

# THE DUTY OF GOOD FAITH IN FRANCHISE AGREEMENTS – A COMPARATIVE STUDY OF THE CIVIL AND COMMON LAW APPROACHES IN THE EU

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This article considers how the duty of good faith impacts on the on-going relationship between franchisor and franchisee in the civil and common law traditions. The concept of good faith is firmly established in the civil law jurisdictions of the EU, particularly in German and French law, but it manifests itself in different forms in each of them. In English law, the idea that good faith is not part of business-to-business contracting is now outdated. Recent English case law confirms that an implied concept of good faith is steadily gaining recognition as a legally binding concept during the performance phase of contracts particularly long term relational agreements such as franchise agreements.

The duty of good faith has a substantial impact upon the on-going franchisor/franchisee relationship. It seeks to deliver a degree of equilibrium to the inherent tension within the franchise relationship between the desire of both parties to obtain the best commercial deal for themselves and a need to have a good on-going commercial relationship based upon a modicum of mutual trust.

It exists in most civil law jurisdictions but is frequently interpreted in different ways. Common law jurisdictions such as England generally have an uneasy relationship with the concept of a duty of good faith. There are generally considered to be three main 'families' of law in Europe - German, French (both civil law jurisdictions) and English (a common law jurisdiction). Each takes a different approach to the concept of good faith.

This article considers the impact that each of these "families" of good faith has on franchising and highlights how the recent developments in English law are changing the common law historical approach to the concept to one that more closely resembles the civil law aspect. Although the English courts are traditionally suspicious of the concept, a recent decision has placed it very much at the centre of franchising and we should expect to see it raised by franchisees in their disputes with their franchisors.

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centre of franchising”*

## THE CIVIL LAW APPROACH

### The German approach to good faith

In Germany, the concept of good faith is extremely sophisticated and far reaching. It has 'been used as a convenient legislative peg on which to place a whole raft of developments by German courts to deal with perceived problems either technical or social... It remains a "general principle" of German contract law ... but its effects have been worked out and elaborately classified into particular categories (known as *Fallgruppen*)<sup>1</sup>. Each category takes a markedly different approach. In order to understand how these various interpretations of the duty of good faith work together one commentator has broken them down into three different approaches<sup>2</sup>, 'collateral', 'restrictive' and 'adaptive'. This categorisation is subjective. More often than not a particular provision contains elements of two or three different approaches. A black and white categorisation is usually not possible. Most jurisdictions follow the 'restrictive approach' to a certain extent, whereas the 'collateral approach' is primarily confined to pre-contractual disclosure and most heavily used in countries which have a long-standing tradition of protecting the weaker party. An 'adaptive approach' is the least common and tends to be used in the circumstances in which the English law concept of 'frustration' of contract would be applied. There is an important distinction between '*Treu und Glauben*' (objective good faith) and '*gutter Glaube*' (subjective good faith) which has to do with knowledge. *Treu und Glauben* has become an 'open' norm and although not a legal rule with specific requirements takes shape in the way it is applied.<sup>3</sup>

### The collateral approach to good faith under German law

Article 311 BGB takes a 'collateral approach'. It imposes totally new obligations on the parties to the agreement and in doing so can reduce the risks to which both the franchisor and franchisee are exposed. In Germany, the franchisor has certain continuing implied obligations<sup>4</sup> which include advising, instructing and supervising the franchisee. The franchisor also has a fiduciary duty to refrain from interfering in the franchisee's business, especially if the franchisor is active himself in the same market area<sup>5</sup>. Thus encroachment and the adequacy of support are dealt with. The franchisee's main duty of good faith and fair dealing is to pay the royalty and other fees to the franchisor.

In return he receives access to the franchisor's know-how, trademark equipment and so forth. Usually the franchisee will be obliged to purchase certain kinds of products from the franchisor. Even without a non-compete clause the business secrets of the franchisor will be protected by the franchisee's fiduciary duties to the franchisor.<sup>6</sup> Accordingly the risks to which the franchisor is exposed are reduced.

*“In Germany, the concept of good faith is extremely sophisticated and far reaching.”*

<sup>1</sup> Whittaker, *The 'Draft Common Frame of Reference – An Assessment*, Commissioned by Ministry of Justice, Appendix II p. 138.

<sup>2</sup> Kroppholler, *Studienkommentar BGB*, 10th edition 2007, § 242 Rn. 1.

<sup>3</sup> Hesselink, M. W., 2004, "The Politics of a European Civil Code", *European Law Journal*, Volume 10, (n.35) 289.

<sup>4</sup> BAG 30.05.1978, BB 1979, 325.

<sup>5</sup> Petsche, A., S. Riegler and W. Theiss, 2004, 'Franchising in Austria', *International journal of Franchising Law*, 2004, pp. 3-4.

<sup>6</sup> BGH, WB1 1989, 131.

### The restrictive approach to good faith under German law

The duty of *Treu und Glauben*<sup>7</sup> takes a 'restrictive approach' to the concept of good faith. It requires that a franchisor is bound to perform its obligations according to the requirements of good faith, ordinary usage being taken into consideration.<sup>8</sup> It seeks to restrict the ability of parties to the agreement to exercise their agreed contractual rights in an unreasonable manner.

This means that the franchisor must exercise its discretion reasonably for it to be considered valid by the German courts. It can be a substantial fetter on the ability of the franchisor to act in the best interests of the franchise network as a whole rather than an individual franchisee. What may seem to be reasonable in the context of a bilateral relationship between the franchisor and a particular franchisee may be totally unreasonable in the context of a multilateral relationship between the franchisor and all of its franchisees. Article 138 BGB provides that a legal transaction which offends good morals (*contra bonas mores*) is void. It seeks to adjust the terms agreed by the parties to the agreement to new and unforeseen circumstances that arise so if the franchisor exploits the predicament, inexperience, lack of judgement or considerable (economic) weakness of the franchisee or gains a financial benefit which is clearly disproportionate to its performance the agreement will be void. Agreements which breach the duty of *Treu und Glauben* in Article 242 of the German Civil Code are therefore void under Article 138. This is clearly far from the English concept of 'caveat emptor' and the freedom of the parties to negotiate the contractual terms of their relationship is thus limited.<sup>9</sup>

<sup>7</sup> Article 242 of the German Civil Code ('BGB').

