

The Impact of Pre-contractual Liability on Transnational Business Negotiations

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Abstract— Pre-contractual liability is imposed by law inconsistently across the globe. While not all legal systems even recognize pre-contractual liability, the concept is meant to remedy injured parties who have not yet entered a contract, but have a relationship with opposing parties and have suffered damage as a result of that relationship. Unfortunately, due to the various applications of pre-contractual liability, business parties are left surprised with the outcome of the results of its imposition by law. Consequently, parties cannot sufficiently anticipate when and how legal rights and obligations are created. This uncertainty causes threats to business parties as they fear creating unintended legal obligations. An alternative juridical framework is needed to set default standards of communications and standards of conduct to monitor our evolving global trade and would aid law to provide the security, predictability and foreseeability during alternative dispute resolution required by TBN parties.

Keywords— pre-contractual liability, transnational business negotiations, business relationship, alternative juridical framework

I. INTRODUCTION

Pre-contractual liability must be taken into context and in accordance with each legal jurisdiction. When legal systems impose pre-contractual liability they do so using different characterizations. German civil law systems (with the exception of Japan) tend to impose pre-contractual liability on a contractual basis, whereas French civil law systems (except Quebec) are inclined to apply pre-contractual liability on a delictual level [1].

There is a large distinction between French and German law systems: “Unlike the French Civil Code and its progeny, German law does not have a general principle of non-contractual liability. Von Jhering therefore had to resort to an ingenious construction: an implied contract between the parties, with the object of conduct of negotiations in good faith...More in general, the construction of a *pactum de contrahendo* is often used by legal scholars in civil law countries in order to consider parties bound” [2].

Under common law, in the absence of contract, the courts adhere to the parole evidence law which precludes the production of evidence of a pre-contractual nature. However, courts have applied equitable remedies such as promissory estoppel, restitution or tort [3]. Promissory estoppel requires proof of damage as a result of justifiable reliance on what another party promised to do or to abstain from doing. When the common law response is based on restitution, the claimant must prove that the services rendered resulted in an actual

benefit to the defendant at the loss of the claimant. Tort requires negligence or malice intention.

Quebec law tends to patch pre-contractual situations with breach of good faith obligations, rather than recognizing the doctrine of pre-contractual liability. Yet, good faith as a principle provides a very uncertain response since the level and intensity has not been defined by law, even in context of building towards a contract, nor are there any juridical tools available for parties to choose such a level and intensity.

The American Uniform Commercial Code [U.C.C.] binds business parties engaged in commercial activities to a duty of good faith, bridging injured parties to a remedy where a contractual relationship has ensued.

On a transnational basis, Unidroit Principles require under Article 2.1.15 that conduct during negotiations must not be made in bad faith. In such a case, the principle of good faith may furnish justification for the *interpretation* of the contract. For example, in *Oberster Gerichtshof Spanish Co (SP) v. Austrian Co. (AUS)*, AUS refused to pay for delivered goods (fruits and vegetables) on the basis that it was not the actual seller but acted as an agent for the buyer (with whom he shared the same address). Although the Court found that the question of agency was excluded from the jurisdiction of CISG by virtue of Art. 4, nevertheless the validity of the contract could be explained by the application of good faith during negotiations according to Art. 7(1) CISG. [4].

All of these responses accost uncertainty to the global market, as TBN parties must be wary of legal ramifications that may arise at any given time [5]. The purpose of law is to offer certainty, to securitize transactions and honour the flexibility required when people exercise human activities. The inconsistency of legal categorization of the parties' actions during negotiations is a threat to the global market. Whether parties will be recognized as falling into a pre-contractual category paves a nebulous path for TBN parties who must query whether their conduct will be treated on a contractual or extra-contractual level falling inadvertently into the creation of legal obligations that they did not intend.

There is no universal recognition of how to set standards of conduct and standards of communication. TBN parties have no juridical tools to allow them to operate through party choice. Good faith has been applied inconsistently and has only embryonically been accepted under English and Canadian common law contract law [6] in the performance of contracts under Canadian common law [CCL]. Business parties are left with no manner to measure these legal risks [7].

