THE CONSTRUCTION DISPUTES LAW REVIEW

Second Edition

Editor
Hamish Lal

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For further information please contact Nick.Barette@thelawreviews.co.uk

Editor
Hamish Lal

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JAPAN

Kaori Sugimoto and Naoki Iguchi[1]

I INTRODUCTION

Before 2020, when the 2020 Tokyo Summer Olympics was scheduled to take place, the number and volume of construction and infrastructure projects in Japan had been increasing. However, due to the covid-19 pandemic, many Japanese construction companies were forced to restrict their activities during certain periods. Also, due to the recent depreciation of the Japanese yen and the price increases of construction materials in 2022, many Japanese companies in the construction industry are struggling to continue with ongoing construction projects in Japan. On the other hand, inbound projects (i.e., where foreign companies make investments in Japan by constructing certain facilities in Japan) are increasing, such as the construction of a data centre and manufacturing plant.

Another trend is renewable projects in Japan. According to the Sixth Energy Basic Plan approved by the Cabinet in October 2021, the Japanese government aims to realise its target of 36 per cent to 38 per cent of all power in Japan being from renewable sources. In order to achieve this target, the Japanese government is promoting a variety of renewable energy projects on, for example, solar power, wind power, biomass and geothermal power.

So far, many of the construction disputes referred to the courts relate to defects in housing. However, as it is expected that more foreign investors or players will participate in construction and infrastructure projects in Japan, a variety of construction disputes associated with these projects will likely increase.

II YEAR IN REVIEW

A recent noteworthy construction dispute relates to the owner's termination of a construction contract due to the impossibility of completion.[2] A summary of the case and judgment is as follows.

A major Japanese construction company (the defendant) undertook a public construction project for an ash melting plant system ordered by Kyoto City (the plaintiff). The defendant completed the installation works and the first commissioning. During the second commissioning, failures occurred (e.g., damage to the refractory brick, emission of dioxin and other chemicals exceeding safety levels, and clogging dust), and thus the defendant stopped the second commissioning. The plaintiff determined that the completion of the second commissioning by the completion date was no longer possible and terminated the

1 Kaori Sugimoto is counsel and Naoki Iguchi is a partner at Nagashima Ohno & Tsunematsu.

2 Judgment of the Kyoto District Court dated 27 May 2016.

construction contract due to (1) the defendant's breach of contract and (2) impossibility. The plaintiff demanded that the constructed portions be removed, as well as compensation for damages.

The Kyoto District Court held that the plaintiff's termination of the contract was invalid and did not grant its claim. As for point (1), the Kyoto District Court determined that, under the good faith principle, the owner owed an obligation to cooperate with the defendant contractor for the contractor to recommence the commissioning, and since the owner breached such obligation, it constituted 'repudiation', and thus the contractor had not breached its obligations under the construction contract. As for point (2), the Kyoto District Court determined that, under the circumstances, there was a possibility that the contractor could complete the second commissioning, and thus the performance of the contract had not become impossible.

Kyoto City appealed the case to the Osaka High Court. In the appellate proceeding, the parties entered into a settlement and the defendant agreed to pay ¥154 million.[3] Therefore, there is no publicly available judgment at the moment determining the issue of whether contractors should remove all the completed portions of the works, which would impose a significant burden on construction companies.

III COURTS AND PROCEDURE

In Japan, most of the construction disputes relate to defects in housing. Since the parties (including Japanese entities) to construction contracts for large infrastructure projects (particularly for international projects) tend to include an arbitration agreement, the disputes relating to such projects are not, in general, referred to Japanese courts. Japanese courts tend to respect the parties' autonomy so tend to be reluctant to intervene in or supervise arbitration proceedings conducted in Japan.

i Fora

In Japan, the courts hear construction disputes. No special and separate construction court exists. However, the Tokyo and Osaka District Courts have a building dispute department. Since the disputes relating to defects in housings are common in urbanised areas, these courts have established a special department to handle such disputes. In those departments, construction specialists called expert committee members advise, assist and support the judge in preparatory proceedings, witness examinations and conciliation procedures for construction disputes.