<sup>8</sup> Raymond, Y., 1994, *Sourcebook on German Law*, 1st edition, Routledge Cavendish, pp. 304-305.

<sup>9</sup> But see the decision in *Fleet Mobile Tyres Limited v. Stone and Another* (Trading as Tyre20) (2006) EWCA Civ 1209 which shows that the English courts will not always implement the strict letter of a franchise agreement.

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The German courts have ruled that the following did not comply with the principle of good faith and fair dealing:

- lack of consideration;<sup>10</sup>
- if the franchisor's obligations are merely discretionary;<sup>11</sup>
- if the franchise system is based on pyramid selling or multilevel marketing systems;<sup>12</sup>
- if the franchisee is obliged to buy overpriced goods or an excessive amount of them;<sup>13</sup> or
- provisions providing the franchisor's access to the franchisee's accounts twice a month (on the basis that this unduly restricts the franchisee's entrepreneurial freedom).<sup>14</sup>

### The adaptive approach to good faith under German law

The prime example of the 'adaptive approach' is Section 313 BGB which stipulates that if circumstances upon which a contract was based change substantially after the conclusion of the contract and if the parties would not have concluded the contract or would have done so on different terms if they had foreseen the change, adaptation of the contract can be claimed if a party cannot reasonably be expected to continue to be bound by the contract in its unaltered form. German courts

<sup>10</sup> LG Paderborn NJW-RR 1987,S, 672f; LG Karlsruhe NJW-RR 1989, S. 822f.

<sup>11</sup> BGH NJW-RR 2000,1159ff.

<sup>12</sup> OLG Muenchen NJW 1986, S.1880ff.

<sup>13</sup> Giesler, *Franchisevertrag*, Rn. 60.

<sup>14</sup> Giesler, *ibid*, Rn. 62.

*“The German concept of good faith has a substantial impact upon the franchisor/franchisee relationship ...”*

will only make very limited use of the adaptive powers under this provision in situations in which the English courts might apply the concept of 'frustration'. It is used to save a contractual relationship rather than to invoke termination from the beginning. This has the potential to re-enforce the economic drivers that attract both franchisors and franchisees to franchising and reduce the consequential risks. The German concept of good faith has a substantial impact upon the franchisor/franchisee relationship and, as is evident from the above, reduces the risks to which both franchisor and franchisee are exposed and re-enforce the economic drivers that attract franchisees to franchising.

### **THE FRENCH APPROACH TO GOOD FAITH ('BONNE FOI')**

The restrictive, adaptive and collateral approaches to a duty of good faith can be found in differing combinations and degrees in most of the civil jurisdictions in the EU despite the fact that some of them have a very different historical perspective and approach to the concept of good faith. In France, although the general concept of good faith or *bonne foi* is found in Article 1134 of the French Civil Code, until the last quarter of the twentieth century it was substantially limited by the judicial view that 'if a person says something it is fair'.<sup>15</sup> Since the late part of the last century, the doctrine has become controversial amongst French lawyers<sup>16</sup>. Increasingly the legal profession seems to be advocating that it should be more interventionist and less 'liberal' to ensure more 'socially' appropriate

<sup>15</sup> ('*Qui dit Contractuel dit juste*') Whittaker, *The 'Draft Common Frame of Reference' - An Assessment*, Appendix II p. 139.

<sup>16</sup> See Flour, J. and J. Aubert, 1994, *Les obligations, L'acte juridique*, 6th edition, pp. 289-90 and Demogue, R., 1931, '*Traite des obligations en general*'.

outcomes, although some feel that this interferes too much with contractual freedom.<sup>17</sup> Other provisions of French law also contain notions of good faith.<sup>18</sup>

The ascendancy of the interventionist school is evidenced by the fact that although the wording of the provision only requires good faith in the performance of the contract,<sup>19</sup> French courts have extended this obligation to impose a duty of good faith at the earlier stages of pre-contractual negotiations,<sup>20</sup> the formation of the contract<sup>21</sup> and even its termination.<sup>22</sup> The notion of good faith has also been used by the French courts, in 'restrictive' and 'adaptive' and 'collateral' manners, to import morality and justice into contracts commonly by

*“... French courts have extended this obligation to impose a duty of good faith at the earlier stages of pre-contractual negotiations, the formation of the contract and even its termination.”*

<sup>17</sup> Whittaker, *The 'Draft Common Frame of Reference'-An Assessment*, Appendix II p. 139 and Mazeaud, 'La politique contractuelle de la Cour de Cassation', in *Libres Propos sur les Sources du Droit — Melanges en l'honneur de Philippe Jestaz* (Paris : Dalloz-Sirey, 2006), p. 371.

<sup>18</sup> Article 1135 of the Civil Code, Articles 111-1 and 113-3 of the Consumer Code and Article 330 of the Civil Code.

<sup>19</sup> See [www.legifrance.gouv.fr](http://www.legifrance.gouv.fr) for a translation by Georges Rouhette, Professor of Law, with the assistance of Dr Anne Rouhette-Berton, Assistant Professor of English.

<sup>20</sup> Cass. com. 26 November 2003, Bull. civ. IV, No. 186, (Manoukian case).

<sup>21</sup> Cass. com. 4 February 2004, no. 00-21.319: Juris-Data no. 2004-022354; D.2005, p. 151 - In this case the franchisor was held liable for failure to provide pre-contractual information necessary to allow the franchisee to enter into the contract with full knowledge of the facts.

<sup>22</sup> Cass. com. 11 July 1978, no. 76-13752; Cass. com. 23 Mai 2000, no. 97-10553 - A franchisor may refuse to renew the franchise agreement, but should not let the franchisee believe that the agreement will be renewed whereby inducing him to make investments in the franchise.

way of interpretation and implied terms. Although no judge can award an injured party more than the law allows under the contract, it is possible to prevent a party from exercising the fullest rights which the law would otherwise permit him to do.