II. PRE-CONTRACTUAL LIABILITY AROUND THE GLOBE

Characterization of pre-contractual liability is not harmonized around the world. Although Hondius amalgamated and documented an overview of precontractual liability around the globe in a conference in 1990 to demonstrate some of the circumstances that pre-contractual liability that are imposed upon commercial parties, there has been little interest in harmonizing laws around the globe. The majority of jurisdictions that will impose pre-contractual liability will do so through remedies of tort/delict. These legal systems include Belgium, France and Venezuela, to name a few [8]. Civil law systems that are based on German civil law tend to rest pre-contractual liability on a contractual pedestal as an implied contract, such as Germany, Switzerland and Turkey.

III. THE GERMAN APPROACH

Liability is not always dependent upon the fault of a person; it can result from *culpa in contrahendo* [c.i.c.]. The early stages of the concept was fraught with resistance. It was initially advanced to protect commercial needs as a solution to weaknesses in German common law by Rudolf von Ihering, father of its foundation to remedy an injured party even if the contract was void. The modern concept of c.i.c. means that “the mere opening of negotiations intended to lead to a contract imposes upon duties of care...giving rise to a special relationship (*Sonderverbindung*). Culpable neglect of such a duty resulting in damage to the other party entails liability according to the rules governing contractual relations.”[9].

The ideology behind the concept is that when a visitor enters a shop, she *might* enter into contractual negotiations with the store keeper [10]. The reasoning for the contractual remedy is that the tort action would have been prescribed and the injured party would otherwise be left without remedy.

A woman entered a department store with the intention to purchase linoleum floor-covering. A discussion ensued between the customer and the employee when a roll of the floor-covering—the woman appeared to be interested in fell and injured the woman and her daughter. The store was considered liable for the employee’s negligence on the basis of a pre-contractual relationship between the woman who was a potential buyer and the department store [11].

In 1976, the *Bundergerichtshof* took another step forward. A young girl slipped on a vegetable leaf while entering a department store. The court considered that the storekeeper had ‘a contract with protective effects towards a third party’ and awarded damages to the young girl in accordance with the standards of contract. The longer prescription period allowed her to make the claim[12].

“In German law a general proposition that once the parties have entered into negotiations for a contract, neither can break off arbitrarily without compensating the other for his reliance damages must be received with some caution”[13].

Furthermore, if a party leads another party to believe during negotiations that a contract will ensue or has been made, and without good reason refuses to continue negotiations, the court will order compensation for reliance damages as necessary under the circumstances[14]. Therefore, the parties are

precluded from using inaccurate or vague language that can result in misunderstandings[15].

Precontractual business contracts are considered to be a ‘legal relationship of contract negotiations’ (*Rechtsverhältnis der Vertragsverhandlungen*). This relationship that means that the parties owe each other duties of care due to mutual reliance is imposed by law with the presumption that the parties are no longer strangers. C.i.c. does not necessitate that a contract is actually forthcoming. C.i.c. lies in between contract and tort and therefore liability is not one or the other but more similar to contract because of its likeness to contract.

What we learn from the German approach is that the relational aspects of negotiations are recognized; that negotiation parties have formed a relationship deserving of more than a tort response. What the response of c.i.c. lacks is that it does not distinguish the intensity of the negotiations, nor the terms and conditions applicable during the processes of negotiation.

IV. THE FRENCH RESPONSE

France more generally treats pre-contractual liability under a delictual recourse, as a ‘*perte d’une chance*’ that is compensated if there is proof of reasonable probability that the ‘*chance*’ could be realized if a contract had been concluded.

Article 1101 of the French Civil Code depicts the formation of a contract: “A contract is a convention by which one or more persons obligate themselves, towards one or more others, to give, to do, or not to do something...As a consequence, a contract is considered as resulting from an agreement between the parties.” Consent is sufficient to form a contract under French law and consent can occur even without a prior discussion or may be concluded after stages of negotiations.[16] A party who is not satisfied with the conclusion of a contract due to improper behaviour during negotiations can also be compensated[17].