Apart from small claims, the district courts are the first instance courts for construction disputes. Either party that loses the case at the district court may file an appeal to the High Court. The Supreme Court is the ultimate judicial organ. The Japanese Constitution does not allow any kind of court that is not included in the aforementioned hierarchy.

3 Based on the fact that the contractor paid a certain amount for settlement to Kyoto City, it may be assumed that the Osaka High Court might have considered that the termination by Kyoto City was valid and disclosed it to the defendant.

ii Jurisdiction

General rules on jurisdiction governing all types of disputes also apply to construction disputes. The Japanese Code of Civil Procedure (Act No. 109 of 1996) (CCP) provides that the general forum is determined by the place of residence of the defendant (in the case of an individual) or the location of its principal office or place of business of the defendant (in the case of juridical persons or other entities) (Article 4, Paragraph 1 of the CCP).

The Arbitration Act (Act No. 138 of 2003) provides that if a claim subject to an arbitration agreement is filed, the court, in principle, must dismiss such action without prejudice (Article 14, Paragraph 1 of the Arbitration Act). There are some case precedents where the court dismissed the action relating to construction disputes due to an arbitration agreement in the applicable construction contract (e.g., Judgment No. 2625 (*wa*) 2004 of the Nagoya District Court dated 28 September 2005).

The principle requiring mediation prior to filing an action (e.g., Article 256 of the Domestic Relations Case Procedure Act (Act No. 52 of 2011)) does not apply to construction disputes. Accordingly, a party is not legally required to file an action to the court to settle a construction dispute without resorting to a mediation. However, if there is a provision in a contract requiring an attempt at mediation prior to filing an action but a party directly files an action to the court, it is likely that the court will dismiss the case due to lack of jurisdiction.

iii Procedural rules

General procedural rules governing all types of disputes also apply to construction disputes. The CCP provides the following procedures.

a The court conducts preparatory proceedings to clarify and ascertain the material issues and evidence. In 2020, it became possible to hold preparatory proceedings via web conferences.

b Witness examination is conducted focusing on the material issues identified in the preparatory proceedings.

c The court is not usually inquisitorial in respect of fact finding. The court relies on the parties to make arguments and obtain evidence.

In the Tokyo District Court and the Osaka District Court, which each have a department specialised in construction disputes, expert committee members who are construction specialists assist and support the judge. Also, the parties in general are required to submit a list of matters subject to dispute (e.g., a list of defects, list of additional works, list of the amounts for the completed works and list of chronology) to facilitate the clarification and ascertainment of the material issues and evidence.

iv Evidence

As stated above, it is the parties' responsibility to collect and submit the evidence. Unlike the common law jurisdictions, in Japan, document discovery or disclosure is quite limited. A party may file a petition to the court to order the other party or a third party to produce documents (Article 221 of the CCP), but the number of case precedents granting such petitions is limited and, even under the case precedents granting such petitions, the scope of production of documents ordered is also quite limited.

IV ALTERNATIVE DISPUTE RESOLUTION

There are some alternative dispute resolution (ADR) methods: arbitration, mediation and other ADR methods. The advantages and disadvantages of each method are summarised below.

i Statutory adjudication

'Statutory adjudication' means a form of the dispute resolution procedure called a 'pay now, argue later' mechanism, which is adopted in most of the common law jurisdictions. There is no statute in Japan that provides the mechanism equivalent to the statutory adjudication. This means that, if there is a dispute relating to payments, the contractor in general may not receive the payments until it obtains the judgment ordering the owner to make payments to the contractor.

ii Arbitration

Japan is a member state of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards.[4] Furthermore, Japan enacted the Arbitration Act (Act No. 138 of 2003), which is modelled on the 1985 United Nations Commission on International Trade Law (UNCITRAL) Model Law on International Commercial Arbitration (the UNCITRAL Model Law), but has not adopted its 2006 amendments. In addition, the Supreme Court Rules on Procedures of Arbitration Related Cases (Supreme Court Rules No. 27 of 2003) provide the specific procedural rules applicable to court cases relating to arbitration proceedings. Although arbitration is not a popular method of dispute resolution for domestic disputes, Japanese courts have sought to take an arbitration-friendly position.

