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1. Introduction

Cashflow is the lifeblood of the construction industry. To maintain cashflow, one of the key concerns of owners/employers and contractors would be to manage the financial exposure of a project. Drafting clauses affecting the financial exposure of owners/employers and contractors, which in turn would have a trickle down effect on evaluation of progress claims and issuance of payment certificates, thus would be one of the issues at the forefront of the minds of owners/employers and contractors.

In the final part of this three part newsletter series, the clauses related to the limitation of liability, retention monies and issuance of performance security in the “General Conditions of Construction Contract” (*Minkan (Nanakai) Rengo Kyoutei Kouji Ukeoi Keiyaku Yakkan*), otherwise known as the “**Minkanrengo**” standard form,¹ will be examined in relation to the relevant clauses in the FIDIC Red Book (1999) (“**FIDIC RB (1999)**”).

2. Key Differences between the financial exposure clauses in the Minkanrengo and FIDIC RB (1999)

The Minkanrengo does not specifically address limitation of liability, its conditions regarding financial exposure are often criticised as lacking specificity and coverage, and its terms regarding provision of performance security are vaguely drafted and optional. Furthermore, the timing of retention monies disbursement mechanisms under the Minkanrengo is accelerated compared to that of the FIDIC RB (1999). Specific provisions addressing such matters ought to be implemented, if non-Japanese parties wish to see the Minkanrengo aligned with the FIDIC RB (1999).

(1) Limitation of liability

Article 30 of the Minkanrengo refers to the owner’s / employer’s right to “demand compensation for the loss or damage arising out of” certain generally described events noted in Article 30(1), items (a) to (d). Under Article 30, limitations of the owner’s / employer’s right to claim for loss or damage is not specified.

Article 30-2 of the Minkanrengo correspondingly refers to the contractor’s right to “demand compensation for loss or damage arising out of” certain generally described events in Article 30-2(1), items (a) to (c). Similarly, the limitations of the contractor’s right to claim for loss or damage is not specified.

¹ The version of the Minkanrengo which will be analysed in this newsletter is Minkanrengo, Rev Version: April 2020.

Unlike the Minkanrengo conditions, the FIDIC RB (1999) expressly excludes claims for loss of use, loss of profits, loss of any contract or for any indirect or consequential loss or damage which may be suffered by either party in connection with the contract under Sub-Clause 17.6 [Limitation of Liability], save for fraud, deliberate default or reckless misconduct. Sub-Clause 17.6 of the FIDIC RB (1999) also goes further to limit that the contractor's maximum liability towards the owner / employer to the contract price (unless otherwise stated in the Particular Conditions), which notably is absent from the Minkanrengo conditions. Parties contracting under the Minkanrengo may consider supplementing the contract with a maximum cumulative liability clause, such that risks of commencing / undertaking the relevant project may be managed. It bears noting that under Sub-Clause 8.7 [Delay Damages] of the FIDIC RB (1999), there is also an option for parties to specify the maximum amount of delay damages under the contract, however limitations on delay / liquidated damages are absent from Article 30 of the Minkanrengo.

If the Minkanrengo conditions are not supplemented with further Specific / Particular Conditions, the parties may have to rely on the governing law of the contract to determine the relevant limitations of liability. Although the commentary on the Minkanrengo explains that Civil Code Article 416, which provides that the scope of loss or damage that can be claimed for a breach of duty is both "loss or damage which would ordinarily arise from the breach of duty" or "damage which has arisen from any special circumstances if the party did foresee" applies to the above articles², such scope of loss or damage is not clear on the face of the articles themselves. Also, the concept of ordinary loss/damage or loss/damage based on special circumstances foreseeable for the party do not directly correspond to the indirect or consequential loss or damage which has been excluded under FIDIC RB (1999) conditions.

(2) Retention monies mechanism

The practice of retaining a percentage of sums which are payable by the owner/employer to the contractor is widely accepted in projects not only in common law jurisdictions, but in Continental Europe as well. The concept of retention monies is familiar particularly in civil law jurisdictions such as Germany and France, and serves to provide security to the owner/employer in the event of any failure by the contractor to (i) complete any outstanding works; (ii) rectify any defects; or (iii) discharge any other liability of the contractor to the owner/employer.

Although the mechanism where the owner/employer retains a certain portion of payments based on progresses described below is commonly incorporated in both public projects and private projects, the concept of "retention monies" would not be so common among Japanese parties.

Under the Minkanrengo, there is no reference to "retention monies". However, Article 26(2), which sets out partial payment(s) provides that before the completion of the works, the contractor may only claim progress payment for nine-tenths "of the Contract Sum" for the relevant portion that has passed inspection by the owner/employer, which consequently allows the owner / employer to retain 10% of the amount payable to the contractor from each progress payment. This Minkanrengo default position may serve as a form of security for performance of the contract, wherein a 10% retention sum for each of the contractor's progress payments only is released to the contractor upon final delivery of the works.³

² *Commentaries on General Conditions of Construction Contract, Minkan (Nanakai) Rengo Kyotei [Revised in April 2020]*, written and edited by the Committee of General Conditions of Construction Contract Minkan (Nanakai) Rengo Kyotei (published in 2021 by TAISEI-SHUPPAN CO., LTD.