The French Courts have taken a 'restrictive approach' and held that a party who has acted in bad faith cannot require the other party to perform the contract as if nothing had happened or claim damages.<sup>23</sup> French courts have the power to terminate the contract when requested by the victim of the unfair behaviour.<sup>24</sup> In addition, a French court can prevent the breaching party from relying on a limitation or exclusion of liability clause when it acts in a deceptive manner.<sup>25</sup> A restrictive approach was taken by the courts when an open price term to be determined by the franchisor was deemed enforceable under French law only so long as it is proportional.<sup>26</sup>

An 'adaptive approach' to the concept of good faith comes into play when there is a change in circumstance which prevents a distributor from being competitive. The French duty of good faith requires the supplier in these circumstances to renegotiate the terms of the contract in order to allow it to be competitive.<sup>27</sup> A more recent case raised an important doctrinal debate around a possible duty of 'solidarity' between the parties (suggesting an adaptive approach to good faith) but the French Supreme Court failed to clearly state its position on the question.<sup>28</sup> One party claimed that good faith imposed an obligation to renegotiate, when a change in circumstances significantly altered

the initial balance of the contract. The Supreme Court rejected the claim on the basis that the imbalance already existed when the contract was formed, so failing to clarify whether or not the courts have the power to vary the terms of a contract in such circumstances. There are no cases which suggest that the concept of *bonne foi* can be applied to prevent encroachment by the franchisor.

The French courts have also considered adopting a collateral approach to the duty of good faith. From the formation of the contract until the end of the contract, a franchisor has the continuing duty to support its franchisees with commercial and technical assistance.<sup>29</sup> A lack of advice and support during the start-up period can lead to the termination of the agreement.<sup>30</sup> The level of support which needs to be provided depends on the needs of each franchisee and therefore needs to be adapted.<sup>31</sup> The French concept of good faith has a substantial impact upon the franchisor/franchisee relationship and, as is evident from the above, reduces the risks to which both franchisors and franchisee are exposed and re-enforces the economic drivers that attract franchisees to franchising.

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<sup>23</sup> Cass ire ch.civ., 16 February 1999 no 96-21997, Bull. Civ. I no. 52 p.34

<sup>24</sup> Benabent, A., *Les contrats spéciaux civils commerciaux*, Ed, 2008, no 456, p. 202.

<sup>25</sup> Cass. com., 3 April 2001 no 98-21233, Bull. civ. IV, no. 70.

<sup>26</sup> Cass. ass. plen. 1 December 1995 no. 91-19.653, Bulletin 1995 A. P. N° 8 p. 15.

<sup>27</sup> Cass. com. 3 November 1992 CCC. 1993 no. 45 in a fuel supply agreement; Cass com. 24 November 1998, RTD civ. 1999, 98 in a commercial agency contract.

<sup>28</sup> Cass. Ire civ., 16 March 2004, n° 01-15.804, D. 2004, p. 1754.

<sup>29</sup> Philippe le Tourneau, *Les contrats de franchisage*, 2e edition, Litec 2007, no. 89.

<sup>30</sup> CA. de Reims, 8 November 2000, no. 2000-152146, SARL L'age d'or expansion.

<sup>31</sup> CA. de Douai, 2e ch., 6 September 2007, no. RG: 06/177, Phildar-Le Donnant, D., 2007, p. 2303.



## THE IMPACT OF THE GERMAN AND FRENCH LAW ON OTHER EU JURISDICTIONS

Different jurisdictions have different ideas about what good faith is and the existence of a general doctrine of good faith does not guarantee a particular outcome.

### Greece

The Greek Civil Code (Article 288) is a verbatim translation of 242 BGB. Also, Article 200 of the Greek Civil Code reflects 157 BGB. The terms of the franchise agreement must not unduly restrict the freedom of the franchisee or allow the franchisor to exploit the need or inexperience of the franchisee to obtain for himself or a third person benefits which are clearly disproportionate to the franchisor's obligations<sup>32</sup>. To do so would be contrary to public policy<sup>33</sup>. The parties must also act towards one another with loyalty, fairness and good faith<sup>34</sup>. The franchisee may not assign its obligations to a third party<sup>35</sup> and must provide the franchisor with information about its business (Article 718 of the Greek Civil Code). The franchisor has a general obligation to assist the franchisee in the exercise of its activities and supply him with documents, brochures and other information in order to enable him to promote the franchise system<sup>36</sup>. In return, the franchisee has to pay the fees and royalties agreed and has a duty of confidentiality which continues after the termination of the agreement<sup>37</sup>. In the absence of a specific provision to the contrary in the franchise agreement, the franchisee is under an obligation not to compete with his franchisor during the duration of the agreement<sup>38</sup>.

<sup>32</sup> Article 179 of the Greek Civil Code

<sup>33</sup> Articles 174 and 178 of the Greek Civil Code

<sup>34</sup> Article 281 of the Greek Civil Code

<sup>35</sup> Article 715 of the Greek Civil Code

<sup>36</sup> F.I.C. of Salonica 1671/71, JCL (1972) 52

<sup>37</sup> Articles 200 and 288 of the Greek Civil Code as well as Law 146/14 on unfair competition

<sup>38</sup> Article 919 of the Civil Code F.I.C. of Athens 11486/80 JCL (1981) 50,131

### Belgium

Belgium was formerly directly subject to the French Civil Code but, perhaps due to German influence, has relied more on Article 113 of the German Civil Code than the French approach to good faith.

### Spain

The Spanish Civil Code Article 1258 provides that contracts give rise not only to obligations to accomplish what has been expressly agreed but also the results that are in accordance with good faith, custom and the law. Whilst Article 7, inter alia, provides that rights must be exercised in conformity with the requirements of good faith.

### Austria

Although the Austrian Civil Code does not refer to 'Treu und Glauben' it does refer to honest business usage which is used to determine the circumstances under which a contract has been concluded<sup>39</sup> and how they should be interpreted<sup>40</sup>. The Austrian Supreme Court has used these two rules as a route to asserting that 'Treu und Glauben' and reliance on honest business usage are ethical principles which are so generally acknowledged that they may be applied without having been included in the Civil Code. There are subtle differences to the BGB 242<sup>41</sup>.

### The Netherlands

In the Netherlands, all contracts must be construed and performed in good faith<sup>42</sup>. However, a contractual provision of a franchise contract will only be set aside on the basis of 'good faith' in limited situations. For example, if the provision

<sup>39</sup> ABGB § 863

<sup>40</sup> ABGB § 914

<sup>41</sup> Whittaker, S. and R. Zimmerman, 2000, *Good Faith in European Contract Law*, CSICL Cambridge University Press, p. 51

<sup>42</sup> Article 6:248 Dutch Civil Code (the rules of reasonableness and fairness (redelijkheid en billijkheid))

concerned is manifestly not in accordance with the character of the franchise contract, or if the franchisee could not be aware of the breadth of the provision concerned. It has been established by case law that in certain circumstances it may be contrary to good faith to invoke an exclusion of liability clause<sup>43</sup>.