Recently, the Japanese government has welcomed and aims to facilitate international arbitration in Japan.[5] In December 2017, the Japan International Arbitration Center Establishment Association was founded (soon thereafter renamed the Japan International Dispute Resolution Center Operating Association) (the Association). With the support of the Association, the Japan International Dispute Resolution Center was established in Osaka in February 2018 and in Tokyo in April 2020. The Japan Commercial Arbitration Association (JCAA) is the main arbitration institution in Japan that administers international arbitration cases in Japan. The JCAA offers the following three sets of arbitration rules. Each of the rules has its own particular features. The parties may choose the most suitable set of rules for their dispute, depending on their needs and preferences:

4 Convention on the Recognition and Enforcement of Foreign Arbitral Awards, opened for signature 10 June 1958, 330 UNTS 38 (entered into force 7 June 1959).

5 In June 2017, the Basic Policy on Economic and Fiscal Management and Reform 2017 (the 2017 Policy) was approved by the Cabinet of Japan. It aimed to 'develop a foundation to activate international arbitration' in Japan as one of the important policies of the Japanese government. Responding to the 2017 Policy, in September 2017, the Liaison Conference of Relevant Ministries and Agencies for Stimulating International Arbitration was established within the Japanese government with the aim of encouraging cooperation among relevant government organisations and to consider and promote comprehensive and efficient approaches to develop the necessary foundation for the expansion of international arbitration in Japan. Since December 2020, the Study Group for Reformation of the Arbitration Legal Framework, in which the Ministry of Justice and the Japanese Supreme Court are also involved, has continued the discussions. In July 2020, the Study Group published the Report of the Study Group for Reformation of the Arbitration Legal Framework, the main subject of which is whether the interim measures issued by the tribunal may be enforced by the Japanese court, irrespective of the country in which they were issued.

a the UNCITRAL Arbitration Rules and the Administrative Rules for UNCITRAL Arbitration;
b the Commercial Arbitration Rules (2019); and
c the Interactive Arbitration Rules (2019).

Many of the commercial disputes involving Japanese parties are also referred to arbitration administered by the International Chamber of Commerce and the Singapore International Arbitration Centre.

The Arbitration Act allows the court to set aside an arbitral award or reject the recognition and enforcement of an arbitral award. However, in order to respect the parties' autonomy, the grounds for setting aside an arbitral award and for the rejection of recognition and enforcement of an arbitral award under the Arbitration Act are limited, generally corresponding to the grounds set out under the 1985 Model Law as shown in the table below.

Table 1: Grounds for setting aside an arbitral award and grounds for the rejection of recognition and enforcement of an arbitral award under the Arbitration Act