There are no specific rules regarding negotiations under French law. An offer is considered unilateral in its legal nature and, therefore, may be withdrawn until it is accepted. A proposition to make a contract is not a contract unless it is a definite promise. A partial agreement that leaves accessory issues vacant can be recognized as a contract if all the essential elements of a contract have been addressed, but parties may exercise expressly the freedom not to contract. Whether a preliminary agreement is recognized by French law depends on its wording. Yet, because of the innate imprecision of these instruments, interpretation is scrutinized in French courts who must weigh whether the expressed intention and the real intention are the same and whether the same elements of the offeror were accepted by the offeree.

In the event that damage, such as loss of incurred expenses, caused to another party as a result of expected advantages during negotiations, delictual liability applies. A court will consider two conditions to decide on compensation under delict. There must be *proof of causation* and *evidence that the damage has not already been compensated*. Losses are generally compensated by the loss actually suffered by a party in light of an expected contract, but may include the anticipated benefits of the contract. Ordering the parties to continue negotiations that have been broken off is ordinarily denied in

France^[18], but damages could be imposed by law if there is proof of delict.

V. QUEBEC: ANOTHER RESPONSE

Although Quebec is a French civil law system, Quebec only recognizes pre-contractual liability as a repercussion of the *breach* of good faith obligations. Articles 6 and 7 of the *Civil code of Quebec* [C.c.Q.] impose a general duty upon [e]very person...to exercise his civil right in good faith...and that “[n]o right may be exercised with the intent of injuring another or in an excessive and unreasonable manner which is contrary to the requirements of good faith.”

There is no legislative provision regarding the principle of good faith as it applies to negotiations. However, there are provisions that relate to contracts. Article 1375 C.c.Q. solidifies when a duty of good faith will be imposed by law: “The parties shall conduct themselves in good faith at the time the obligation is created and at the time it is performed or extinguished.

Prior to the enactment of the *Civil code of Quebec*, there was no codified imposition of a duty of good faith. However, the courts developed the scope and application of good faith in the context of various contractual facts and circumstances that arose following the general recognition of a principle of good faith in the 1980s and 1990s¹⁹ to establish when a breach of good faith could be found: during the formation, performance and extinction of a contract. It further expounded that the scope of good faith is wider than simply honesty and includes cooperation and loyalty²⁰.

There has been recognition that the *formation* of a contract includes *negotiations* prior to the signature a contract²¹. Quebec courts continued to develop the concept of good faith in contractual settings and went so far to say that in relational contracts (as opposed to transactional contracts which are typically one shot deals) there is a duty to renegotiate should the circumstances that the parties find themselves in differ from the original contractual setting²². However, what constitutes a relational contract as opposed to a transactional contract has recently been challenged by the Supreme Court of Canada²³, which supported the sanctity of contract in the antiquated fashion over the principle of good faith in a long term contract, leaving this area of law in a further conundrum.

VI. THE DUTCH ATTITUDE

The Dutch attitude is one of precision. The landmark case remains *Plas v. Valburg*, distinguished between three stages of negotiation to determine whether any liability exists. “(i) an initial stage where parties are free to break off negotiations, without any obligation to compensate the other party; (ii) in a continuing stage, a party may be free to break off negotiations, however, under the obligation to compensate the other party for expenses incurred; (iii) in a final stage a party is not allowed to break off negotiations and violation of this obligation may give rise to compensation of the other party's expenses and, in addition, the profits that would have been made by that party”^[24]. In more recent years *Plas v. Valburg* has been cited but refined with regard to the (iii) final stage to allow certain unforeseen circumstances to justify breaking off of negotiations.

Although the Dutch response is highly organized, it has a tendency to over-regulate negotiation parties, removing the autonomy from the parties with presumptions that may or may not reflect the specific circumstances that have arisen between the parties during the processes of negotiations. Even in the initial stages of negotiations, trade secrets may be exchanged or one of the parties may be trying to obtain information by negotiating, never intending to go through with any deal. Looming liabilities may arise on a pre-contractual basis even when no contract or agreement has ensued. Furthermore, the intensity of the negotiation relationship remains, currently, unrecorded between the parties. “Legal ramifications in the early stages of negotiation are probable at inception”^[25].