### Poland

Polish Civil Code Art 56. Under Polish law, Art. 56 KC imposes a duty of good faith and provides that:

'an action produces not only those effects expressly intended by it, but also those arising from law, principles of community life and accepted customs'.

Thus the parties to the franchise agreement are bound by not only the express contractual terms but also those implied by law. These obligations can be collateral, adaptive or restrictive. An example of the franchisor's collateral obligations is the requirement to provide the franchisee appropriate assistance both at the beginning of the relationship, in the form of both initial and ongoing training. This obligation arises from the need to enable the franchisee to effectively exercise rights granted it in the franchise agreement (in particular the intellectual and/or industrial property rights). Without the franchisor's appropriate advice and guidance the franchisee would not be able to put the contractual provisions into effect<sup>44</sup>. Revealing or taking advantage of the franchisor's trade secrets or obtaining them from an unauthorised person, if it may harm or endanger the entrepreneur's interest, is deemed to be an act of unfair competition<sup>45</sup>. Breach of this duty of confidentiality entitles the franchisor<sup>46</sup> 'to end the

infringement and to prohibit further violation; to eliminate the consequences of the infringement by requiring the infringer to make an appropriate public declaration or declarations; pay damages according to general compensation rules and account for any profits made according to general unjustified enrichment rules'. Breach can lead to imposition of a fine or a custodial sentence of up to two years' imprisonment<sup>47</sup>. Damages are limited to the actual loss directly resulting from the unsuccessful continued negotiations<sup>48</sup>. The Polish Act Against Unfair Competition<sup>49</sup> may also apply.

### The Czech Republic

Czech Civil Code Art 6-228(1). In the Czech Republic the doctrine of good faith means that a contractual obligation is enforceable only to the extent that it does not conflict with 'principles of fair dealing'. Given the lack of precedence in franchise matters, judges have wide discretion in defining whether or not a term is fair<sup>50</sup>.

### Finland

Section 1 of the Finnish Unfair Business Practices Act (1978). In Finland, the duty of good faith is well protected. Section 36 of the Contracts Act (228/1929) imposes a duty of good faith and states that unfair contract terms may be adjusted or set aside if their application leads to an unfair result. The rest of the contract may also be adjusted or declared terminated under this provision, if it is unfair to enforce the rest of the contract after the adjustment of a contract term<sup>51</sup>. The Act on Regulating the Contract Terms between Entrepreneurs<sup>52</sup> provides that the use of an unfair

<sup>43</sup> Judgment of 19 May 1967, (Supreme Court) 'Hoge Raad' (HR), 1967 (Dutch Court Reporter) 'Nederlandse Jurisprudentie' (NJ) No. 261; Judgment of 20 Feb. 1976, HR, 1976 NJ No. 261; Judgment of 18 Dec. 1981, HR, 1982 NJ No. 71; Judgment of 7 May 1982, HR, 1983 NJ No. 509

<sup>44</sup> Bagan-Kurluta, *Umowa franchisingu Monografie prawnicze*, pp. 77, 79

<sup>45</sup> Art 11 § 1 ZNKU

<sup>46</sup> Art. 18 ZNKU

<sup>47</sup> Art. 23 ZNKU

<sup>48</sup> Article 721 § 1 KC

<sup>49</sup> ZNKU (Ustawa o zwalczaniu nieuczciwej konkurencji)

<sup>50</sup> Marc, P. and W. Theiss, 2004, 'Franchising in the Czech Republic', *International Journal of Franchising Law*, Volume 2, Issue 6, pp. 25-34, 27

<sup>51</sup> Section 36 of the Contracts Act (228/1929)

<sup>52</sup> Section 38 of the Act on Regulating Contract Terms between Entrepreneurs (1062/1993)

contract term in contracts between business parties is prohibited, if one of the parties is in a weaker bargaining position and therefore needs protection<sup>53</sup>. It is difficult to predict the way in which the courts will amend a contractual term to make it more reasonable<sup>54</sup>. In one case the courts declared it possible for a franchisee to terminate the franchise agreement on the grounds that the franchise business was no longer profitable, even though this was not a contractual ground for termination. It was also held to be unreasonable to charge franchising fees for a period once a franchisee had already ceased trading<sup>55</sup>.

The Act on Regulating the Contract Terms between Entrepreneurs also prohibits unfair contract terms if one of the parties is in a weaker bargaining position<sup>56</sup>. Unfair terms will be adjusted in accordance with the general rules of adjustment under the Contracts Act<sup>57</sup> by the Market Court<sup>58</sup> by way of an injunction and a conditional fine<sup>59</sup>.

### Bulgaria

Bulgarian law recognises a duty of good faith, which only has an impact on the on-going franchise relationship. The parties to a franchise agreement or any other commercial agreement for that matter owe each other a duty of good faith when exercising their rights under the agreement. In addition, although the parties may freely determine the content of the franchise agreement and the parties' obligations, a contract may not contravene the mandatory

provisions of law and the duty of good faith. Article 26(1) of the Bulgarian Obligations and Contracts Act stipulates that a contract which contravenes or circumvents the law as well as a contract which infringes the duty of good faith shall be null and void. This means that Bulgarian law recognises a restrictive approach to good faith as well as possibly an adaptive approach.

### Portugal

In Portugal, the on-going relationship between franchisor and franchisee is governed by general contract law particularly the principal of good faith<sup>60</sup>. This requires honesty of intention, the absence of malice, the absence of a desire to defraud or to seek an unconscionable advantage and a duty to supply to the franchisee all the information and cooperation which is needed for the performance of the agreement and discharge of the obligations by and of the other parties<sup>61</sup>.