	Grounds for setting aside	Grounds for rejection of recognition and enforcement
1	The arbitration agreement is not valid due to the limited capacity of a party.	The arbitration agreement is not valid due to the limited capacity of a party.
2	The arbitration agreement is not valid on grounds other than the limited capacity of a party pursuant to the laws and regulations designated by the agreement of the parties as those that should be applied to the arbitration agreement (if said designation has not been made, Japanese laws and regulations).	The arbitration agreement is not valid on grounds other than the limited capacity of a party pursuant to the laws and regulations designated by the agreement of the parties as those that should be applied to the arbitration agreement (if said designation has not been made, the laws and regulations of the country to which the place of arbitration belongs).
3	The petitioner did not receive the notice required under Japanese laws and regulations (if the parties have reached an agreement on the matters concerning the provisions unrelated to public order in such laws and regulations, said agreement) in the procedure of appointing arbitrators or in the arbitration procedure.	The party did not receive the notice required under the laws and regulations of the country to which the place of arbitration belongs (if the parties have reached an agreement on the matters concerning the provisions unrelated to public order in such laws and regulations, said agreement) in the procedure of appointing arbitrators or in the arbitration procedure.
4	The petitioner was unable to make its defence in the arbitration procedure.	The party was unable to make its defence in the arbitration procedure.
5	The arbitral award contains a decision on matters beyond the scope of the arbitration agreement or of the petition presented in the arbitration procedure.	The arbitral award contains a decision on matters beyond the scope of the arbitration agreement or of a petition in the arbitration procedure.
6	The composition of the arbitral tribunal or the arbitration procedure is in violation of Japanese laws and regulations (if the parties have reached an agreement on the matters concerning the provisions unrelated to public order in such laws and regulations, said agreement).	The composition of the arbitral tribunal or the arbitration procedure is in violation of the laws and regulations of the country to which the place of arbitration belongs (if the parties have reached an agreement on the matters concerning the provisions unrelated to public order in said laws and regulations, said agreement).
7	—	According to the laws and regulations of the country to which the place of arbitration belongs (if the laws and regulations applied to the arbitration procedure are laws and regulations of a country other than the country to which the place of arbitration belongs, said other country), the arbitral award is not final and binding, or the arbitral award has been set aside or its effect has been suspended by a judicial body of that country.
8	A petition filed in the arbitration procedure is concerned with a dispute that may not be subject to an arbitration agreement pursuant to the provisions of Japanese laws and regulations.	The petition filed in the arbitration procedure is concerned with a dispute that may not be subject to an arbitration agreement pursuant to the provisions of Japanese laws and regulations.
9	The content of the arbitral award is contrary to public policy in Japan.	The content of the arbitral award is contrary to public policy in Japan

iii Mediation

The Tokyo and Osaka District Courts have a building dispute department. Once a claim is filed, the department assigns a mediation panel member from its private list to encourage the parties to settle the dispute amicably. The judges in charge of the case are the only members of the panel. Parties are not entitled to designate their own panel members. Usually, listed members are retired architects, retired employees of construction or manufacturing companies and private practitioners. Since the majority of the claims are defect-related matters, the list does not include delay experts or quantum surveyors. In reality, delay experts and quantum surveyors are not chartered professions in Japan.

iv Other ADR methods

The Construction Business Act (Act No. 100 of 1949) (CBA) establishes the construction dispute adjudication board (KFSK) as a government-sponsored alternative dispute resolution body.[6] There are 47 local KFSKs and a single central (national) KFSK in Tokyo. The relevant jurisdiction in each case is determined by the registered office of the claimant or the construction site in question. Central and local governments appoint a panel of mediator-arbitrators. The KFSK is formulated mainly for domestic disputes. Around 40 cases were registered at the central KFSK in 2019. However, it should be noted that the KFSK strongly recommends amicable settlement rather than an issuance of an award based on adversarial procedures. The central KFSK issued three awards based on adversarial procedures in 2019 and settled 16 cases with mediation and conciliation during the same period of time. The KFSK's procedure is significantly different from that of international arbitration — notably, there is no party-appointed arbitrator or mediator, no document disclosure and almost no witness examinations.

V CONSTRUCTION CONTRACTS

i Public procurement

The Public Account Act (Act No. 35 of 1947) (in relation to procurement by central government) and the Local Autonomy Act (Act No. 67 of 1947) (in relation to procurement by local government) refer to the permitted forms and procedures for public procurement (i.e., open competitive tenders, selective tenders and negotiated contracts).

Criminal sanctions are applicable to persons or entities who commit serious violations of procurement procedures (e.g., bribery or graft, cartel and unfair methods of competition, etc.). However, under the Criminal Code (Act No. 45 of 1907) or the Act on Prohibition of Private Monopolization and Maintenance of Fair Trade (Act No. 54 of 1947), there is no specific cause of action available to losing bidders that can stop the procurement procedure or the conclusion of the contract.

