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***"Crossing Borders in the International Franchise Relationship:  
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**Good Faith and Economic Power Issues in  
International Franchising**

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# Good Faith and Economic Power Issues in International Franchising

Franchising is inherently and understandably an unevenly weighted relationship. A franchisor needs particular rights and powers to protect its brand and its system as a whole, which the franchisee does not require. With these powers, come responsibilities.

The power of the stronger party in an unevenly balanced commercial relationship (be it corporation and consumer, banker and lender, employer and employee or franchisor and franchisee) has been eroding from some time. It is no longer safe to assume that a contracting party can always exercise a power given to it on the face of an agreement. Locally imposed concepts of fairness, or appropriate business behaviour, often intervene.

In this paper, we review the contrasting approaches to the notion of good faith taken in Canada, the USA, Brazil and France. We consider when an obligation to act in good faith arises, what it means, and its implications for the franchising relationship in those countries.

## **A. Canada**

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### **1. Introduction**

The duty to act in good faith is a principle that arises with frequency in many areas of the law. Indeed, it is often described as an elusive concept, as its meaning can vary considerably depending on the context within which it is used. While there is no universally accepted definition of “good faith” as it applies to a party’s obligations under a commercial contract, the term generally refers to an obligation to act in a manner that conforms to an agreed upon purpose and that is consistent with the expectations of the other party.

The duty of good faith has long been a staple of commercial law in the United States, where it was incorporated into the Uniform Commercial Code in the 1950’s. Canadian courts and legislatures, on the other hand, have been much slower to embrace the concept. Unlike the United States, there is no generalized legislation in Canada that establishes a duty to act in good faith with respect to the performance and enforcement of a contract. And at the judicial level, a recent judgment from the Ontario Court of Appeal acknowledged that “Canadian courts have not developed a

comprehensive and principled approach to the implication of duties of good faith in commercial contracts.”<sup>1</sup>

There is, however, a small (but growing) number of provincial franchise statutes that impose duties of good faith and fair dealing upon parties to franchise agreements. Moreover, Canadian common law has gradually acknowledged that the duty of good faith applies to franchise agreements in order to stabilize the relationship between parties of disparate bargaining power.

In this part of the paper, we review the evolution of the duty in Canada at common law and through franchise-specific legislation; how and when the duties of good faith and fair dealing apply to franchisors and franchisees; which aspects of the franchise relationship are affected by these legal duties; and how these duties may have an impact on franchise systems.

## **2. Sources of the Duty**

### **(a) Overview of Canada’s Legal System**

There are currently franchise laws in force in the provinces of Alberta, Ontario and Prince Edward Island (PEI). These are the only three provinces in Canada with a franchise law that is in effect. A fourth province, New Brunswick, has passed franchise legislation but as of the date of publication, it is not yet in force. None of the remaining six provinces of Canada, and none of the three territories, has a franchise law.

The reader may invariably ask as to why there could be franchise laws in some parts of a country but not in others. The answer is rooted in Canada's political structure and constitutional division of powers. Canada, like the United States, has a system of federalism. All aspects of governmental power are divided between the federal (national) and provincial levels of government. While there is but one federal government, there are 10 provinces. In addition there are now three territories, comprising much of Canada's uninhabited north. Territories enjoy a certain degree of autonomy, and have their own territorial governments, but otherwise rely to a great extent on the federal government.

The constitution of Canada grants the federal government exclusive jurisdiction over many areas, including trade and commerce, banking and bills of exchange, bankruptcy and insolvency, trademarks, patents, and copyrights. On the other hand, the constitution grants provincial governments exclusive jurisdiction over such areas as property and civil rights as well as the administration of justice in the province.

Of relevance to franchisors, therefore, is the fact that intellectual property law (patents, trademarks and copyright), as well as competition (antitrust) law, is within the federal jurisdiction with statutes that apply nationally, while private contractual matters fall within the purview of the provincial governments with their jurisdiction over "property and civil rights." Hence, any franchise legislation in Canada will only ever likely arise at the provincial level, and to date as mentioned, only the provinces of Alberta, Ontario, and Prince Edward Island have laws that are fully in force.

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<sup>1</sup> Transamerica Life Canada Inc. v. ING Canada Inc. (2003), 68 O.R. (3<sup>rd</sup>) 457 (Ont. C.A.).

(b) Provincial Franchise Legislation

As noted above, there are currently no Canadian statutes of general application – at either the federal or provincial level – that establish a duty to act in good faith. Consequently, the legislative sources of this duty in Canada are found only in franchise-specific legislation in Alberta, Ontario and P.E.I. Each of the three provincial statutes addresses good faith and fair dealing in a similar fashion, although there are some noteworthy differences.

Alberta's Franchises Act, which was the first piece of franchise-specific legislation to be passed in Canada, provides that "every franchise agreement imposes on each party a duty of fair dealing in its performance and enforcement."<sup>2</sup> The franchise laws that were subsequently passed in Ontario and P.E.I. adopted this provision verbatim, but also went further by adding a statutory cause of action for breach of the duty, and by defining the duty of fair dealing as a "duty to act in good faith and in accordance with reasonable commercial standards."<sup>3</sup> The P.E.I. legislation differs from the Ontario and Alberta franchise laws in that it explicitly states that the duty of fair dealing also applies to the exercise of a right under the agreement.<sup>4</sup> As such, the statutory duty of good faith in P.E.I. appears to extend to discretionary actions authorized under the franchise agreement, whereas in Alberta and Ontario it is unclear whether a franchisor may exercise discretionary options without regard to fair dealing.<sup>5</sup>

(c) The Civil Code of Quebec

In the civil law jurisdiction of Quebec, franchise agreements are governed by the Civil Code provisions that deal with contracts of adhesion.<sup>6</sup> The Civil Code states that "every person is bound to exercise his civil rights in good faith,"<sup>7</sup> and that "no 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."<sup>8</sup>

(d) Common Law

At common law, the duty of good faith has grown primarily out of judicial concern over inequality in the relationship of parties to certain agreements. A leading example in this regard is the landmark case of Wallace v. United Grain Growers Ltd.<sup>9</sup> In Wallace, the Supreme Court of Canada established a good faith duty in connection with employment contracts due primarily to the disparity in bargaining power between the employer and the employee.

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<sup>2</sup> Franchises Act, R.S.A. 2000, c. F-23, s.7.

<sup>3</sup> Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c. 3, ss.3(1) and (2); Franchises Act, R.S.P.E.I. 1998, c. F-14.1, ss.3(1) and (2).

<sup>4</sup> Franchises Act, R.S.P.E.I. 1998, c. F-14.1, ss.3(1).

<sup>5</sup> F. Zaid and D. Mochrie, P.E.I. and New Brunswick On Board With Franchise-Specific Legislation, Osler, Hoskin & Harcourt LLP (July 7, 2006), online:<<http://www.osler.com/resources.aspx?id=11154>> (date accessed: March 13, 2008).