### Denmark

The general starting point in Danish law is the principle of freedom of contract, but this general rule has been restricted over time, notably by the Danish Contracts Act<sup>62</sup>. The most important provision in relation to franchise agreements is Section 36, which provides that a contract may be found entirely or partly void if it, or specific clauses in it, are found to be 'unfair' to one of the parties. Although this duty of good faith is very rarely applied by the courts to contracts between business partners, it is an assessment based on the facts in each individual case and may therefore be applied to modify the franchise agreement<sup>63</sup>. For example, although a franchise agreement may prohibit or

<sup>53</sup> Hanna-Maija Elo, 'Finland' in: *Getting the deal through - Franchise 2008*, p. 37 para. 22

<sup>54</sup> Petri Rinkinen, 'Franchising Legislation in Finland', [www.franchising.fi/ukindex](http://www.franchising.fi/ukindex)

<sup>55</sup> Vaasa District Court judgment, dated 20.11.2003 in the case of Kotipizza Oy v. Ekosmart Ky

<sup>56</sup> Hanna-Maija Elo, 'Finland' in: *Getting the deal through - Franchise 2008*, p. 37 para. 22

<sup>57</sup> Riitta Ahonen "Unconscionability and adjustment of unfair contract terms", (Master's thesis, University of Joensuu 2004) p.9)

<sup>58</sup> Section 1(1).3 of the Market Court Act and Section 2(3) of the Act on Certain Proceedings before the Market Court.

<sup>59</sup> Hanna- Maija Elo, 'Finland' in: *Getting the deal through - Franchise 2008*, p. 37 para. 22

<sup>60</sup> Article 762 of the Portuguese Civil Code

<sup>61</sup> 'Outline of franchise issues in Portugal', questionnaire with answers provided by Jose Alves Do Carmo, associate, Barrocas Sarmento Neves

<sup>62</sup> Law no 781 of 26.08.1996

<sup>63</sup> Christensen, L.A., 2008, *Franchising in Denmark, International Franchising*, Kluwer Law International, p. 9



restrict the right to transfer the franchise, the combination of an unusually long notice period and a prohibition against transferring the franchise may be considered unfair and, hence, be set aside<sup>64</sup>.

#### *Latvia*

Latvian Civil Code Art. 14. Section 14 of the Latvian Civil Law regulating leases is not restricted to real estate but also applies to franchise agreements<sup>65</sup>. The franchisor is responsible for the quality of the rights granted to the franchisee<sup>66</sup>. The franchisee is required to use the rights of the lease 'wisely and with care'<sup>67</sup> and has to exercise them according to the purpose of the intended agreement<sup>68</sup>. This is interpreted widely, and includes preserving the franchise's distinct image. It means that the franchisor has the right to ensure that the franchisee complies with the franchisor's business and marketing concepts<sup>69</sup>. There is a general duty to fulfil all responsibilities and rights in good faith<sup>70</sup>.

#### **Romania**

Article 3 of the Romanian law<sup>71</sup> provides that a franchise agreement must include the principle of fairness, stating that it must reflect the interests of the members of the franchise network, as well as protect the franchisor's interests. This idea of fairness is further reflected in Article 7 of the Ordinance, under which the franchisor, in case of breach, has to notify the franchisee in writing of the breach and grant him a reasonable time to remedy the contravention of the franchise agreement.

<sup>64</sup> *Ibid.*, p. 10

<sup>65</sup> Article 2113 of the Latvian Civil Law

<sup>66</sup> Article 2135 of the Latvian Civil Law

<sup>67</sup> Article 2150 of the Latvian Civil Law

<sup>68</sup> Article 2151 of the Latvian Civil Law

<sup>69</sup> 'Legal framework of franchising development in Latvia' on the website [www.franchising%20.lv/new\\_site/lt/legislation\\_latvia.html](http://www.franchising%20.lv/new_site/lt/legislation_latvia.html)

<sup>70</sup> Article 1 of the Latvian Civil Law

<sup>71</sup> Ordinance no 52/1997 of 28 August 1997 on the law governing franchising, modified by Law 79/1998

## **THE ENGLISH COMMON LAW APPROACH**

### **The traditional view of good faith under English law**

Historically, there is no *general* doctrine under English law that parties to arms' length commercial contracts between businesses are legally obliged to perform their contractual obligations, or exercise their rights, in 'good faith'. English law traditionally focuses on the external, verifiable action of a party, measured by reference to express contract provisions. 'Good faith' can only be measured by reference to the inner motivation of a party (e.g. 'honesty'), which is harder to ascertain and prove. A legally binding 'good faith' doctrine would undermine the commercial freedom of the parties (which English law has historically proudly upheld) to regulate their contractual relationship in accordance with a written contract, rather than by reference to an unwritten standard of commercial morality.

*“A legally binding ‘good faith’ doctrine would undermine the commercial freedom of the parties (...) to regulate their contractual relationship in accordance with a written contract ...”*

*“... in certain circumstances equity works almost as much as a corrective instrument as the principle of good faith does in civil jurisdictions.”*

The traditional English view of the concept of a duty of good faith between contracting parties was best summed up by Bingham, LJ, who commented<sup>72</sup>:

"in many civil law systems, and perhaps in most legal systems outside of the common law world, the law of obligations recognises and enforces an overriding principle that in making and carrying out contracts parties should act in good faith. This does not simply mean that they should not deceive each other, a principle which any legal system must recognise; its effect is perhaps most aptly conveyed by such metaphorical colloquialisms as 'playing fair', 'coming clean' or 'putting one's cards face down on the table'. It is in essence a principle of fair and open dealing".

There has been much debate about whether good faith is the behaviour of one who acts with a 'pure heart and empty head'<sup>73</sup> or merely the 'prudence and causation of a reasonable man'.<sup>74</sup> However, the English courts do seem to agree that:

"the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations"<sup>75</sup>

and that it is

"as unworkable in practice as it is inherently inconsistent with the position of a negotiating party".<sup>76</sup>

<sup>72</sup> *Interfoto Picture Library Ltd v. Stiletto Visual Programmes Ltd* [1988] 1 All ER 384 at 352 (CA).

<sup>73</sup> *Sir John Lawson v. Weston* 170 ER 640 (KB 1801) per Lord Kenyon.

<sup>74</sup> *Gill v. Cubitt* (1824) 3 B. & C. 466, 107 ER 806.