In addition to the above statutes, the Act for Promoting Proper Tendering and Contracting for Public Works (Act No. 127 of 2000) (the Proper Tendering Act) was enacted to ensure (1) information disclosure, (2) sanctions on unfair conducts, (3) the bidder's obligation to prepare details or breakdowns of the bid, and (4) the government's obligation to prepare guidelines. Under the Proper Tendering Act, the central government encourages

6 CBA (n 33) Article 25.

public project owners to prepare claim procedures for losing bidders should they identify any problems in the bidding process. However, it should be noted that this claims procedure is yet to be legally guaranteed by national legislation.

ii Contract interpretation

The way of construing contracts differs fundamentally from the approach in common law, which relies on the parol evidence rule, according to which extrinsic evidence is inadmissible to vary a written contract that is intended to be a complete and final expression of the parties' agreement.

What is written in the contract constitutes the main subject of the interpretation of contract terms. But, since the terms of the contract can be implied by law, custom and fact, there is much room for the intervention of a judge in the interpretation of a contract. Especially in cases where a contract contains a clause that the judge deems to be unjust or unreasonable, the court will not hesitate to rely on normative considerations external to the contract. The contract will be viewed holistically, taking into account all relevant circumstances. Thus, even a clearly written clause can be ignored by courts.

VI COMMON SUBSTANTIVE ISSUES AND REMEDIES

i Time bars as condition precedent to entitlement

At common law, a time bar under a contract is interpreted strictly. More specifically, if a contractor fails to submit a claim within the period specified in the contract, the contractor loses its entitlement to make a claim (e.g., Clause 20.1 of the International Federation of Consulting Engineers 1999 and 2017 contracts). However, under Japanese law, time bars are not interpreted so strictly.

In Japan, some construction contracts do not provide a time period during which a contractor is required to make a claim. For example, the General Conditions for Construction Contracts (GCCC), published by a committee of architects and contractors, and the ENAA General Conditions for Domestic Plant Construction Works (ENAA-Domestic) (last amended in 2020) published by the Engineering Advancement Association (ENAA) do not stipulate a specific time period within which the contractor must make a claim.

Instead, a notice period is often provided for in construction contracts in Japan. However, even if a contractor fails to provide a notification within such period, there are no cases in which Japanese courts have held that the contractor consequently loses its right to make a claim.

The Civil Code provides a one-year notice period during which an owner is required to provide notice after it becomes aware of non-compliance.[7] After this period, the owner may not demand further performance, reduction of remuneration, compensation for damages and termination.[8] Japanese courts have yet to determine whether an owner loses the right to make such demands when it fails to provide notice within one year.

7 ibid., Article 637(I).

8 ibid.

ii Right to payment for variations and varied scope of work

The CBA provides formal requirements for variations in a construction project. It stipulates that (1) the parties to a construction contract are required to stipulate certain understandings (including the amount of the contract price) in writing, sign or affix a registered seal impression on such written agreement, and exchange such written agreement (CBA, Article 19), and (2) any changes to those understandings stipulated in the signed or sealed written agreement must also be specified in a written document that is signed or sealed by the parties and exchanged in the same manner (CBA, Article 19-2).

The CBA empowers the authority only to regulate and sanction construction companies and does not invalidate contract provisions. From a private law perspective, there are no clear guidelines on whether the owner is entitled to issue variations that directly contradict the contract and the contractor's rights; however, parties are free to agree to a particular change or variation mechanism in the contract. The GCCC explicitly provides that the owner is entitled to order additional or extra works or changes in the works and, if such order is issued, the contractor can make a claim for the necessary adjustment to the contract price.