<sup>6</sup> Civil Code of Quebec, S.Q. 1991, c.64, Arts 1435, 1436.

<sup>7</sup> Ibid, Art. 6.

<sup>8</sup> Ibid, Art.7.

<sup>9</sup> Wallace v. United Grain Growers, [1997] 3 S.C.R. 701.

The Court in Wallace identified three specific characteristics of an employment contract that distinguished it from other commercial contracts. First, the Court stated that the formation of an employment contract is not the result of a bargaining process between two equal parties. Second, the weaker party in the arrangement typically faces difficulty in obtaining more advantageous contractual terms due to that party's limited access to information. Third, the power imbalance continues to affect the relationship between the parties after the contract has been formed.<sup>10</sup> As a result, the Court concluded that the nature of the relationship between the parties to an employment contract warranted the application of a duty to act in good faith.

Subsequently, in Shelanu Inc. v. Print Three Franchising Corp.,<sup>11</sup> the Ontario Court of Appeal, the highest appeal court in the Province of Ontario, incorporated the Supreme Court's analysis into the franchise law context. The court held that the relationship between franchisor and franchisee is analogous to an employer-employee relationship in each of the three characteristics identified in Wallace. First, the franchisee is usually on an unequal footing with respect to its relative bargaining power. Second, the franchisor is unable to negotiate more favourable terms because a franchise agreement is a contract of adhesion, meaning that the agreement was predominantly drafted by the dominant party. Third, the franchise relationship continues to be affected by the disparity of bargaining power, as the franchisee must permit inspections and audits, and is generally obligated to purchase supplies and equipment from the franchisor.

Due to these similarities between employment contracts and franchise agreements, the court concluded that a common law duty to act in good faith applies to franchise agreements as well.<sup>12</sup> This case is significant in that it clearly established a common law duty of good faith that exists apart from any franchise statute. As a result, this case provides strong authority for the proposition that the common law duty of good faith also applies to franchise agreements that are not regulated by a provincial franchise statute.<sup>13</sup> Although the Ontario Court of Appeal decision is binding only on the lower courts in the Province of Ontario, it is considered the leading common law case in Canada regarding the duty of good faith in the franchising context. As a result, Print Three has been followed by courts in British Columbia and Nova Scotia.<sup>14</sup>

### **3. Application of the Duty**

#### **(a) To Whom the Duty Applies**

The statutory duty of fair dealing (which, in each of the franchise laws identified above, is defined to include the duty to act in good faith) applies to any

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<sup>10</sup> Ibid.

<sup>11</sup> Shelanu v. Print Three Franchising Cop. (2003), 64 O.R. (3d) 533 (C.A.).

<sup>12</sup> Ibid.

<sup>13</sup> For example, in Machias v. Mr. Submarine Ltd., [2002] No.1261 (Ont. S.C.J.), the franchise at the centre of the dispute was operated in Montreal, Quebec, and the Arthur Wishart Act did not apply. However, counsel for the defence acknowledged that the good faith requirements of common law applied.

<sup>14</sup> See, for example 362041 B.C. Ltd v. Domino's Pizza [2006] B.C.J. No. 1127 (BCSC); Sultani v. Blenz The Canadian Coffee Co. [2005] B.C.J. No. 846 (BCSC); Ismail v. Treats Inc., [2004] N.S.J. No. 21 (NSSC).

franchise agreement to which the respective franchise statutes apply. In the case of Ontario and PEI, that is any franchise that is to be operated in whole or in part in the regulated province. In Alberta, there is the additional requirement that the prospective franchisee be a resident of Alberta. While the fair dealing provisions are included in these acts primarily to prevent the franchisor from exploiting its position of strength vis-à-vis the franchisee, the statutory language is unambiguous: the duty applies to both parties to a franchise agreement. In addition, the parties are not entitled to contract out of this statutory duty; the rights conferred and obligations imposed by the provincial franchise laws cannot be waived or otherwise excluded from a franchise agreement.

(b) Performance and Enforcement

Each of Canada's provincial franchise laws states that the duty of fair dealing applies only to the performance and enforcement of a franchise agreement. Canadian courts in the common law provinces have repeatedly held that the duty to act in good faith does not extend to contractual negotiations.<sup>15</sup> In contrast, Article 1375 of the Quebec Civil Code states that the duty to act in good faith is triggered at the time an obligation is created.<sup>16</sup> This provision has been interpreted such that the duty to act in good faith extends to contractual negotiations in the province of Quebec.

(c) Pre-Contractual Conduct

There are certain forms of pre-contractual conduct that may give rise to a common law duty of good faith. For instance, there is Ontario case law that suggests statements and representations made prior to entering a franchise agreement are subject to the good faith duty.<sup>17</sup> This is significant in that it demonstrates how the common law duty of good faith – which appears not to be limited to the performance and enforcement of a franchise agreement – may overlap with the statutory provisions in provinces that are regulated by franchise legislation.

#### **4. Content and Scope of the Duty**

(a) Meaning of "Good Faith"

The duty of good faith imposes an obligation upon one party to consider the interests of the other before taking action. It connotes "a state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business or (4) absence of intent to defraud or to see unconscionable advantage."<sup>18</sup>

It is important to distinguish this standard from the more onerous fiduciary duty, under which a party is required to act only in accordance with the other party's interests. The key difference between these concepts is that a party under a fiduciary

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<sup>15</sup> For example, Martel Building Ltd. v. Canada, [2000] 2 S.C.R. 860.

<sup>16</sup> Civil Code of Quebec, S.Q. 1991, Art. 1375.

<sup>17</sup> For a discussion of this development, see Frank Zaid, The Courts get Tough on Breaches of Good Faith, Osler, Hoskin & Harcourt LLP (September 27, 2002), online: <<http://www.osler.com/resources.aspx?id=85111>> (date accessed: March 12, 2008).

<sup>18</sup> Black's Law Dictionary.

duty must act in a manner entirely in the interests of the other party, whereas a party under the duty to act in good faith is permitted to act self-interestedly.

Canadian courts have held that the relationship between a franchisor and a franchisee does not give rise to a fiduciary duty.<sup>19</sup> As a result, franchisors in Canada are not required to place the interests of a franchisee above those of the franchisor or the franchise system. In Print Three, the Ontario Court of Appeal explained that the duty to act in good faith simply requires the duty-bound party to give consideration to the interests of the other party before exercising power under the agreement, and to act honestly and reasonably.<sup>20</sup>

(b) Scope of the Duty

The scope of this duty is largely fact-driven, and must be considered within the context of each franchise relationship. For instance, the relative bargaining power of parties to a franchise agreement will vary depending on the circumstances, and case law suggests that where one party is particularly vulnerable to the bargaining strength of the other, the dominant party will be required to show greater deference to the interests of its counterpart.