<sup>75</sup> Lord Ackner in *Walford v. Miles* [1992] 1 All ER 453 at 460

<sup>76</sup> *Ibid* at 461

Although English law has not committed itself to any such overriding principle<sup>77</sup> it has 'developed piecemeal solutions in response to demonstrated problems of unfairness',<sup>78</sup> which amount to a species of good faith. The law is suffused with good faith but does not use it as a general legal basis for intervention.<sup>79</sup>

The common law rules of mistake, misrepresentation and duress all require the fairness and honesty that are indicative of a general duty of good faith. The principles of equity are also similar to the concept of good faith. Their origins lie in the jurisdiction of the Chancellor who would grant remedies to mitigate the harshness and rigidity of the common law.<sup>80</sup> The rules of promissory estoppel, specific performance, injunctions, consideration, undue influence and more recently the notion of unconscionable bargains<sup>81</sup> all focus on the need for honesty and fairness and so have all led to a whittling away of the common law principles.

Therefore, in certain circumstances equity works almost as much as a corrective instrument as the principle of good faith does in civil jurisdictions. The courts have also seriously interfered with the express terms of contracts as regards exclusion and exemption clauses,<sup>82</sup> whilst statutes, such as the Partnership Act 1890 and the Unfair Contract Terms Act 1977 also impose good faith principles.

<sup>77</sup> The doctrine of 'Uberrima Fides' in insurance contracts and the concept of good faith in partnership and agency are notable exceptions.

<sup>78</sup> *Interfoto Picture Library Ltd v. Stiletto Visual Programmes Ltd* [1988] 2 WLR 615 per Bingham LJ at 621.

<sup>79</sup> *Op. cit.*, Whittaker and Zimmerman.

<sup>80</sup> Halsbury's Laws of England, *Contract* Vol. 9 No. 612.

<sup>81</sup> *Hughes v. Metropolitan Rly Co* (1877) 2 App Cas 439; *Cross v. Cross* (1983) 4 FLR235; *Stiff v. Cassell* (1856) 2 Kay & J. 279; *Maythorn v. Palmer* (1864) 11 Jur NS 230; *Nocton v. Lord Ashburton* [1914] AC 932; *Credit Lyonnaise Bank Nederland NV v. Burch* [1997] 1 All ER 144, CA.

<sup>82</sup> Halsbury's Laws of England, *Contract* Vol. 9 No. 614

*“Over time, legislation has reduced common law's inherent sympathies towards 'laissez-faire' in commerce, to such an extent that one should acknowledge the existence of a loose and implied form of good faith in those EU member states that have a common law system.”*

The European Union has had an influence upon English law. It means that the continental notion of good faith now impacts on discrete local legislation. The Uniform Law of International Sales Act 1967, the Commercial Agents (Council Directive) Regulations 1993 and the Unfair Terms in Consumer Contracts Regulations 1999 all contain provisions of the concept of good faith.

### **Overview of cases in which an obligation of good faith has been implied**

The case of *Fleet Mobile Tyres Limited v. Stone and Another (trading as Tyre 20)*<sup>83</sup> shows how in franchise disputes, although English law will not imply into a franchise agreement an obligation on a franchisor to act fairly or reasonably towards its franchisees, the courts can look beyond the strict wording of a franchise agreement and utilise less known legal principles of equity in order to protect what the court considers to be the 'innocent' party.

Over time, legislation has reduced common law's inherent sympathies towards 'laissez-faire' in

<sup>83</sup> (2006) EWCA Civ 1209 *Fleet Mobile Tyres Limited v. Stone and Another* (trading as Tyre 20). The House of Lords refused an application by the franchisor, Fleet Mobile Tyres, to appeal against a controversial decision by the Court of Appeal which allowed a franchisee to terminate its franchise agreement following a forced re-branding by the franchisor. Deducting more than the agreed 6% from the franchisee and changing its brand focus were such fundamental breaches in the opinion of the Court of Appeal that they entitled the franchisee to terminate.

commerce, to such an extent that one should acknowledge the existence of a loose and implied form of good faith in those EU member states that have a common law system. A good example of the equivalent of a duty of good faith being inferred into a franchise agreement under English law is provided by two cases. In *MGB Printing v. KallKwik*<sup>84</sup> the court implied an obligation on the franchisor to ensure that it provided services to the franchisee using reasonable skill and care on the basis of 'business efficacy'. In *Stream Healthcare v. Pitman*<sup>85</sup> the court ruled that services should be provided to the franchisee by the franchisor when reasonably required or requested. Section 13 of the UK's Supply of Goods and Services Act 1982 can also be applied to reach a similar result, as it provides that services supplied in the course of the supplier's business must be carried out with reasonable care and skill.

The courts have been prepared to imply an obligation of good faith in relation to the exercise of certain specific rights or obligations by one party to a contract. For example, in the case of *Astrazeneca UK Limited v. Albemarle International Corporation and another*<sup>86</sup> the High Court held that a contractual clause in a supply agreement which granted the supplier a 'right of first refusal' must be exercised by the customer in 'good faith'. In that case, the customer engaged the services of a third party supplier without providing the original supplier with the opportunity to match the third party's offer. The judge held that in these circumstances, the customer was obliged to act in good faith and to provide the original supplier with "full and fair" disclosure of the precise terms of any third party deal which the customer was minded to accept, even if the terms of the contract might require further negotiation or may even fail to result in a contract at all. There was no express 'good faith' claim in the contract, but the court was prepared to imply a legally binding duty of good faith. This case is of relevance to those master franchise agreements which grant the master franchisee a right of first refusal for an extended or new territory.

<sup>84</sup> 2010 EWHC 624 para 43.

<sup>85</sup> *Ibid*, para 55

<sup>86</sup> [2011] EWHC 1574 (High Court)

*“The concept of good faith under English law in "relational" agreements such as franchise and long term distribution agreements has taken a substantial leap forward ..”*

A legally binding 'good faith' principle has also been implied into a contractual provision which gave the decision-maker under the contract a seemingly total discretion whether to consent to an assignment by the other (it is common to see such a discretion given to a franchisor on a request for assignment by the franchisee). It has been held by the Court of Appeal that, where the contract does not explicitly give the decision-maker absolute discretion, the right to withhold such consent must still be exercised in "good faith" and not "capriciously" or in an "arbitrary fashion"<sup>87</sup>. The exercise of the discretion must also not be for an "improper purpose"<sup>88</sup>. It is commonplace in a franchise agreement for the words "to be exercised in the franchisor's sole and absolute discretion" to be included in the clause granting the discretion; or to say in the interpretation section that all references to 'consent' mean in the franchisor's sole and absolute discretion. It is questionable whether such language ousts the implied term to exercise the discretion in good faith<sup>89</sup> although that question has not been directly tested in the courts in a franchise context.