In cases where the parties had not agreed on the price of additional work, there are many case precedents where the Japanese court awarded the payment of compensation or costs for such additional work by the contractor (1) by finding an express agreement on the price,[9] (2) by finding an implied agreement on the price[10] or (3) based on Article 512 of the Commercial Code (Act No. 48 of 1899).[11,12]

iii Concurrent delay

There is no specific provision or court precedent in Japan that addresses whether and to what extent the contractor is entitled to an extension of time or additional costs, or both, in the case of concurrent delay. Unless otherwise stipulated in a contract, the court or arbitrator will consider the owner's delay in determining the damage amounts claimed by the contractor through Article 130, Paragraph 1 of the Civil Code[13] (which provides the concept equivalent to the prevention principle), comparative fault or the good faith principle.

The GCCC and the ENAA-Domestic entitle the contractor to an extension of time in the case of concurrent delay but does not entitle the contractor to receive additional costs.

9 Judgment of the Tokyo District Court dated 6 August 2015, judgment of the Tokyo District Court dated 14 January 2016, judgment of the Tokyo District Court dated 24 February 2016, judgment of the Tokyo District Court dated 24 March 2016, judgment of the Tokyo District Court dated 25 March 2016 (2015 (*wa*) No. 1036, 2015 (*wa*) No. 2154), judgment of the Nagano District Court dated 28 December 2016 and judgment of the Tokyo District Court dated 13 August 2017.

10 Judgment of the Nagoya High Court dated 18 March 2002, judgment of the Tokyo District Court dated 11 October 2007 and judgment of the Tokyo District Court dated 23 March 2016.

11 Article 512 of the Commercial Code provides that 'When a merchant has conducted any act for another person within the scope of his/her business, he/she may claim a reasonable remuneration.' Under such Article, the Contractor may claim 'reasonable remuneration' from the owner if the contractor performs work for the owner without executing the contract (*negotiorum gestio* in legal terms).

12 Judgment of the Tokyo District Court dated 16 March 2016 and judgment of the Tokyo District Court dated 13 July 2016.

13 Article 130, Paragraph 1 of the Civil Code provides that 'If a party that would suffer a detriment as a result of the fulfillment of a condition intentionally prevents the fulfillment of that condition, the counterparty may deem that the condition has been fulfilled.'

iv Suspension and termination

The Civil Code does not provide any provisions relating to suspensions. However, the parties to the construction contracts tend to agree to include the provision relating to suspensions. The GCCC and the ENAA-Domestic entitle both the owner and the contractor to suspend the works upon the occurrence of any of the specified events.

With regard to termination, as a general rule for all types of contract, either party may terminate the contract upon the other party's non-performance of the obligation[14] (i.e., breach of contract in common law terminology). Generally, prior notice is necessary to give a non-performing obligor (i.e., the breaching party) an opportunity to cure its non-performance or breach (Civil Code, Article 542). However, if non-performance of the obligation is caused by the grounds attributable to the obligee (i.e., the non-breaching party), the obligee may not terminate the contract (Civil Code, Article 543).

Additionally, as a special rule for construction contracts, the owner can terminate the contract 'at any time whilst a contractor has not completed the work by paying compensation for loss or damage' (Civil Code, Article 641). This right is given to the owner because it would be useless to compel an owner to receive work that is no longer necessary. A contractor, on the contrary, may terminate the contract before completion of the work if an owner receives an order of commencement of bankruptcy proceedings (Civil Code, Article 642). The contractor can thus avoid the risk of not being paid before completing the construction.

v Penalties and liquidated damages

If a contractor fails to complete the works by the time for completion specified in the construction contract, such a delay constitutes non-performance of an obligation.

When a contractor's delay is caused by reasons attributable to the contractor, the contractor is obliged to compensate the damages incurred by the owner as a result of the delay.[15] Also, even if the contractor's delay is caused by reasons not attributable to the contractor, if the delay is material from a 'commercial social norm' perspective, the owner is entitled to terminate the contract with notice.[16]

Under the Civil Code, in principle, the scope of damages is determined according to the criteria of 'ordinary loss' and 'special loss'.[17] For the latter type of loss, the amount of which can exceed that of the former, an owner must prove foreseeability to be compensated.[18] Regardless of this general rule, the parties may agree that the contractor will pay liquidated damages in the case of delay.[19]

There is no specific threshold under Japanese law as to the amount and proportion of liquidated damages. However, an excessive amount or proportion of liquidated damages will be invalid and unenforceable due to a breach of public policy.