As the provincial franchise statutes in Ontario and PEI were introduced fairly recently, there are relatively few cases that have considered the scope of the good faith duty. The available case law does, however, assist with identifying the type of conduct that will be deemed to breach the duty of good faith. Canadian courts have held, for example, that the duty to deal fairly and act in good faith applies to the preparation of financial statements,<sup>21</sup> the disclosure of financial information and other material facts,<sup>22</sup> and the practice of awarding new franchises.<sup>23</sup>

The duty of good faith has also been utilized by plaintiffs seeking to obtain punitive damages in cases where the franchisee has sued the franchisor for breach of contract on other grounds. Under Canadian law, a plaintiff must establish an independent actionable wrong in order to succeed in a claim for punitive damages. Where there has been a particularly egregious breach by a party to a franchise agreement, it is open to the plaintiff to invoke the duty of good faith in order to establish the additional actionable wrong. Thus, in Katotikidis v. Mr. Submarine Ltd., the plaintiff successfully satisfied the court that the franchisor's conduct was sufficiently malicious to justify the deterrent effect of an award of punitive damages.

It is essential to note that, while the duty of good faith may be invoked to establish an independent actionable wrong as described above, the duty does not create any rights that exist independently of the explicit terms of a franchise agreement. The Ontario Court of Appeal recently emphasized this point in Transamerica Life Canada Inc. v. ING, in which it was observed that "the implication of a duty of good faith has not gone so far as to create new, unbargained-for rights and obligations. Nor has it been used to alter the express terms of the contract

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<sup>19</sup> Jirna Ltd. v. Mister Donut of Canada Ltd., [1972] 1 O.R. 251 (C.A.), aff'd [1975] 1 S.C.R. 2.

<sup>20</sup> Supra, note 10.

<sup>21</sup> Ismail v. Treats Inc., [2004] N.S.J. No. 21 (N.S.S.C.).

<sup>22</sup> Ibid.

<sup>23</sup> Katotikidis v. Mr. Submarine Ltd., [2002] O.J. 1959 (Ont. S.C.J.).

reached by the parties.”<sup>24</sup> Instead, the duty operates to secure the performance and enforcement of the agreement reached by the parties, and to prevent bad faith efforts to circumvent the essential purposes of the contract.

## **5. Other Constraints on the Exercise of the Franchisor’s Power**

As noted above, the provincial franchise statutes impose a duty of good faith on both parties to a franchise agreement. In practice, however, this duty is essentially a constraint on the exercise of the franchisor’s power. It should be noted that this is not the only such constraint faced by franchisors under Canadian law.

### **(a) Restraints at Common Law**

In addition to the duty of good faith, there have been other common law approaches to restraining the exercise of power by the overreaching franchisor. The most notable of these has been the doctrine of unconscionability. Under this doctrine, a party is entitled to pursue objectives that are in its self-interest, while acknowledging another party’s interests by prohibiting excessively selfish or exploitative conduct.

In the franchise law context, this doctrine has been applied by the courts in cases where part or all of the entire franchise agreement has been held to be unenforceable. For instance, in Canadian Kawasaki Motors Ltd. v. McKenzie, the court held that the franchisor’s abject failure to explain certain material facts about the business rendered the agreement unenforceable.<sup>25</sup> In Atlas Supply Co. of Canada v. Yarmouth Equipment Ltd., the Nova Scotia Court of Appeal held that an exclusionary clause was unconscionable and therefore unenforceable.<sup>26</sup> The court explained that unequal bargaining power was one of several situations that may ground a finding of unconscionability, and that the facts of each case determine whether or not the doctrine applies.

### **(b) Franchise Statutes**

An additional constraint on franchisors in Canada derives from the provincial franchise statutes which expressly provide the right of a franchisee to associate with other franchisees.<sup>27</sup> This statutory right grants franchisees the freedom to form or join an organization or association of franchisees. Pursuant to these provisions, franchisors are precluded from prohibiting, restricting or penalizing a franchisee for doing so. The Ontario and P.E.I. statutes state that any clause in a franchise agreement that attempts to prevent a franchisee from exercising its right of association is void, and a statutory cause of action for breach of this provision is provided.

## **6. Conclusion**

As the foregoing analysis has demonstrated, Canadian franchise agreements are regulated by statute and common law. And while the interaction of case law,

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<sup>24</sup> Supra, note 1.

<sup>25</sup> (1981), 126 D.L.R. (3d) 253 (Ont.Co.Ct.).

<sup>26</sup> (1990), 20 C.P.R. (3d) 380 (N.S.T.D.), aff’d in part (1991) 37 C.P.R. (3d) 28 (N.S.C.A.).

<sup>27</sup> See s.8 of Alberta’s Franchises Act; s.4 of Ontario’s Arthur Wishart Act, and s.4 of P.E.I.’s Franchises Act.

legislation, and the Civil Code of Quebec may be a source of some confusion for the uninitiated, suffice it to say that the duty to act in good faith is a significant aspect of franchise regulation in all of the provinces with franchise regulation, and likely across Canada.

The definition of the concept and its application to franchise relationships in Canada largely depends on the factual context of each case. However, it appears that the measure of inequality in the relationship between the franchisor and franchisee is a major factor in determining the appropriate standard of conduct. In essence, the duty of good faith is designed to operate as a protective device for franchisees with relatively weak bargaining positions. That being said, franchisees also need to be cognizant that they too owe a duty of good faith in the regulated provinces.

## **B. USA**

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### **1. Introduction**

The implied covenant of good faith and fair dealing is a topic that has long been discussed, debated, and analysed among members of the franchise bar in the United States. The concept has been the subject of numerous articles, discussions at extended symposia, and dialogue in the bar. Because contracts in the U.S. are governed by state law, an international lawyer considering how the implied covenant might impact her or his transaction must consider the different approaches taken in each state, whether under statute or in the courts, because nuances and developments have evolved separately in most jurisdictions. While cases can be heard by federal or state courts, even when federal courts are called upon to decide these matters, they apply state law or attempt to discern how states might interpret the law. This typically leaves intact variations, sometimes subtle and sometimes stark, among the states.