VII. THE JAPANESE POSITION

Japanese law sees negotiations as the foundation of the formation of a business relationship. The focus of liability follows the facts and circumstances and whether there is evidence of justified reliance. The Japanese image is ‘the degree of ripeness of the contract’ (Keiyaku no jukudo), operating like a set of stairs whereby each step towards the mutual goal increases the intensity of rights and obligations between the parties. ‘A duty to negotiate faithfully towards a conclusion of contract’ has been imposed in Japan^[26].

Elements that are considered that sway the court to decide whether there are any obligations that have incurred during the negotiation period include the *type of transaction* and price of the object. If the object has a high value, the courts will look for a written contract. How far along the *progression of negotiations* also impacts Japanese law and the intensity of the obligations incurred. The closer the parties are to fulfilling the conclusion of the contract, the more likely that Japanese courts will remedy the expectations therein^[27]. Furthermore, *preparatory work* that has been even implicitly allowed may be sufficient for a court to remedy if a party has relied on the other party's commitment. *Initiative in negotiations* is not enough to incur liability, but if a party induces another with the expectation that the contract would be concluded or pretends that a business relationship is in progress this element may be considered. The *cause of frustration* can be recognized in different classes: “cases in which legal requirements for valid performance are for some reason not fulfilled”, “cases in which economic circumstances have changed so much that the transaction has become unattractive”, “cases in which during negotiations a more attractive trading partner appears”, and “cases where important matters which have been pending since the start of the negotiations could not be arranged after all” and whether oral or written representations took place^[28].

VIII. THE AMERICAN PERSPECTIVE

The landmark case regarding precontractual liability under American law was the triangle between *Pennzoil*, *Getty* and *Texaco*²⁹. *Pennzoil* negotiated with *Getty* for additional oil reserves and its major stockholders reached an ‘agreement in principle’ to purchase *Getty* shares. *Getty* entered a parallel transaction with *Texaco* who agreed to pay more for each share. The trial judge ruled against *Texaco* characterizing the largest

civil judgement in the United States as intentional “tortious interference with Pennzoil’s contractual relations with Getty.” The Trial Court awarded damages of \$10.53 billion U.S. dollars. \$7.53 billion dollars were actual damages and \$3 billion dollars was awarded as punitive damages.

On appeal, the Texas Court of Appeal considered whether the “agreement in principle” could be construed as a binding contract under New York law. The court decided that Getty and Pennzoil were in a contractual relationship, justifying their decision as follows:

“Several factors have been articulated to help determine whether the parties intended to be bound only by a formal, signed writing: (1) whether a party expressly reserved the right to be bound only when a written agreement is signed; (2) whether there was any partial performance by one party that the party disclaiming the contract accepted; (3) whether all essential terms of the alleged contract had been agreed upon; and (4) whether the complexity or magnitude of the transaction was such that a formal, executed writing would normally be expected”. Although the Texas Court of Appeal reduced punitive damages to \$1 billion U.S. dollars, with interest the award was still \$10 billion U.S. dollars and Texaco’s net worth was only \$9 billion.

American law has also been known to remedy an injured party who has not entered into a validly recognized contract. In the controversial case of *Hoffman v. Red Owl Stores*³⁰ Hoffman relied on repeated promises by Red Owl Stores to his detriment. Due to absence of any contractual relationship, the court found the tort remedy of promissory misrepresentation.

IX. SHOULD PRE-CONTRACTUAL LIABILITY BE DEALT WITH UNDER THE DOCTRINE OF CONTRACT, TORT OR SOME OTHER MANNER?

Characterization of pre-contractual liability is not uniform. Whether pre-contractual liability should be dealt with under the doctrine of contract, tort or any other matter should, nevertheless remain consistent in all legal families. Most jurisdictions that recognize pre-contractual liability will do so through remedies of tort/delict. However, most German civil law pre-contractual liability rests on a contractual pedestal, in the form of an implied contract.