14 In addition to the non-performance of the obligations, 'impossibility' to perform the obligations is another cause for termination (Civil Code, Article 541).

15 ibid., Article 415(I).

16 ibid., Article 541.

17 ibid., Article 416(I).

18 ibid., Article 416(II).

19 ibid., Article 420(I).

Unlike at common law, in Japan, a penalty provision does not become invalid and unenforceable by the mere reason that it is a penalty provision. A penalty provision is deemed to be a liquidated damages provision and thus is valid unless it is contrary to public policy.[20]

Even when a contractor is obliged to pay liquidated damages, the contractor can claim a reduction of the amount if the owner is contributorily negligent.[21]

vi Defects correction and liabilities

Under the Civil Code before the amendment in 2020, if a 'latent defect' is found in the work completed by a contractor and it becomes difficult to achieve the objectives of the contract due to such a latent defect, the owner may terminate the contract and claim compensation for damages. It is necessary for the owner to have been unaware of the existence of the defect at the time of delivery in order to terminate the contract and claim compensation for damages from the contractor (Article 570 of the old Civil Code).

Under the amended Civil Code, the concept of latent defects was eliminated. Instead, the new concept of 'non-compliance' was introduced (Articles 562 to 564 of the reformed Civil Code). If work done by the contractor does not conform to the terms of the contract, there is non-performance by the contractor regarding his or her obligations under the contract. Regardless of whether the owner was aware of the existence of the defect, if there is non-compliance in the works at the time of delivery, the owner may seek special remedies, such as remedial work, replacement and a reduction in the contract price.

vii Bonds and guarantees

There is no statutory law that explicitly regulates bonds or guarantees. There are some court cases relating to a bank guarantee issued by a Japanese bank for a foreign beneficiary that granted a petition for a preliminary injunction prohibiting a beneficiary from exercising the guarantee and the issuing bank from making payments to a beneficiary under certain circumstances.

viii Overall caps on liability

As a default rule, the scope of damages to be compensated by a breaching party includes ordinary damages as well as special damages to the extent that the parties foresaw or should have foreseen such special damages.[22] However, under the principle of 'freedom of contract', the parties may agree to a different term in the contract as to the parties' liability.

In a construction contract, an owner and a contractor sometimes limit the scope of damages to be compensated by a breaching party to direct damages while excluding indirect damages, consequential damages, incidental damages and loss of profit. For example, in the ENAA-Domestic, lost profit, loss of business, loss of time, loss of raw materials or production materials, indirect damages and any other comparable damages are excluded from the scope of damages.

The parties also sometimes set a cap on the damage to be compensated by a breaching party (including liquidated damages). The capped amount depends on factors including the project, the parties, the works and the contract price. In some projects, the parties may agree to set a contract price as a cap on the damages to be compensated by a breaching party.

20 ibid., Article 420(III).

21 Supreme Court of Japan, 1990(O)1456, 21 April 1994, reported in 172 Minshu, 379.

22 Civil Code (n 2) Article 416.

The parties may agree not to enforce a limitation of liability clause in a case where the damage is caused by wilful conduct or gross negligence of a breaching party. This is provided for in the ENAA-Domestic.

Under Japanese law, a defaulting party may be liable in tort as well as for breach of contract. For example, if there is a defect in the works, an owner may demand compensation for damages incurred due to such a defect by arguing that the contractor has not only breached the contract but also committed a tort. In order for a contractor to avoid tortious liability, the contractor should make sure that a limitation of liability clause excludes liability for not only breach of contract but also tort.

VII OUTLOOK

As stated in Section I, as it is expected that more foreign investors or players will participate in construction and infrastructure projects in Japan, a variety of construction disputes that have never been referred to the Japanese courts will likely increase and will lead to the courts' determination on those issues.

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