### **2. Sources of the Duty**

In general, the implied covenant has enjoyed a long and vibrant history in U.S. statute books and in the courts. Application of the covenant dates back to the late 19<sup>th</sup> century, when the New York Court of Appeals concluded that the reasonable expectations of a party expecting contractual performance was a standard by which the contracting party's performance should be considered in a breach of contract case.<sup>28</sup> The classic summary of the concept in the U.S. can be found in Section 205

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<sup>28</sup> Doll v. Noble, 116 N.Y. 230, 232-33 (N.Y. 1889) (upholding award against defendant that "arbitrarily and unreasonably" sought to impose a subjective standard for performance of contractual obligations). See also Kirke la Shelle Co. v. Paul Armstrong Co., 188 N.E. 163, 167 (N.Y. 1933) ("neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.").

of the Restatement (Second) of Contracts: “every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.” Some states have woven the implied covenant into their franchise relationship statutes, such as Arkansas, Hawaii, Iowa, and Washington.<sup>29</sup>

### 3. Content and scope of the duty

The California Supreme Court observed that the covenant "exists merely to prevent one contracting party from unfairly frustrating the other party's right to receive the benefits of the agreement actually made. The covenant thus cannot 'be endowed with an existence independent of its contractual underpinnings.' It cannot impose substantive duties or limits on the contracting parties beyond those incorporated in the specific terms of their agreement." Guz v. Bechtel Nat. Inc.<sup>30</sup>

Courts have limited application of the covenant, noting for example that too broad a construction of the covenant would “impose unintended obligations upon parties and destroy[ ] the mutual benefits created by legally binding agreements.” Northview Motors, Inc. v. Chrysler Motors Corp.<sup>31</sup> A recent explanation of these limits came in a decision handed down by the U.S. Court of Appeals for the 10th Circuit, in a case also interpreting New York law:

*Under New York law, every contract carries with it an implied duty of good faith and fair dealing. ‘This covenant embraces a pledge that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.’ ‘Where the contract contemplates the exercise of discretion, this pledge includes a promise not to act arbitrarily or irrationally in exercising that discretion.’ ‘Encompassed within the implied obligation of each promisor to exercise good faith are any promises which a reasonable person in the position of the promisee would be justified in understanding were included.’ ‘The covenant is violated when a party to a contract acts in a manner that, although not expressly forbidden by any contractual provision, would deprive the other of the right to receive the benefits under their agreement.’*

The U.S. Court of Appeals, in Pepsi-Cola Bottling Co. of Pittsburg, Inc. v. PepsiCo, Inc.,<sup>32</sup> went on to explain the limits on application of the covenant:

*The implied duty of good faith and fair dealing is not without limitation. It ‘does not provide a court carte blanche to rewrite the parties’ agreement,’ and ‘the mere exercise of one’s contractual rights, without more, cannot constitute . . . a breach’ of the implied covenant of good faith and fair dealing. Rather, ‘it simply ensures that parties to a contract perform the substantive, bargained-for terms of their agreement and that parties are not unfairly denied express, explicitly*

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<sup>29</sup> Ark. Code § Sec. 4-72-206; Haw. Rev. Stat. § 482E-6(1); Iowa Code § 523H.10; and Wash. Rev. Code § 19.100.180(1).

<sup>30</sup> 24 Cal. 4th 317, 349 (2000).

<sup>31</sup> 227 F.3d 78, 92 (3d Cir. 2000).

<sup>32</sup> 431 F.3d 1241, 1260-1261 (10th Cir. 2005).

*bargained for benefits.’ ... Additionally, courts are not ‘at liberty to impose obligations under the guise of the implied covenant which are inconsistent with the terms of the contract from which the covenant is to be implied.’ Thus, ‘[a] party which acts in accordance with rights expressly provided in a contract cannot be held liable for breaching an implied covenant of good faith.’*

In The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., U.S. Circuit Judge Richard Posner wrote that:

*Illinois like other states requires, as a matter of common law, that each party to a contract act with good faith, and some Illinois cases say that the test for good faith “seems to centre on a determination of commercial reasonability.” ... Contract law does not require partners to behave altruistically toward each other; it does not proceed on the philosophy that I am my brother’s keeper... Contract law imposes a duty, not to “be reasonable,” but to avoid taking advantage of gaps in a contract in order to exploit the vulnerabilities that arise when contractual performance is sequential rather than simultaneous.<sup>33</sup>*

Cases in which the implied covenant is plead range from those involving termination, to transfers, to sales of the franchise system, sales of products in competing channels of business, and claims of “encroachment” by a franchisor upon the territorial rights granted to a franchisee under the franchise agreement. As the authority noted above suggests and as courts have confirmed, the question of whether the implied covenant could be applied at all typically must be answered, initially, by a careful review of the relevant contract terms.

Under the federal legal system in the U.S., courts apply state law to cases involving claims that the implied covenant should be applied to find that a breach of contract occurred. How the courts of different states apply the implied covenant varies considerably, but there are some central themes. This paper notes some of the basic tenets of these cases.

Generally speaking, courts examining implied covenant claims must determine whether contract language addresses the conduct that the moving party seeks to compel or prevent, or due to which the moving party seeks damages. For example, where a plaintiff franchisee alleges that a franchisor improperly terminated that franchisee’s rights, but under contract the franchisor had the right to terminate under the fact pattern at hand, courts will not apply the implied covenant to trump or overrule the parties’ agreement reflected in the franchise agreement. In Cromeens, Holloman, Siber, Inc. v. AB Volvo,<sup>34</sup> the U.S. Court of Appeals concluded that “Volvo cannot be held to have breached the covenant of good faith and fair dealing for simply enforcing the contracts as written.”<sup>35</sup> However, courts do not always adhere

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<sup>33</sup> 970 F.2d 273, 279-80 (7th Cir. 1992).

<sup>34</sup> 349 F.3d 376, 396 (7th Cir. 2003).

<sup>35</sup> See also Bishop v. GNC Franchising LLC, 248 Fed. Appx. 298, 300 (3d Cir. 2007) (applying Pennsylvania law); Pepsi-Cola Bottling Co. of Pittsburg, 431 F.3d at 1261 (New York law); Rich Food Servs. v. Rich Plan Corp., 98 Fed. Appx. 206, 211 (4th Cir. 2004) (unpublished op.) (NC and NY law); McDonald’s Corp. v. Watson, 69 F.3d 36, 43 (5th Cir. 1995) (Illinois law); Pennington’s, Inc. v. Brown-Forman Corp., Bus. Fran. Guide (CCH) ¶ 10,260 (9th Cir. 1993) (unpublished op.)

to that general rule, and in the context of termination, some judges have found that the parties' conduct may breach the implied covenant even when a franchisor exercises its contractual discretion and terminates the agreement.<sup>36</sup> A recent decision of the federal district court in Denver addressed discretion and the implied covenant, and concluded that "[t]he duty of good faith and fair dealing may be relied upon 'when the manner of performance under a specific contract term allows for discretion on the part of either party.'" Bonanno v. Quizno's Franchise Co. LLC.<sup>37</sup> In Magna Cum Latte, Inc. v. Diedrich Coffee, Inc.,<sup>38</sup> the court noted that "discretion should not be used to seize benefits that were not bargained for during contract formation."