³ Pursuant to Minkanrengo Article 26(1), which requires "full and final payment of the Contract Sum to the Contractor" upon the contractor's delivery of the Work to the owner.

The retention monies mechanism under the FIDIC RB (1999) is dealt with under Clause 14, with specific mechanisms for the deduction of retention monies in Sub-Clause 14.3 [Application for Interim Payment Certificates] and the release of retention monies in Sub-Clause 14.9 [Payment of Retention Money]. Here, the retention monies are released in two tranches, the first tranche to be released when “the Taking-Over Certificate has been issued”, and the second tranche to be released “after the latest of the expiry dates of the Defects Notification Periods”.

The key difference between the retention monies mechanism under the Minkanrengo and the FIDIC RB (1999) is with regard to the time of disbursement of the retention sums. Under the Minkanrengo conditions, as the full retention monies may be released to the contractor upon delivery of the works pursuant to Article 26(1), the owner / employer may not have any security for the contractor’s rectification of defects during the relevant non-conformity liability period under the Minkanrengo conditions (e.g., Article 27-2). As large construction projects would inevitably have non-conformities in the works and other defects, when contracting under the Minkanrengo conditions, owners / employers may have to factor the release timing of retention monies into the calculation of the contract price or consider other ways to secure the contractor’s performance during the non-conformity liability period, such as adjustments to the payment mechanism under the Minkanrengo conditions to allow for the release of the retention monies only after the non-conformity liability period.⁴ The parties may also consider the issuance of performance security or the nomination of a surety under the Minkanrengo conditions, which will be discussed below.

(3) Performance security

The requirement for the contractor to provide a Performance Security is commonly accepted in international construction contracts, and similar to retention monies, is meant to secure the performance of the contractor’s obligations under the contract. With a Performance Security, the risks of non-performance of the contract may be reallocated and, while it is likely that the costs of issuing a Performance Security will be reflected in the contract price, the Performance Security is a powerful remedy for owners / employers to ensure the performance of the contract. Although most of the public projects in Japan require submission of a Performance Security, mechanisms which govern the timelines and specific details of the Performance Security would not be so common among Japanese parties, especially in private projects. Parties contracting under the Minkanrengo conditions who wish to add a requirement for the contractor to provide a Performance Security should be aware of the lack of a comprehensive mechanism for the provision of performance security, and make the relevant amendments to align the Minkanrengo conditions with internationally accepted procedures.

Under Article 8 of the Minkanrengo, the owner and/or the contractor may nominate a surety at will and subsequently, “the surety shall be jointly and severally liable with the principal for any monetary debts arising from the Contract”. Here, there are no timelines for the delivery of any written acknowledgement of such a surety, and no clear provisions on the period of time for which the surety is to remain liable for the principal’s debts. There are also no specific criteria for the nomination of a surety, and while either party may nominate a surety under the Minkanrengo conditions, there may be little reason for the owner / employer to nominate a surety to the benefit of the contractor.

⁴ For subcontracts, under the Construction Business Act Article 24-3 requires the main contractor to pay the work price to the subcontractor within one month after receiving the payment from the owner/employer for the completed work, therefore retention monies arrangements not conforming with such requirement are not allowed.

In contrast, the FIDIC RB (1999) appears to have more specificity and comprehensiveness compared with Article 8 of the Minkanrengo. Under Sub-Clause 4.2 [Performance Security] of the FIDIC RB (1999), clear timelines for the contractor to deliver to the owner/employer the Performance Security are in place, and limitations to the owner / employer's right to make a claim under the Performance Security have been put in place. The period that the contractor is required to ensure that the Performance Security is valid and enforceable is also specified, ensuring that the contractor does not have to maintain the Performance Security for an excessive period of time. The obligation on the owner / employer to return the Performance Security to the contractor has also been stipulated in Sub-Clause 4.2.

In addition, while performance security under the FIDIC FB (1999) may be in a form as agreed in the Particular Conditions, an "unconditional bond" where the owner / employer may call on the bond without proof of the contractor's non-performance of the contract seems to be most common. A claim made by the owner/employer under the Performance Security in the form of such an unconditional bond is different from a claim by the owner / employer against a surety (as adopted in the Minkanrengo). Claims against the surety may depend on the actual terms agreed upon between the party nominating the surety and the surety and are likely to be less straightforward when compared to a Performance Security.

3. Conclusion of Part Three

Financial exposure and issues surrounding the disbursement / receipt of payment for work are some of the most important issues which owners/employers and contractors may consider when entering into a construction contract. When contracting on a Minkanrengo basis, such issues may not be addressed with specificity or sufficiency, requiring further supplementation in the form of Particular / Specific Conditions so as to ensure a mutually beneficial relationship and the completion of the project in a financially viable manner.

This three part newsletter series sought to give readers a general overview of some key differences between the Minkanrengo and the FIDIC RB (1999), and provided suggestions as to how these differences may be resolved. With the general trend of more Japanese construction projects being commenced, it is likely that the Minkanrengo conditions may eventually be increasingly used by both Japanese and non-Japanese parties, requiring further analysis of their interpretation.

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