The ideology behind the German approach is that there is a potential relationship even when a visitor simply enters a shop and since she might enter into contractual negotiations with the storekeeper, a duty of care is imposed. The concept of *culpa in contrahendo* is now well adopted in German courts as an implied contract, because of the relationship that is presumed to have taken place between the parties. What we learn from the German approach is the relational aspects of negotiations are recognized; that negotiation parties have formed a relationship deserving of more than a tort response. This approach is insufficient, however, as it does not distinguish the intensity of the negotiations, nor the terms and conditions applicable in the processes of negotiation.

The challenge with the German position is that it is inconsistent with other jurisdictions that approach pre-contractual liability under the scope of tort, and those

jurisdictions that prefer to deal with pre-contractual liability as a matter of good faith.

X. THE PERIL

Pre-contractual liability is a dangerous concept in law because business parties have no way to plan for the surprise that may ensue if a party finds themselves in a foreign jurisdiction. Pre-contractual liability may arise as a result of a relationship and expectations of the parties to that relationship and may include good faith conduct as an expectation during the negotiations, the preservation of confidentiality of trade secrets, the necessity of disclosure of material facts, and cooperation in good faith towards a mutually rewarding goal.

Perhaps the most disturbing element of pre-contractual liability is the uncertainty of not knowing when and how obligations during negotiations will be recognized by law and under what circumstances an agreement will fall outside of contractual recognition. Preliminary agreements are meant to evidence the seriousness of the negotiations through agreements that provide parties with a manner to plan affairs that are ancillary to the buy-sell agreement even though there are matters that require further exploration. This is particularly prevalent in long-term TBN where the economic stakes are high and where one or more parties invests, speculatively or not, in a project for a long period of time and parties must rely on one another to attain mutual goals. An agreement to agree sets out the terms the parties have settled on while leaving open terms for secondary matters to be discussed later. While some preliminary agreements or some elements within an agreement may be recognized in some jurisdictions, other jurisdictions will not recognize such an agreement at all. Yet pre-contractual liability does not require that any such agreement exist, only that the parties are subject to a business relationship.

XI. CONCLUSION

For law to regulate TBN and impose behavioral standards to TBN it must first come to a greater understanding of when negotiations begin, the functioning of negotiations, how TBN parties communicate with one another, and the relevance of successful negotiations.

Although law has few tools to regulate negotiations and no globally accepted *sui generis* rules that apply directly to international deal making, law is currently regulating using various legal vehicles, including the imposition of pre-contractual liability and other remedies “under the shadow of the law.” As a result, negotiation obligations stumble like misfits between various categorizations of legal obligations, contributing to the threat that business negotiations are burdened with uncertainty as to how legal obligations will be recognized or imposed by law.

Negotiations are not just a dance of strategies and tactics. They involve the building of a relationship, maintaining trust and cooperation. Negotiations are the path of communications taken by the parties to arrive at successful destinations. To guide this path of negotiations, law must provide TBN parties

with the certainty that the arrangements they intend to be binding will be recognized by law.

Hondius has documented various responses to remedying conduct of parties who are negotiating in business prior to the formation of a contract, whereby characterization remains poles apart somewhere outside or between the scope of contract and tort. However, there is no common consensus that negotiations must be conducted in accordance with a particular duty, be it good faith or any other concept. Nor has the nature and scope of such a concept been consistently applied to negotiations. While American UCC draws closer to QCL in commercial law by recognizing a general duty of good faith and fair dealings in commercial contracts, it is not clear how good faith is applied to negotiations. All sources of law could potentially recognize standards of good faith that have been expressly accepted by the parties themselves, if only there was a way to record such standards privately between the parties.

Therefore, a pursuit must be aimed for an alternative legal framework to harmonize discrepancies that run rampant as a result of differing responses from legal systems across the globe.

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Linda Frazer, L.L.D. and proud member of the *Chambre des notaires du Québec*.