The parties' intent, as well as the factual circumstances, is often determinative in good faith cases. "A party acts in good faith and deals fairly when it exercises its contractually granted discretion for purposes within the reasonable contemplation of the parties. But a party acts in bad faith where it exercises its discretion to recapture forgone opportunities."<sup>39</sup> However, "[a]bsent bad motive or intention, decisions a contract expressly permits which happen to result in economic disadvantage to the other party are of no legal significance."<sup>40</sup>

In a 2006 case involving termination of a franchise agreement for the distribution of Red Rose Iced Tea mix, the U.S. District Court for the District of New Jersey rejected a claim that the franchise agreement was wrongfully terminated or that the franchisor had violated the covenant of good faith and fair dealing. The court noted that "[a]llowing this claim to advance would hold a party to a contract liable for exercising rights expressly granted in the contract and create an additional benefit on the part of [the distributor]."<sup>41</sup>

In some cases, the threshold inquiry is whether the parties entered into a valid, binding contract in the first place. Courts will not apply the implied covenant where there is no contract, even if the litigants have a business relationship. The

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(California and Montana law); General Aviation, Inc. v. The Cessna Aircraft Co., 915 F.2d 1038 (6th Cir. 1990) (Michigan law); Davis v. Sears, Roebuck and Co., 873 F.2d 888 (6th Cir. 1989) (Georgia law); Corenswet, Inc. v. Amana Refrigeration, Inc., 594 F.2d 129, 138 (5th Cir. 1979), cert. denied, 444 U.S. 938 (1979) (Iowa law); Payne v. McDonald's Corp., 957 F. Supp. 749, 758 (D. Md. 1997) (Illinois law).

<sup>36</sup> See, e.g., Wilson v. Amerada Hess Corp., 773 A.2d 1121, 1130 (N.J. 2001); Shell Oil Co. v. Marinello, 63 N.J. 402, 307 A.2d 598, 600 (N.J. 1973).

<sup>37</sup> 2008 U.S. Dist. LEXIS 21678 (D. Colo. 2008) (denying franchisor's motion to dismiss the complaint).

<sup>38</sup> 2007 Bankr. LEXIS 4265 (Bankr. S.D. Tex. 2007).

<sup>39</sup> Newman v. Snap-On Tools Corp., 1988 U.S. Dist. LEXIS 18385, \*9 (E.D. Va. 1988). See also Amerada Hess, supra, at 1130-31; Givemepower Corp. v. Pace Compumetrics, Inc., 2007 U.S. Dist. LEXIS 59371 (D. Cal. 2007) (allegation that defendant acted in bad faith to frustrate the contract's benefits central to implied covenant claims); Brill v. Catfish Shaks of Am., Inc., 727 F. Supp. 1035, 1041 (E.D. La. 1989) ("mere failure to fulfill an obligation without a showing of intent or ill will does not constitute a breach of good faith"); Dayan v. McDonald's Corp., 466 N.E. 2d 958, 972 (Ill. App. 1984) (a party cannot exercise discretion "arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties").

<sup>40</sup> Elliott & Frantz, Inc. v. Ingersoll-Rand Co., 457 F.3d 312, 329 (3d Cir. 2006)

<sup>41</sup> Click Corp. of America v. Redco Foods, Inc., 424 F. Supp. 2d 753, 762 (D.N.J. 2006) (applying New York law).

“covenant ... is not an independent source of duties for parties to a contract, but instead an implied term that ‘guides the construction of explicit terms in an agreement.’”<sup>42</sup> Indeed, once the underlying agreement expires, “there can be no breach of that agreement, including any implied obligations arising from that agreement.”<sup>43</sup>

#### 4. Application of the Duty

##### (a) Termination Cases

Often, claims of breach of the implied covenant of good faith and fair dealing arise in the context of a challenge to a franchisor’s termination of a franchisee. While courts may apply a higher standard in termination cases, judges will not apply the implied covenant if the underlying agreement expressly allows one party to terminate the agreement without cause or for any reason.<sup>44</sup> However, not many agreements give that much latitude to any party – typically, contact clauses permit one party to exercise termination rights if the other party is in default, and often in the franchise context, the default must be one that remains uncured even after notice.

Here, courts will apply the covenant of good faith and fair dealing if there is evidence of bad faith. In Piantes v. Pepperidge Farm<sup>45</sup>, the court wrote that “[e]ven where some loss of value is shown, courts have been unwilling to intercede where the contract terms give the defendant a clear right to act as it did and where there is no evidence of fraud, deceit or misrepresentation. By contrast, in those cases where the plaintiff has prevailed, the evidence has suggested that the defendant was in essence *motivated by a desire to capitalize on the plaintiff’s business opportunities under the franchise agreement by constructively or pretextually terminating the franchise agreement without compensation.*”<sup>46</sup>

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<sup>42</sup> Home Repair, Inc. v. Universal Restoration Servs., 90 Fed. Appx. 142, 144 (7th Cir. 2003). See also Rennick v. O.P.T.I.O.N. Care, Inc., Bus. Fran. Guide (CCH) ¶ 10,607 (9th Cir. 1996) (applying California law); Glacier Optical, Inc. v. Optique du Monde and Safilo America, Inc., Bus. Fran. Guide (CCH) ¶ 10,607 (9th Cir. 1995) (not for publication) (Washington State law); Papa John’s Int’l, Inc. v. Rezko, 2006 U.S. Dist. LEXIS 43944 (N.D. Ill. 2006) (Kentucky law); Union Cosmetic Castle, Inc. v. Amorepacific Cosmetics USA, Inc., Bus. Fran. Guide (CCH) ¶ 13,508 (E.D.N.Y. 2006) (New York law); McLaughlin Equipment Company, Inc. v. Newcourt Credit Group, Inc., Bus. Fran. Guide (CCH) ¶ 12,903 (S.D. Ind. 2004) (North Dakota law).

<sup>43</sup> Unified Dealer Group v. Tosco Corp., 16 F. Supp. 2d 1137, 1144 (D. Cal. 1998).

<sup>44</sup> See, e.g., Burnette Techno-Metrics v. TSI Inc., 44 F.3d 641, 643 (8th Cir. 1994); Devery Implement Co. v. J.I. Case Co., 944 F.2d 724, 729-730 (10th Cir. 1991); Piantes v. Pepperidge Farm, 875 F. Supp. 929, 938 (D. Mass. 1995).

<sup>45</sup> 875 F. Supp. 929, 939 (D. Mass. 1995),

<sup>46</sup> See, e.g., Gram v. Liberty Mutual Insurance Co., 384 Mass. 659, 667, 429 N.E.2d 21 (1981) (claim of bad faith or unfairness in termination context requires court to consider impact of the termination to determine if it resulted in a “deprivation of earnings, loss of good will, or loss of investment,” and if there was unfair dealing); cf. Wilson v. Amerada Hess Corp., 773 A.2d 1121, 1130 (N.J. 2001) (“a party exercising its right to use discretion in setting price under a contract breaches the duty of good faith and fair dealing if that party exercises its discretionary authority arbitrarily, unreasonably, or capriciously, with the objective of preventing the other party from receiving its reasonably expected fruits under the contract.”).