**The Yam Seng case – A change of direction for the English courts**

The concept of good faith under English law in "relational" agreements such as franchise and long term distribution agreements has taken a substantial leap forward with the recent decision of *Yam Seng*

<sup>87</sup> *Lymington Marina v McNamara* [2007] EWCA 151 (Court of Appeal)

<sup>88</sup> *Gan Insurance Co Ltd v Tai Ping Insurance* [2001] EWCA 1047 (Court of Appeal)

<sup>89</sup> See *Nomura v West LB* [2012] EWCA 495 (Court of Appeal)

*Limited v International Trade Corporation Limited*<sup>90</sup>. In May 2009, Singapore-based company Yam Seng entered into an exclusive distribution agreement with International Trade Corporation (ITC), an English company, to market Manchester United branded toiletries to duty free outlets in Asia and the Middle East. Unfortunately the relationship was far from successful and the judge held that ITC's CEO misled Yam Seng about the legal, commercial and logistical position and repeatedly missed deadlines for supplying products to Yam Seng. He made promises which he knew to be unachievable, undercut prices agreed with Yam Seng and provided information which the judge held to be false. Yam Seng terminated the agreement and sued ITC for damages for breach of contract and misrepresentation.

The judge found in favour of Yam Seng and awarded it damages for breach of contract and misrepresentation (which equaled the same amount). An important issue which the court was asked to consider (in the context of whether ITC's conduct involved sufficiently serious breaches of contract to justify Yam Seng's termination of the agreement) was whether a duty of "good faith" should be implied into the contract. Mr Justice Leggatt held that the agreement contained an enforceable implied obligation on the parties to act in good faith and concluded that ITC breached that obligation by knowingly concealing from Yam Seng the true situation concerning ITC's pricing arrangements with a crucial distribution channel in Singapore. The breach of that implied obligation was held to be repudiatory which justified Yam Seng's termination of the agreement and thus entitled Yam Seng to the damages that it sought.

Leggatt J went on to analyse in great detail and clarity why English law should impose an obligation of good faith in such a situation. Leggatt J's judgment draws together the pre-existing, disparate strands of English case law on the issue of "good faith" in commercial contracts and explains the importance of implied good faith in what he called "relational" agreements which are long term agreements requiring extensive co-operation, a high

<sup>90</sup> [2013] EWHC 111 (QB)

degree of communication, mutual trust and confidence and expectations of loyalty referring expressly to joint venture agreements, franchise agreements and long-term distribution agreements. Leggatt J relied on the evolving attitude towards good faith in other common law countries, such as Australia, and sought to dispel the traditional English hostility to a binding good faith principle. Leggatt J doubted that English courts would recognise a requirement of good faith as a duty implied by law into all commercial contracts. He justified its implication into the distribution agreement between ITC and Yam Seng based on the presumed intention of the parties and the relevant background against which the contract was made. Leggatt J concluded that the relevant background could include shared values and behavioural norms (both general and specific to a particular trade or industry) as well as the specific facts known to the parties.

Leggatt J held that the test of good faith is an objective, not a subjective, one. The test is whether the conduct in question would be regarded as commercially unacceptable by a reasonable and honest person, it is not based on either party's perceptions of what is improper conduct. Leggatt argued that the recognition of a duty of good faith is consistent with the case-by-case approach utilised by common law systems and it is not an illegitimate restriction of the parties' freedom of contract as it is open to them to restrict the duty by way of the express terms of the contract.

The *Yam Seng* case is the high water mark in the current series of good faith cases. Arguably, the concept was utilised to give legal credence to the judge's view that a wrong had been committed by ITC to which Yam Seng should, as a matter of equity, have some redress. The facts of the case are fairly specific and there was clear evidence of bad faith and dishonesty by ITC. It would have been interesting to see whether the High Court decision would have been upheld under scrutiny from the Court of Appeal if ITC had chosen to appeal.

### Post Yam Seng

Subsequent to the *Yam Seng* case, the High Court has reaffirmed that the English courts will only imply terms, such as a duty of good faith, into complex commercial arrangements in specific and fairly limited circumstances and will not do so where such an implied term potentially contradicts an express term or is rendered unnecessary by the express terms.

The case of *TSG Building Services plc. v South Anglia Housing Limited*<sup>91</sup> arose out of a contract to provide gas servicing and associated works for housing stock which contained an express term that the parties would "work together and individually in the spirit of trust, fairness and mutual co-operation. and in all matters governed by the Partnering Contract they shall act reasonably and without delay". The contract allowed South Anglia the right to terminate at its convenience which it chose to do without explanation just over a year into the four year term. TSG argued that South Anglia was under a duty to act in good faith when exercising its right to terminate and that duty arose either on a proper interpretation of the express obligation set out above or by implication following the *Yam Seng* case.

*“... the English courts will only imply terms, such as a duty of good faith, into complex commercial arrangements in specific and fairly limited circumstances and will not do so where such an implied term potentially contradicts an express term or is rendered unnecessary by the express terms.”*

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<sup>91</sup> [2013] EWHC 1151]



*Over the last decade, express 'good faith' provisions have been given legally binding effect although (...) such clauses are likely to be construed narrowly and their meaning must be ascertained in relation to the nature of the contract and its context.*

Mr Justice Akenhead held that the express terms of the contract allowed South Anglia to terminate at will and that right was not limited by the express obligation to "work together and individually in the spirit of trust, fairness and mutual co-operation". In addition, as the parties had expressly stated how they would work together, an obligation would not be implied that could have the result of contradicting the express terms agreed. A fundamental difference between this case and *Yam Seng* was that there was no allegation that South Anglia had acted dishonestly or in bad faith when it took the decision to terminate and Akenhead J distinguished *Yam Seng* by saying that case is not authority for any general principles of good faith which are applicable to all commercial contracts.

