Churchill Falls (Labrador) Corp. v. Hydro-Québec | The Supreme Court rules in favour of Hydro-Québec: the interaction between good faith and the scheme of the contract

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Introduction

Although 24 years of jurisprudence have gone by since its codification in article 1375 of the Civil Code of Québec, the notion of good faith remains a vague concept whose incidence on the performance of contracts is still unclear. Although it is increasingly evident that good faith is not a mere interpretive concept without substantial meaning, the most fundamental uncertainty remains—or rather, remained, until the Supreme Court of Canada rendered the decision that is the subject of this bulletin.

This uncertainty has to do with knowing to what extent the general obligation of good faith can change the content of a contract duly entered into by the parties. In other words, could the judge, on the basis of article 1375 CCQ, intervene in the contract, the "law for the parties," to remodel it according to the judge's understanding of good faith?

Context

In this matter, the plaintiff, Churchill Falls, argued that the other contracting party, Hydro-Québec, had an obligation to renegotiate the price in a contract under which the latter had undertaken to purchase most of the electricity produced by the Churchill Falls power plant at a fixed price for a period of 65 years. According to Churchill Falls, this obligation to renegotiate the price was a matter of good faith and was required of Hydro-Québec due to the changes in the electricity market that meant that the fixed price in the contract had become too low compared to the prices paid on this market. The Court thus had to decide whether it could, on the basis of the notion of good faith, add an obligation to renegotiate the price to the fixed price contract.

Decision

The Supreme Court of Canada responded to this question in the negative, as had the Superior Court and Court of Appeal of Quebec. To do this, it analyzed and rejected each of the arguments submitted by Churchill Falls. We will briefly examine these arguments and the way in which the Supreme Court rejected them.

The contract is not a joint venture contract

Churchill Falls initially claimed that the contract that it had signed with Hydro-Québec was a joint venture contract, which, by its very nature, implies an equitable sharing of risks and profits, and therefore entails an obligation to renegotiate the price in order to better share the profits generated from the sale of electricity.

The legal nature of a joint venture contract is disputed since some authors, looking to Quebec jurisprudence, are of the opinion that it consists of an undeclared partnership, while others defend the existence in Quebec law of a *sui generis* contract of joint venture.

Without getting into this debate, the majority of the Court was of the opinion that the contract in question fulfilled neither the criteria of an undeclared partnership contract, nor those of a *sui generis* contract of joint venture. In fact, regarding the undeclared partnership, the evidence showed no common intention to form a partnership (*animus societatis*) nor any combining of resources. Regarding the *sui generis* contract of joint venture, the majority of the Court identified from authors who defend this unnamed legal form the determining factor of "an intention to jointly assume the responsibility involved in carrying out the proposed project." However, the contract in question clearly defined and divided the responsibility of each party to the contract in such a way that no intention to share responsibility for the project could be deduced.

The contract is not a relational contract

Churchill Falls then claimed that the contract that it had signed with Hydro-Québec was a relational contract that, by its very nature, entailed a stricter obligation of good faith, including, given the change in circumstances, the obligation for the parties to renegotiate the price in order to better share the profits from the sale of electricity.

The majority of the Court rejected this argument because they were of the opinion that the contract in question was not a relational contract. They did not rule on the second part of this argument, regarding the scope of a good faith obligation if it were a relational contract.

Regarding the definition of relational contracts, the position of the majority of the Court sets a precedent. In fact, while jurisprudence and authors have defined the relational contract in a variety of somewhat eclectic ways, the majority of the Court accepted only the definition proposed in 1998 by Professor Belley: "a relational contract can roughly be defined as a contract that sets out the rules for a close cooperation that the parties wish to maintain over the long term." In essence, relational contracts provide for economic coordination as opposed to setting out a series of defined prestations. It is a corollary to the emphasis on the parties' relationship that their respective prestations are not defined in much detail. The contract in question here clearly quantified and defined each party's prestations, so that no important prestations were left undefined.

According to the majority of the Court, this shows that the parties intended the project to proceed according to the words of the contract at face value, not on the basis of their ability to agree and cooperate from day to day to fill any gaps in the contract: "The Power Contract sets out a series of defined and detailed prestations as opposed to providing for flexible economic coordination. It is not therefore a relational contract."

No implied obligation to renegotiate the price

Churchill Falls (CFLCo) also claimed that an implied obligation to collaborate and renegotiate the price is incident to the contract according to its nature, under art. 1434 CCQ. The majority of the Court dismissed this argument.

On this subject also, the position of the majority of the Court sets a precedent. In fact, to a certain degree, the judges strengthened and shed light on the concept of implied contractual obligations under article 1434 CCQ. According to them, an implied duty may be incident to a contract according to the nature of the contract if the duty is consistent with the general scheme of the contract and if the contract's coherency seems to require such a duty. However, such an implied clause must not merely add duties to the contract that might enhance it, but must fill a gap in the terms of the contract such that it can be presumed that the clause reflects the parties' intention, which is inferred from their choice to enter into a given type of contract.