In a recent case, Cottman Transmission Sys., LLC v. Kershner,<sup>47</sup> the court wrote that “a franchise relationship may be terminated by the franchisor only when consistent with ‘[the franchisee’s] reasonable expectations, principles of good faith and commercial reasonableness,’ or where the termination is specifically provided for by the contract.” (citations omitted) In this case, the federal court sought to determine how Pennsylvania courts would apply the covenant and observed that “[t]he Pennsylvania Supreme Court has at least indicated that the duty applies in cases ‘of direct or indirect termination,’ with an example of indirect termination being a “bad faith” effort ‘to force [franchisees] to abandon their franchises..<sup>48</sup>

However, a plaintiff claiming a breach of the implied covenant of good faith will, ultimately, find its allegation judged under the facts of the case. In a case involving a typical default – a franchisee’s failure to make contractually-required payments – a U.S. Court of Appeals upheld the franchisor’s termination and concluded that unproven allegations of ulterior motive were irrelevant “because the [franchisees’] non-payment constituted a material breach of the contract, which provided [the franchisor with] legitimate grounds for termination.”<sup>49</sup>

(b) Encroachment Cases

Before an unexpected court decision in 1991, claims of a violation of the implied covenant in cases alleging encroachment upon the franchisee’s business were judged under standards such as those enunciated in the Original Great American Chocolate Chip Cookie and the Corenswet decisions, discussed above. For example, in Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.,<sup>50</sup> the Court of Appeals rejected a franchisee’s claim that a franchisor violated the implied covenant by acquiring another hotel in the same area as the plaintiff’s hotel. The court observed that the franchisee had not been granted territorial rights and refused to override the contract terms by applying the implied covenant.<sup>51</sup> However, in a case where the court concluded that there was an element of bad faith present, the plaintiff

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<sup>47</sup> 536 F. Supp. 2d 543, \*31-32 (E.D. Pa. 2008).

<sup>48</sup> Claims of bad faith sometimes arise in the context of alleged misrepresentation. See, e.g., GE v. Latin Am. Imps., S.A., 126 Fed. Appx. 209, 214 (6th Cir. 2005) (alleged misrepresentation as a violation of the implied covenant dismissed; alleged statement was contradicted by the terms of the distributorship contract); Eden Elec. Ltd. v. Amana Co., 370 F.3d 824, 827 (8th Cir. 2004) (allegation of fraud in the inducement allowed to proceed; punitive damage award upheld in case involving termination of Israeli distributor for Amana appliances).

<sup>49</sup> Dunkin’ Donuts Inc. v. Guang Chyi Liu, 79 Fed. Appx. 543, 547 (3d Cir. 2003) (unpublished op.); cert. denied, 541 U.S. 989 (2004). See also S & R Corp. v. Jiffy Lube Int’l, Inc., 968 F.2d 371, 375 (3d Cir. 1992) (the franchisor has the power to terminate the relationship where the terms of the franchise agreement are violated). Cf. Gram v. Liberty Mutual Insurance Co., 384 Mass. 659, 666, 429 N.E.2d 21 (1981) (“the absence of good cause is not the equivalent of absence of good faith”).

<sup>50</sup> 732 F. 2d 480, 483 (5th Cir. 1984).

<sup>51</sup> See also Eichman v. Fotomat Corp., 880 F.2d 149, 163-64 (9th Cir. 1989) (“as a general rule where there is no express grant of an exclusive territory in a contract or franchise agreement, none will be impliedly written into the contract”); Fickling v. Burger King Corp., Bus. Fran. Guide (CCH) ¶ 9099 (4th Cir. 1989) (unpublished op.) (franchise agreement disavowed territorial protection, and implied covenant cannot vary the express terms of a contract); Patel v. Dunkin’ Donuts of America, Inc., 146 Ill. App. 3d 323, 496 N.E.2d 1159 (1986) (barring franchisee’s encroachment claim because the parties had “address[ed] the competition issue in the franchise agreement by giving [the franchisor] the right to establish a new business of its own discretion and at its own terms.”).

franchisee prevailed. In Photovest Corp. v. Fotomat Corp.<sup>52</sup>, the court found in favour of the franchisee, who alleged that the franchisor had saturated the franchisee's market with company stores in an effort drive down the value of the franchisee's stores, so that the franchisor could buy them at a favorable price.

But in January 1991, U.S. District Judge William M. Hoeweler issued an unusual decision in Scheck v. Burger King Corp.<sup>53</sup> Judge Hoeweler denied summary judgment in a case where the franchise agreement in question made clear that no territorial rights were granted to the franchisee. The court observed that there was, in its view, a question of fact, and commented that the language of the franchise agreement did not go far enough:

*The express refusal to grant territorial rights does not necessarily imply a wholly different right to Burger King – the right to open other proximate franchises at will regardless of their effect on Plaintiff's operations. It is clear that, while Scheck is not entitled to an exclusive territory, he is entitled to expect that Burger King will not act to destroy the right of the franchisee to enjoy the fruits of the contract.*<sup>54</sup>

In Scheck, the franchisor argued that an action specifically permitted under the parties' agreement cannot constitute bad faith and, therefore, no breach of the implied covenant could have taken place. The court concluded, however, that it would not grant the motion for summary judgment sought by the franchisor. Instead, citing the Photovest decision discussed above, the court noted that the franchisor might have violated its own 'encroachment policy' by granting a second franchise in the area, and that factual issues remained to be resolved to determine whether the franchisor breached the covenant of good faith and fair dealing.<sup>55</sup> †

Burger King filed a motion for reconsideration in the Scheck case, arguing that in his original decision, the judge ignored the rule that the implied covenant cannot be used to contradict the express terms of the agreement. However, in Scheck II, Judge Hoeweler rejected that argument and did not depart from his original conclusion:

*It is evident that although the language of the Franchise Agreement states that the franchisee cannot expect an exclusive territory, such language does not even mention the franchisor, let alone does the language provide that Burger King retains the unlimited right to establish Burger King franchises at any location desired.*

*That the Franchise Agreement does not address this subject is quite notable, for it thus becomes apparent that there exists no explicit contractual language that this Court is overriding by virtue of implying a covenant of good faith and fair dealing into the Agreement. Because*

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<sup>52</sup> 606 F. 2d 704 (7th Cir. 1979).

<sup>53</sup> 756 F. Supp. 543 (S.D. Fla. 1991). At the time he issued his ruling in Scheck, Judge Hoeweler may not have foreseen the furor that he was about to create in the franchise bar. When he handed down the Scheck decision, the Judge was roughly two weeks from starting a criminal trial of substantial international significance – that of Manuel Noriega, the former Panamanian leader, who had surrendered to U.S. forces during the 1990 U.S. invasion of Panama.

<sup>54</sup> Id. at 548.

<sup>55</sup> Id. at 549.

