The Effect of the Disaster in Japan on Contractual Obligations in the United States

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Our thoughts go out to those affected by the events that took place in Japan on March 11, 2011. As a result of these disasters, and the resulting nuclear crisis, we have received a number of inquiries from clients regarding their contractual obligations. Recent news reports confirm that manufacturers are facing disruptions to their supply chains due to these events. This Client Advisory will outline some legal concepts that may offer a basis to obtain relief under U.S. law from those contractual obligations while Japan works toward recovery.

Force Majeure

If you are having difficulty performing your obligations under a contract due to the Japan disasters, you should first determine whether that contract contains a force majeure clause. A force majeure clause allows a party to suspend or terminate the performance of its obligations under a contract due to the occurrence of an event beyond its control, without being liable for a breach of the contract because of such non-performance. The language will typically be located near the end of the contract, and read something like this:
Neither party shall be responsible for any resulting loss if the fulfillment of any of the terms or provisions of this agreement is delayed or prevented by revolutions, insurrections, riots, wars, acts of enemies, national emergency, strikes, floods, fires, acts of god, or by any cause not within the control of the party whose performance is interfered with, which by the exercise of reasonable diligence such party is unable to prevent, whether of the class of causes enumerated above or not.
For example, if a hurricane shuts down a port, then a seller planning to ship its goods through that port would not be liable for late delivery of the goods. However, a party relying on a force majeure clause must prove that the event was beyond its control and that, in spite of skill, diligence and good faith on its part, performance remains impossible or unreasonably expensive.

The earthquake and tsunami would almost certainly be covered by almost any force majeure clause. However, the Japanese nuclear crisis may not fit as easily. It is also important to note that the payment of money by a buyer is almost never excused by the occurrence of force majeure events. Finally, even if the force majeure clause does apply it may only suspend performance, leaving the party with an obligation to find alternative ways to perform (i.e. by locating new suppliers).

Impossibility of Performance

The doctrine of impossibility is also sometimes referred to as the doctrine of impracticability. This defense is often asserted by a party who contracted to supply goods or services in exchange for money, but can no longer fulfill its obligations due to an unforeseen event such as an earthquake,

war or other act of god.

This doctrine addresses situations where performance is impracticable due to extreme and unreasonable difficulty, expense, injury or loss. Accordingly, performance may be deemed impracticable where it involves the risk of injury to persons or property. Furthermore, a severe shortage of raw materials or supplies that occurs due to an unforeseen shut-down of major sources of supplies could also fall within this doctrine, if it markedly increases the cost of or precludes performance. However, if the party can still fulfill its contractual obligations through use of a different supplier or method of delivery, then performance will not be excused. For instance, where performance has become difficult due to transportation problems, a party must evaluate whether alternative methods of transportation are available. If alternatives exist, then courts will often conclude that that the party should have used one of the other methods.

The doctrine of impossibility also applies to situations where only a limited supply of goods or resources is available. Here, the seller will be permitted or required to allocate the goods or resources that it does have among its customers. However, the seller must act fairly and reasonably when making such allocations. The specific circumstances of each situation dictate whether a court will find that a party has fairly allocated its supplies. Generally, the seller must take into account each contract that it entered into before the unforeseen event occurred and cannot prefer one customer over the other due to price. Nevertheless, allocating will not necessarily require that the seller deliver an equal amount to each customer, or that the seller will make deliveries in the exact proportion to the amounts provided for in its contracts. Rather, preference can be made for some needs over others. For instance, when distributing materials used for heating, a hospital may be preferred over a hotel.

Frustration of Purpose

Frustration of purpose is commonly asserted by a buyer, lessee or other person who contracted to pay money. Here, the party is capable of performing, but the purpose for doing so no longer exists so performance would be a waste of resources. This doctrine will excuse performance where the objectives of the contract have been utterly defeated by unforeseen circumstances. For example, if a race was cancelled due to a severe storm, a party that had contracted to pay for advertisements in documents produced to be distributed during the race would be excused from paying the advertising fee. The advertiser is able to pay the fee but will be excused from doing so, because the cancellation of the race frustrated the entire purpose of the agreement. Having the advertisements placed in the publication is worthless to the advertiser, because the race will no longer take place.

Whether arguments based on impossibility or frustration of purpose will succeed depends largely upon whether the subsequent event was reasonably foreseeable, the severity of the harm caused by the event, and the allocation of risks within the contractual relationship. Accordingly, determining whether these concepts apply depends on the facts and circumstances of a particular case. However, given the unprecedented nature and severity of the disasters in Japan, these doctrines may very well apply to contracts affected by those events.

United Nations Convention on Contracts for the International Sale of Goods

It is worth noting that the United Nations Convention on Contracts for the International Sale of Goods incorporates the concepts described above. The Convention applies to an international sales contract if (1) both parties are located in countries that have ratified the Convention ("Contracting

States"), or (2) private international law dictates that the law of a Contracting State governs the contract. The United States is a Contracting State.

Under the Convention, a party will not be liable for failing to perform its obligations under a contract if that party shows that its failure was due to an event beyond its control, that it could not have been reasonably expected to have taken such an event into account at the time it entered into the contract and that it could not be reasonably expected to avoid or overcome the event or its consequences. However, the non-performing party must give notice of the event and its effect to the other party in order to utilize this provision.

An evaluation of whether any of these defenses apply to a particular situation is highly fact sensitive. Moreover, with the exception of the Convention, the legal concepts discussed above are based on legal principles generally prevailing in the U.S. If the contract concerned is governed by the law of another jurisdiction, the principles involved or their applicability could differ. We would be happy to assist you in evaluating your options.