The majority of the Court noted that in this case, there is nothing to suggest that the parties' prestations would be incomprehensible and would have no basis or meaningful effect in the absence of an implied duty according to which Hydro-Québec must either exceed the usual requirements of good faith in cooperating with CFLCo or redistribute windfall profits: "The Contract governs the financing of the Plant and the sale of electricity produced there, and also strictly regulates the quantity of electricity to be provided by CFLCo and the price to be paid by Hydro-Québec. The meaningful effect of the sale for the parties is clearly identifiable: Hydro-Québec obtains electricity, while CFLCo receives the price paid for it. The fact that the price might not be in line with market prices does not destroy the very logic behind the sale or deprive it of any meaningful effect.

Furthermore, the benefits each party derives from the sale are related to the other prestations associated with the construction of the Plant. There is no gap or omission in the scheme of the Contract that requires this Court to read an implied duty into the Contract in order to make it coherent."

The limits of good faith and the rejection of the doctrine of unforeseeability

Finally, Churchill Falls argued that independently from the nature of the contract, Hydro-Québec was nonetheless obliged to renegotiate because, in Quebec civil law, the concepts of good faith and equity condition the exercise of the rights created by any type of contract.

It argued that these concepts prevent Hydro-Québec from relying on the words of the Contract, because to do so in circumstances in which the Contract effectively provides for disproportionate prestations would be contrary to its duty to act in good faith and in accordance with equity. And given that the prestations owed by the parties have been disproportionate since the changes in the market occurred, it argued that Hydro-Québec has been violating its duties related to good faith since then by refusing to renegotiate the Contract.

In this regard, the majority of the Court began by categorically affirming that the doctrine of unforeseeability, which Churchill Falls seemed to rely on indirectly, was not part of Quebec civil law. The majority of the Court noted that Churchill Falls was seeking to use the concepts of good faith and equity in a manner that goes beyond the limits of the doctrine of unforeseeability even though the Quebec legislature has refused to incorporate that doctrine into the province's civil law. They added that, "If unforeseeability itself has been rejected, a protection analogous to it that would be linked only to changes in circumstances without regard for the core conditions of the doctrine as recognized in other civil law jurisdictions could not become the rule in Quebec law."

The majority of the Court rejected equity as a basis for a possible obligation to renegotiate the price, because "its effect would then be to indirectly introduce either lesion or unforeseeability into our law in every case." They added that the equity provided in article 1434 as a source of implied obligations "is not so malleable that it can be detached from the will of the parties and their common intention as revealed in and established by a thorough analysis of the whole of the relevant evidence." In fact, the evidence revealed that both parties to the contract were experienced, and they negotiated its clauses at length and intended one of them to bear the risk of fluctuations in electricity prices.

The majority of the Court also rejected the argument of good faith as a basis for a possible obligation to renegotiate the price. Their analysis in this regard is based on the following two assumptions, which clarify the concept of good faith. Firstly, according to them, good faith is a standard associated with the parties' conduct; it cannot be used to impose obligations that are completely unrelated to their conduct. In other words, for good faith to be invoked with success, unreasonable conduct by one of the parties must be shown. In this case, Hydro-Québec did nothing but demand the performance of the contract as it had been agreed upon.

The second assumption is that good faith serves to maintain the relevance of the prestations that form the basis of the contract even if the words of the contract do not specifically prohibit the parties from doing something that would impede its fulfilment. The majority of the Court adds that, "if the main prestations of a contract are renegotiated and modified, they will rarely remain relevant." In other words, "Because good faith takes its form from the terms of the contract, it cannot serve to undermine the contract's paradigm. But in the view of the Superior Court and the Court of Appeal, that is exactly what CFLCo is arguing for in this case: CFLCo is demanding that Hydro-Québec renounce its access to a source of electricity production at a stable cost, that is, to the principal benefit it derives from the Contract."

Commentary

This decision sheds a very useful light on the relationship between good faith and the contents or scheme of a contract. Closing the door to the general application of the doctrine of unforeseeability, the Court instead favoured the binding force of contracts and contractual stability.

Contrary to the claims of Churchill Falls, the obligation to act in good faith cannot oblige the parties to renegotiate the fundamental terms of the contract, but aims rather to enable the performance of the prestations under the contract. However, although in principle it is legitimate to demand adherence to a contract, a party's rigidity must not reach the point of abuse of rights, in which case it could be sanctioned for its conduct and held responsible if there is resulting damage.

Moreover, various judicial instruments can help palliate the unforeseeable. If the unforeseen situation is severe enough to be qualified as superior force under the Civil Code, in that it prevents a party to the contract from fulfilling its obligations, said party could be released from them. The parties are also free to define the concept of superior force in their relationship through a contractual clause. Similarly, the parties can limit the risks associated with the unforeseeable in long-term contracts through adjustment clauses, which can take several forms (indexing clauses, revaluation clauses, renegotiation clauses, etc.). This could be especially useful in a fixed-price contract where the risks are usually attributed to the service provider ahead of time.

However, as the matter of Churchill Falls clearly shows, a party that has agreed by contract to assume a risk without providing for such adjustment mechanisms will have to assume the consequences.