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- [2] *Ibid.* [our underline] at 12.
- [3] *Ibid.* “Traditionally, common law courts have only adhered to estoppel when it is invoked by way of defense.” [which was reversed by *Waltons Stores (Interstate) Ltd. v. Maher* (1988), 164 C.L.R. 387 (H.C.A.)]... “The law of restitution, or unjust enrichment, can provide a further possible remedy for a case where expense has been incurred in the expectation that a contract will eventuate, and this expectation proves to be unfounded.” at 13.
- [4] 2001 (1 Ob 49/01i) Court: Oberster Gerichtshof Spanish Co (SP) v. Austrian Co. (AUS) <http://www.unilex.infor/case.cfm?id=736> It was reasonable for SP to rely on the “apparent authority” demonstrated through conduct at para. [6].
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- [8] *Supra* note 1 at 25.
- [9] Goderre, Diane Madeline, “International Negotiations Gone Sour: Precontractual Liability under the United Nations Sales Convention”, 66 U. Cin. L. Rev. 257, 1997-1998 at 267.
- [10] *Supra* note 1 at 162.
- [11] Reichsgericht (RG), *Entscheidungen des Reichsgerichts in Zivilsachen* (RGZ) Volume 78 page 239 (1912) *See also supra* note 1 at 21.
- [12] *Bundesgerichtshof* 28 Jan. 1976, BGHZ 66, 51.
- [13] *Supra* note 1 at 165. German commentator, Lorenz. A person willfully causing damage will be bound to compensate for damage [§ 826 (originating from Roman law (*action de dolo*)).
- [14] *Ibid* at 166. *Reichsgericht* 19Jna. 1934, RGZ 143, 219(222).
- [15] *Ibid* at 171. *Bundesgerichtshof* 10 July 1970, NJW 1970, 1840 and *Bundersgerichtshof* 12 June 1975, NJW 1975, 1774.
- [16] *Supra* note 1. Schmidt at 147.
- [17] *Ibid.* Schmidt explains: “In some situations, the negotiators attempt to privilege security over freedom, by concluding preliminary agreements designed to prepare the future definitive agreement. The legal problems flowing from such preliminary agreements are solved by application of the ordinary rules of contract law. Finally, the precontractual process under French law may be treated either in torts, or in contracts, depending on whether the parties have or have not concluded any preliminary agreement.” at 148.
- [18] *Ibid* at 149-192.
- [19] *National Bank of Canada v. Soucisse*, [1981] 2 S.C.R. 339; *Bank of Montreal v. Kuet Leong Ng*, [1989] 2 S.C.R. 429; *Bauer v. Bank of Montreal*, [1980] 2 S.C.R., 102, at 112-113, 110 D.L.R. (3d) 424, at 431-432, [1980] S.C.J. No. 46 (S.C.C.); *Canadian National Bank v. Houle* (1990) 3 S.C.R. 122 extended the principle of good faith to qualify that it does not require malice for a principle of good faith to apply objectively by law.
- [20] *Bhasin v. Hrynew*, 2011 ABQB 637; 2013 ABCA98 (CanLII); [2014] S.C.R. 71. *See Cromwell’s* explanation of the good faith principle in Quebec at para. [83].
- [21] *Addison Chevrolet Buick GMC Ltd. v. General Motors of Canada Ltd.* 2015 ONSC 3404 (CanLII). Justice Dunphy noted that: “Good faith and honesty are the boundaries of the field to which the contractual relationship is negotiated and performed.” at para. [16].
- [22] *Dunkin’ Brands Canada Ltd. v. Bernice Inc. et al*, 2013 QCCA 867 at para. 71. A further enlargement took place in *Dunkin’ Brands* where the court extended the duty of good faith to include a heightened duty of good faith in relational contracts when parties must continue to strive to meet their goals over a long period of time.
- [23] *Churchill Falls (Labrador) Corporation Limited [CF] and Hydro-Québec*, 2018 SCC 46.
- [24] *Ibid* at Chapter 14.
- [25] *Supra* note 5.
- [26] *Ibid* Chapter 13, para. 3 under b. Shoji Kawakami.
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- [30] 133 N.W. 2d 267 (Wis. 1965).