Good Faith and Contract Renegotiation

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Authors: Julian Bailey, Michael Turrini, Luke Robottom, Ibaad Hakim

Long-term contracts are made in political and economic circumstances that can change significantly over the life of the contract. If circumstances do change significantly, and the parties are otherwise under an obligation to act in 'good faith' towards each other, does this 'good faith' obligation require the parties to renegotiate the relevant terms of the contract? A recent case before the Supreme Court of Canada considered this important issue.

Background

In *Churchill Falls (Labrador) Corp. v. Hydro-Québec*, 2018 SCC 46, the Supreme Court of Canada explored whether the 'good faith' principle can require contract renegotiation.

In 1969, Churchill Falls and Hydro-Québec entered an agreement for the construction and operation of a hydroelectric plant.

Hydro-Québec undertook to purchase, over a 65-year period, most of the electricity produced by the plant (on 'take-or-pay' terms), which allowed Churchill Falls to use debt financing for the plant's construction.

In return, Hydro-Québec obtained the right to purchase electricity at fixed prices for the entire contract term, thereby taking on the financial risk associated with fluctuations in the market value of energy.

Fifty years later, the market price for energy had surged far above the agreed fixed purchase price, and Hydro-Québec had been generating a substantial profit by selling the plant electricity to third parties.

Churchill Falls, unhappy with the circumstances and wishing to share in the spoils, sought (among other things) an order that Hydro-Québec was under a duty, pursuant to its obligation of 'good faith', to renegotiate the contract so that the profit could be partially reallocated to it.

Decision

The Supreme Court of Canada rejected Churchill Falls' case, and found that the duty to act in good faith cannot give rise to an obligation to renegotiate a contractual term that was duly negotiated by the parties.

The Court:

- Acknowledged that whilst good faith can provide a basis for the courts to intervene and impose new obligations, the concept 'cannot be expanded to include… a duty to renegotiate the principal obligations of a contract', and does not negate a party's right to rely on the words of the original contract, unless such reliance 'constitutes unreasonable conduct in the circumstances';

- Noted that 'good faith serves to protect the equilibrium of a contract, it cannot be used to violate that equilibrium and impose a new bargain on the parties';
- Pointed out that the parties never intended to allocate the project's risk and benefits equally. Hydro-Québec assumed a large measure of price risk by agreeing to guarantee a fixed electricity price for the duration of the contract;
- Noted that both contracting parties were experienced entities, and their relationship was not characterised by inequality or vulnerability; and
- Held that the duty to cooperate, which emanates from the requirements of good faith, does not demand the sacrifice of one's own commercial interests.

Commercial Implications

Churchill Falls indicates that the doctrine of 'good faith', where it applies, does not proffer any general basis upon which a sophisticated commercial party may seek to amend terms of a contract that have become unfavourable to it. The case will be of interest in jurisdictions outside of Canada, including those of the Middle East, where similar 'good faith' obligations are implied under the prevailing civil codes.

The case therefore serves as a sharp reminder of the importance of foresight in drafting long-term contracts, and as a prompt to consider thoroughly the ramifications of assumptions made about future conditions, in the market or otherwise.

Long-term supply and purchase agreements with off-takers usually do (as in the *Churchill Falls* case) take account of market fluctuations that may occur.

It is possible, however, for circumstances to change so radically from what the parties anticipated at the outset of their agreement that the contract, if unchanged and performed, produces an economic result which disadvantages one or both of the contracting parties. Eventualities like this may be accommodated in various ways; for example, by providing for an adjustment of the contract price if the market price of inputs or the end-product exceed certain thresholds. A contract may also provide for the adjustment or renegotiation of its terms after particular intervals of time. In all cases, the most prudent course is for the contract to include such mechanisms, rather than appealing to vague notions of 'good faith'.

White & Case LLP
5 Old Broad Street
London EC2N 1DW
United Kingdom

T +44 20 7532 1000

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