*there is no express language in the Franchise Agreement providing that Burger King can establish Burger King restaurants wherever it so pleases, and because Florida law recognizes the implied covenant of good faith and fair dealing, this Court properly denied summary judgment. For these exact same reasons, furthermore, the pending reconsideration motion cannot succeed.*<sup>56</sup>

The Scheck decisions (referred to as Scheck I and Scheck II) generated considerable discussion in the franchise bar and were cited in numerous claims by franchisees that franchisors violated contract terms and the implied covenant in cases of alleged encroachment. In most of these cases, the courts rejected the holding in Scheck and dismissed the claims.<sup>57</sup>

Within the decade, another decision also arising from the same federal court put the Scheck decision to rest. In Burger King Corp. v. Weaver<sup>58</sup>, the U.S. Court of Appeals for the 11th Circuit considered a case with substantial factual similarity to Scheck. However, unlike Scheck, the district court in Weaver granted summary judgment for the franchisor, and the Eleventh Circuit upheld that ruling, in language that carefully examined, and then debunked, the logic underlying the two Scheck rulings:

*The reasoning of Scheck I and Scheck II is also unconvincing logically. The Scheck court held that the franchisee had a cause of action, even though the franchise agreement provided no right to exclusive territory, because BKC had not expressly reserved the right to license additional Burger King (R) restaurants nearby. The flaw in this reasoning is that right and duty are different sides of the same coin; if one party to a contract has no right to exclusive territory, the other party has no duty to limit licensing of new restaurants.*

*The rights and duties of the parties to a franchise agreement are created by the agreement. In the absence of an agreement, neither party has a duty to perform and neither has a right against the other. Thus, in this case, if Weaver's franchise agreement did not grant him a right to an exclusive territory, BKC incurred no duty to refrain from licensing new franchises in the area. It is undisputed that Weaver's franchise agreements did not grant Weaver the right to an exclusive territory. Therefore, BKC had no duty to refrain from licensing new franchises in Great Falls. The Scheck court's attempt to separate the franchisee's right from the franchisor's duty is logically unsound. ...*

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<sup>56</sup> Scheck v. Burger King Corp., 798 F. Supp. 692, 696 (S.D. Fla. 1992).

<sup>57</sup> See, e.g., Sanchez v. McDonald's Corp., 1994 U.S. App. LEXIS 4498 (4th Cir. 1994) (per curiam); Harford Donuts, Inc. v. Dunkin' Donuts, Inc., 2001 U.S. Dist. LEXIS 25139 (D. Md. 2001); Nibeel v. McDonald's Corp., 1998 U.S. Dist. LEXIS 13425 (N.D. Ill. 1998); Linguist & Craig Hotels & Resorts, Inc. v. Holiday Inns Franchising, Inc., 1998 U.S. Dist. LEXIS 23624 (C.D. Cal. 1998); Payne v. McDonald's Corp., 957 F. Supp. 749 (D. Md. 1997); Barnes v. Burger King Corp., 932 F. Supp. 1420, (S.D. Fla. 1996); Chang v. McDonald's Corp., Bus. Fran. Guide (CCH) ¶ 10,677 (N.D. Cal. 1995), aff'd, 1996 U.S. App. LEXIS 33288 (9th Cir. 1996); and Hobin v. Coldwell Banker Residential Affiliates, Bus. Fran. Guide (CCH) ¶ 11,106 (N.H. Super. Ct. 1997).

<sup>58</sup> 169 F. 3d 1310 (11th Cir. 1999).

*In the present case, the district court correctly concluded that Weaver's claim for breach of the implied covenant must fail as a matter of law, because Weaver cited no express provision of either franchise agreement that had been breached. Under Florida law, Weaver's failure to identify an express contractual provision that has been breached dooms his claim for breach of the implied covenant of good faith and fair dealing. We affirm the district court's grant of summary judgment to BKC.<sup>59</sup>*

The Weaver court also held that no claim could arise under the implied covenant in the absence of a breach of an express term of the agreement:

*We hold that no independent cause of action exists under Florida law for breach of the implied covenant of good faith and fair dealing. Where a party to a contract has in good faith performed the express terms of the contract, an action for breach of the implied covenant of good faith and fair dealing will not lie. More specifically, a cause of action for breach of the implied covenant cannot be maintained (a) in derogation of the express terms of the underlying contract or (b) in the absence of breach of an express term of the underlying contract.*

Several post-Scheck cases found in favour of the franchisee, but in these cases, court cited evidence of bad faith or bad acts on the franchisor's part.<sup>60</sup> In BJM & Associates, Inc. v. Norrell Services, Inc.,<sup>61</sup> the court termed the franchisor's behaviour as "opportunistic" and found that it had breached the implied covenant. Several years later, in Vylene Enterprises, Inc. v. Naugles, Inc.,<sup>62</sup> a franchisor was found to have breached the implied covenant of good faith and fair dealing in part by constructing a company-owned restaurant 1.4 miles from a franchisee's restaurant. The facts in Vylene were peculiar, and while the case found for the franchisee, it has been infrequently cited by other courts. One such case, however, is Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp.,<sup>63</sup> in which the U.S. Court of Appeals for the 11th Circuit overruled the trial court's grant of summary judgment to a franchisor alleged to have violated the implied covenant. The appeals court referred to a series of "bad acts" targeted at the franchisee (e.g., confusing consumers by changing the name of the franchised hotel; favoring the franchisor's hotel in the national reservations system; misusing competitively sensitive information about the franchisee). Although the court held that these facts could not support an

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<sup>59</sup> Burger King Corp. v. Weaver, 169 F.3d 1310, 1318 (11th Cir. 1999).

<sup>60</sup> See also Carvel Corp. v. Baker, 79 F. Supp. 2d 53, 63 (D. Conn. 1997), dismissed on procedural grounds, without prejudice, at Silverman v. Carvel Corp., 192 F. Supp. 2d 1 (W.D.N.Y. 2001) (court denied summary judgment where franchisor exercised its discretion under franchise agreement; court questioned whether franchisees complaining of encroachment from supermarket program were practically able to directly participate in program).

<sup>61</sup> 855 F. Supp. 1481 (E.D. Ky. 1994).

<sup>62</sup> 105 B.R. 42 (Bankr. C.D. Cal. 1989), aff'd, 90 F.3d 1472 (9th Cir. 1996).

<sup>63</sup> 139 F.3d 1396 (11th Cir. 1997).

independent claim for breach, it emphasized that these facts would be probative on the issue of the franchisor's bad faith.<sup>64</sup>

## **C. Brazil**

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### **1. Introduction**

Brazilian contract law gives considerable emphasis to the principles of good faith and the social function of contracts as prerequisites for the validity and enforceability of agreements.

The good faith principle is understood to cover all aspects of the negotiation, execution and performance of agreements. The observance of good faith is expected from the parties in the agreement and even third parties which know about its existence cannot wilfully interfere or prejudice the maintenance of the agreement or its performance by the parties.

This general principle has considerable impact on franchising. As a natural consequence of the franchisor's development of its concept, brand and know-how and of its experience, the franchisor will be perceived as having economic power vis-à-vis the prospective franchisee. This will require transparency and fairness in the offer of the franchise or business opportunity.

### **2. Sources of the Duty**

The principle of good faith is one of the pillars of the contractual relationship in Brazil. Together with other principles of private law, such as the principle of the social function of agreements, good faith is a principle used in interpreting and performing agreements.