In the case of *Mid Essex Hospital Services NHS Trust v Compass Group UK & Ireland Ltd (t/a Medirest)*<sup>92</sup>, the High Court held that a customer's right to levy deductions under a service level regime because of sub-standard performance by the service provider must be exercised in a way that is consistent with an express "good faith cooperation" clause, and in a way that furthers the "common purpose" of the contract. The "good faith cooperation" clause was also taken to entail a legal obligation on the parties not to do "unreasonable things" which could harm/poison the parties' relationship. However, in March 2013 the Court of Appeal overturned this decision. The Court of Appeal held that the express good faith cooperation clause should be read narrowly and did not extend to cover all of the parties' interactions. The Court held that there were express clauses in the agreement which already governed the rights and remedies of the parties if one of them misused the service level regime and therefore an implied obligation of good faith was unnecessary. Whilst the contract at the

centre of the dispute was not a franchise or distribution relationship, it was a 7 year contract for the provision of cleaning and catering services by Compass to the NHS Trust hospital and therefore a fairly long term relationship in which the parties needed to be able to deal with each other with trust and confidence. It is interesting to note that Jackson LJ (who gave the leading judgment from the 3 Appeal Judges) made only a passing reference to the *Yam Seng* case by distinguishing the type of agreement in that case from the type in the *Compass* case and chose not to comment any further on the *Yam Seng* decision.

The above two cases also confirm the general position that express good faith cooperation clauses are capable of having legal effect. The cases demonstrate that the legal effect depends upon a careful interpretation of the clause in question, in the context of the agreement as a whole.

#### **The enforceability of express obligations of good faith**

The traditional and long-standing position was that a 'good faith' clause was not ordinarily legally binding, or capable of being enforced. Over the last decade, express 'good faith' provisions have been given legally binding effect although, as illustrated by the *TSG* and *Compass* cases analysed above, such clauses are likely to be construed narrowly and their meaning must be ascertained in relation to the nature of the contract and its context.

Some contracts, particularly long-term ones, contain express provisions requiring the parties to cooperate or work together in 'good faith'. The meaning of this provision depends upon the context in which it is used.

<sup>92</sup> [2013] EWCA Civ 200

In the case of *Berkeley Community Villages and another v Pullen and others*<sup>93</sup> the High Court held that an express term that the parties would "act in utmost good faith towards one another and reasonably and prudently" imposed on the parties an enforceable contractual obligation "to observe reasonable commercial standards of fair dealing in accordance with their actions which related to the agreement". The 'good faith' provision also required "faithfulness" to the "agreed common purpose" and "consistency with the justified expectations" of the other party.

In *CPC Group Ltd v Qatari Diar Real Estate Investment*<sup>94</sup> the High Court held that an express term requiring "utmost good faith" in a joint venture agreement implied a binding duty on each of the parties to adhere to the spirit of the contract; observe the reasonable commercial standards of fair dealing; be faithful to the agreed common purpose; and act consistently with the justified expectations of the parties. However, it was also stated in the judgment that without bad faith, it was hard to understand how there could be a breach of the duty of good faith.

In the case of *Petromec v Petroleo Brasileiro SA Petrobras*<sup>95</sup> one of the Court of Appeal judges said (obiter) that an obligation under an existing, legally binding agreement to negotiate further sub-agreements in good faith should have some legal effect, especially where the 'groundrules' set out under the binding contract to govern the further negotiation are clear. The judge distinguished this situation (where there was already one binding agreement between the parties) from the situation in the *Walford v Miles* case referred to above where there was no binding agreement ever reached between the parties and therefore no obligation to act in good faith in the negotiations. It is not unusual for franchise agreements to contain clauses obliging the parties to negotiate in good faith in relation to certain issues to be agreed at a later stage such as the

*“... an implied concept of good faith is steadily gaining recognition as a legally binding concept during the performance phase of contracts particularly long term relational agreements such as franchise agreements.”*

rights for a new territory, or the terms of a renewal agreement. Even if the contract contains an express obligation to negotiate such new terms in good faith, such obligations can be difficult to enforce as they may be an unenforceable "agreement to agree"<sup>96</sup>

### Conclusion

The concept of good faith is firmly established in the civil law jurisdiction of the EU, although it manifests itself in different forms in each of them, despite the influence of both the German and French law.

The idea that good faith is not part of English law business-to-business contracting is now outdated. It remains broadly correct in relation to the pre-contract phase but, although some may feel that bad facts have led to bad law, it is now clear that an implied concept of good faith is steadily gaining recognition as a legally binding concept during the performance phase of contracts particularly long term relational agreements such as franchise agreements.

Where good faith is treated as legally binding, it may involve different behaviours in different contexts such as fair dealing, transparency and honesty. However, whilst the *Yam Seng* decision is a milestone in that it draws together the different

<sup>93</sup> [2007] EWHC 1330 (High Court)

<sup>94</sup> [2010] EWHC 1535 (High Court)

<sup>95</sup> [2005] EWCA Civ 891 (Court of Appeal)

<sup>96</sup> See the case of *Barbudev v Eurocom* [2012] EWCA Civ 548 (Court of Appeal) where a side letter was held to be an unenforceable agreement to agree as the terms of a proposed investment were too uncertain to be enforceable and various essential terms were unresolved. The addition of the words "negotiate in good faith" gave the parties' commitment to each other no extra force.

strings and makes the law on good faith more coherent, it does not necessarily represent a drastic change in attitudes by the English courts. Post *Yam Seng* Cases such as *TSG* and *Compass* illustrate that the courts are likely to uphold the more traditional and narrow interpretation of the good faith doctrine and circumstances in which terms will be implied into complex commercial agreements in the absence of bad faith or dishonesty by the breaching party. In addition, an obligation of good faith will not be implied if it is contrary to the express terms of the agreement or the express terms adequately set out the parties' obligations to each other such that an implied obligation is not necessary. Where there is an express obligation to act in good faith in relation

to a specific right or obligation, it will be interpreted narrowly and does not mean that the parties' entire relationship is governed by an overarching obligation of good faith.

What *Yam Seng* does indisputably bring to the area of franchise law in England is additional ammunition to the armoury of the franchisee lawyer. The case is already being quoted by disgruntled franchisees and their lawyers and it is only a matter of time before the case is cited and analysed by a court in relation to a franchise dispute. It may only be once *Yam Seng* is applied (or not as the case may be) by judges in subsequent disputes that its true impact on franchising relationships is known.

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