts will not read a force majeure provision into a contract that does not explicitly have one.

2. Whether the COVID-19 Disruption Is a Force Majeure Event

Whether the force majeure clause applies will depend in the first instance on how the clause defines a force majeure event. Some force majeure clauses specifically state that the failure of a critical supplier will excuse performance and, in the event of a supply chain disruption, this type of language usually provides the strongest basis for a force majeure defense.

A COVID-19 supply disruption may fall under other terms, including defined terms relating to medical contagions, such as "epidemic," "pandemic," or perhaps "quarantine." There is also an argument that COVID-19 constitutes an "Act of God." Moreover, if the virus itself does not qualify as a force majeure event, the effects of the virus may nevertheless fall under typical force majeure terms such as an "act of government" or an "interruption in transportation systems."

Many force majeure clauses also contain a catch-all provision for "other acts" beyond the control of the parties. However, New York courts construe these provisions narrowly and typically enforce them only when the claimed event is similar to the events specifically listed in the force majeure clause. *E.g., Kel Kim Corp. v Cent. Markets, Inc.*, 70 N.Y.2d 900, 903 (1987) ("the general words are not to be given expansive meaning; they are confined to things of the same kind or nature as the particular matters mentioned").

3. Whether the COVID-19 Disruption Prevents the Seller's Performance

To succeed on a force majeure claim, the Japanese seller must show that the force majeure event prevented its performance. This may be tricky if the COVID-19 event primarily affects a supplier, rather than the Japanese seller itself. In such a circumstance, the Japanese seller may still be able to perform if it can obtain parts or materials from another supplier. *See Hess Corp. v. ENI Petroleum US, LLC*, 435 N.J. Super. 39, 51 (N.J. Super. Ct. App. Div. 4 2014) (applying New York law; rejecting a force majeure defense where the contract did not specify a particular pipeline and the seller could have used an alternative).

Moreover, the force majeure event must actually prevent performance, not just make it inconvenient or more expensive. Financial hardship alone does not generally excuse performance, and some force majeure clauses require reasonable efforts to exhaust alternatives. Thus, in the event of a COVID-19 supply disruption, a Japanese seller may have to seek alternative sources of supplies, even if it must pay more for those supplies.

4. Whether Performance Is Excused Permanently or Temporarily

Another issue concerns the duration of the force majeure disruption. The force majeure clause may not excuse performance permanently, but only while the force majeure event lasts. At present, no one knows how long the COVID-19 pandemic may last or, once the number of cases starts to recede, how quickly suppliers will return to full capacity. This may lead to uncertainty, disputes and, if the force majeure clause permits, the termination of the contract.

5. Whether There Are Technical Requirements

Finally, Japanese sellers should review their force majeure clauses to determine what they have to do to assert the defense. Most force majeure clauses require the party invoking the clause to give prompt written notice to the other party. Many clauses require that the party invoking the clause make reasonable efforts to mitigate delays or damages. Additionally, some clauses require that the party invoking the clause keep performing its non-excused obligations; something that a Japanese seller should do anyway to avoid claims that it is in breach of the contract.

Force Majeure-Like Defenses

1. Uniform Commercial Code

A Japanese seller facing supply chain disruptions may also be able to use other, force majeure-like defenses. In contracts for the sale of goods, New York's Uniform Commercial Code (the "UCC") provides a force majeure-like defense when performance becomes commercially impracticable.

UCC § 2-615(a) excuses a seller from delays or non-delivery when its performance "has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with an applicable foreign or domestic government regulation." Importantly, the UCC provides a defense when performance has become "commercially impracticable"; performance does not have to be impossible for the UCC to apply.

In practice, the UCC defense is most likely to succeed when the contract specifies, or it is clear from the circumstances, that the affected supplier was essential to the Japanese seller's performance. However, the Japanese seller must still show that the non-occurrence of a supply chain disruption was a basic assumption of the contract, that the disruption was unforeseeable, and that it made performance commercially impracticable.

The UCC also imposes requirements on the seller. Under UCC § 2-615 if the supply chain disruption were to "affect only a part of the seller's capacity to perform," the Japanese seller must allocate production and deliveries among its customers in a "fair and reasonable manner." (UCC § 2-615(b).) In addition, "[t]he seller must notify the buyer seasonably that there will be delay or non-delivery and, when allocation is required [...], of the estimated quota thus made available for the buyer." (UCC § 2-615(c).)

2. CISG

The United Nations Convention on Contracts for the International Sale of Goods ("CISG") also provides a force majeure defense. The CISG applies to international transactions regarding the sale of goods, unless the contracting parties opt out and select another governing law. When the CISG applies, it excuses a party's failure to perform due to an impediment beyond its control, if the party "could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it, or its consequences." (Article 79(1).) In the event of a COVID-19 supply chain disruption, the CISG may excuse a Japanese seller's performance if the Japanese seller could not avoid or overcome the lack of parts or materials from its affected suppliers.

3. Common Law Doctrines

Finally, a Japanese company might avoid liability based on the common law doctrines of impossibility or frustration of purpose. New York courts interpret these doctrines narrowly, excusing performance only in extreme cases. However, depending on the circumstances, it may be possible to argue that a COVID-19 disruption rendered performance impossible or frustrated the purpose of the contract.

The doctrine of impossibility excuses performance when an unanticipated event – i.e., an event that the parties could not guard against in the contract – destroys the subject matter of the contract or the means of performance, making performance impossible. For example, the doctrine of impossibility would excuse an obligation to renovate a house if the house burned down before the work could start.

The doctrine of frustration of purpose excuses performance when an unforeseeable event frustrates the principal purpose of a contract. Under New York law, the frustrated purpose must be so completely the basis of the contract that without it, the transaction would have made little sense. *See Nitro Powder Co. v. Agency of Canadian*

Car & Foundry Co., 233 N.Y. 294, 298 (1922) (holding that the doctrine of frustration of purpose excused the delivery of explosive materials where the government had expropriated the materials).

Conclusion

If a COVID-19 supply chain disruption threatens a Japanese seller's ability to perform, the Japanese seller should carefully review its sales contracts and determine what legal defenses might apply. Given the uncertainty surrounding the virus, there may not be clear or definite answers, but this only makes it more important to mitigate risks and anticipate potential disputes.

Hughes Hubbard's Japan practice group has decades of experience assisting Japanese companies with contractual issues and disputes in the United States. We can provide specific advice on COVID-19 issues, force majeure, and the applicable law.

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