It is expressly established in the 2002 Brazilian Civil Code<sup>65</sup> (the "New Brazilian Civil Code"), as follows:

*"Art. 133. Legal business shall be interpreted in conformity with good faith and with the custom of the place of its execution."*

*"Art. 422. The parties shall assure the principles of diligence and good faith both in executing and in performing the contract."*

### **3. Content and Scope of the Duty**

In contrast with the Brazilian Civil Code of 1916, which contemplated subjective good faith (*boa fé subjetiva*), the New 2002 Brazilian Civil Code provides

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<sup>64</sup> *Id.* at 1405-07 & n.15. See also *Foodmaker, Inc. v. Quershi*, Bus. Fran. Guide (CCH) ¶ 11,780 (Cal. Super. Ct. 1999) (despite the absence of a grant of an exclusive territory, franchisee was "entitled to expect that [franchisor] will not act to impair or destroy their franchise interest. Whether or not this occurred in this case is a triable issue of fact.").

<sup>65</sup> Articles 113 and 422 of law No. 10,406 of January 10, 2002.

for the principle of objective good faith (*boa fé objetiva*). This new concept of good faith is related to the loyalty, honesty, fairness and mutual trust that the contracting parties must entertain when negotiating and executing the agreement, as well as after its termination. In this sense, good faith attempts to disclose situations that are compatible with a behavior normally required or expected from contracting parties.

This has become a rule and a duty to act in accordance with certain well-known social standards, which are based on the standard conduct of an ordinary man. Such conduct must exist not only during the term of the agreement, but also in the pre and post contractual phases, as the intention of not prejudicing the other contracting party, nor taking advantage of its economic, intellectual or social inferiority, will always prevail.

Good faith is especially relevant in transactions where one party is viewed as having economic power over the other party, which is the case of a franchising relationship. In such a scenario, due to the perceived economic disadvantage of the prospective franchisee, the franchise relationship requires significant attention to the transparency applied during all phases of the transaction, particularly at the offering stage, so that the franchisor, acting in good faith, does not take undue advantage of its perceived economic power vis-à-vis the franchisee.

In franchising, objective good faith is mainly relevant in the pre contractual phase, because agreements can be entered into due to a lack of proper information. In Brazil, pre-contractual negotiation can already generate certain rights if, the parties are led to believe that a final contract will be formed and suddenly or unjustifiably one of the parties withdraws from the ongoing negotiations. In such case, it would be unfair not to consider the investments effected by one of the parties during the pre contractual phase or the expectation already inferred from the negotiation.

In this regard, objective good faith relates to the adequacy of the party's behavior (which involves loyalty, fairness, honesty and trust) in the proper conduct of negotiation or a cooperative legal relationship. It requires that the contract should be negotiated and executed according to what was foreseen or that both parties should obtain the expected returns or results. Thus, beyond the obligation not to harm, afforded by subjective good faith, objective good faith requires the parties to cooperate with fairness and honesty during all phases of the transaction in order to ensure that the other party obtains the expected.

For this reason, it is now very important to review the intended or perceived subject matter of the business, as well as the kind of relationship established between the parties involved, since even before the execution of the agreement, certain obligations may arise and the non-performance of such obligations may trigger consequences leading to indemnification rights or rights to review and adjust the terms or conditions of the agreement.

#### **4. The Social Function of the Agreement**

Under Brazilian law, closely connected to the principle of good faith, is the principle of the social function of the contract. Brazilian law applies to the following principles when construing a contract: (i) freedom to contract; (ii) social function of contracts; (iii) obligation to perform; and (iv) observation of subjective, objective and formal requisites for validity.

Article 421 of the New Brazilian Civil Code provides that freedom to contract is exercised observing its social function, combating unjustified enrichment, rebalancing excessively one-sided contracts and reducing excessive conditions, for instance.

This principle implies that an agreement which infringes the social function of the contract will not be enforceable, as a matter of public policy. The social function is not defined by law. Since the New Brazilian Civil Code is relatively new, the case law has not fully evolved to define its meaning. In essence, the social function implies that the parties enter into an agreement to achieve a certain result or business activity and any provision which may interfere with such objectives will potentially impede the achievement of such goals.

## **5. Application of the Duty**

### **(a) Disclosure**

The offer of franchising operations in Brazil is governed by the Franchise Disclosure Law<sup>66</sup>. The Franchise Disclosure Law does not seek to regulate the relationship between franchisors and franchisees. The franchise relationship is governed by the terms and conditions in the agreement, provided that they do not violate public order, the freedom to contract and the general principle of contracts. The franchise relationship is empirical by nature and is still defined by the parties in the agreement on a case-by-case basis, subject only to the general principles contained in the Civil Code, Commercial and Competition Laws and the intellectual property rules with regard to the rights and obligations of the parties.

The Franchise Disclosure Law imposes on franchisors the duty to supply prospective franchisees with a Franchise Offering Circular (FOC), at least ten (10) days prior to the execution of the franchise agreement.

The Franchise Offering Circular must state relevant and material data about franchisor's corporate structure, such as its annual revenue and other corporate, economic and financial information. Moreover, such document shall clearly indicate, among other factors, what the franchisor is offering the franchisee, and the effects of termination of a franchise contract for the franchisee. The disclosure of information has the purpose of providing prospective franchisees with all necessary information for their investment decision.

The business offer, which terms are contemplated in the FOC, reflects the pre contractual phase of a franchise business. The FOC is the document through which the conditions of the franchise are disclosed, in a transparent manner, to the potential franchisees. Even though the FOC is an initial document, it is at this stage (i.e. the offering stage) where the principle of good faith has its most important dimension. In the negotiation phase, the law assumes that the economic position of the prospective franchisee is so debilitated or weakened that the law has to leverage up its position by imposing on the franchisor the obligation to provide the proper and adequate information to enable the prospect to understand the business and make a decision whether to run the risk of associating with the franchisor.

The applicability of good faith in the offering stage of a franchise relationship is due to the perceived economic power of the franchisor. This is why in franchise

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<sup>66</sup> Law No. 8.955, of December 15, 1994.

transactions, the transparency of the information provided by the franchisor, especially in the offering stage, is more relevant than transparency in other contractual relationships.

The FOC must be prepared in compliance with the principle of good faith, which means that, when preparing the FOC, the franchisor must act with loyalty, honesty, trust and fairness, being absolutely clear and straight forward. The FOC must reflect the real information of the business and will bind the Franchisor. In Brazil, a breach of good faith is considered to be civil misconduct. It may give rise to a cause of action in fraud (where there is a clear intent) or in negligence. A failure to disclose relevant information during a pre contractual phase violates the principle of good faith, since the franchisor could be considered negligent when establishing the conditions of the franchise business. Such negligence may trigger indemnification rights to the injured party.

For such reason, the provisions of the FOC, specially the ones related to the investments and payments by franchisee and the expected services and returns from the franchisor, shall be very critical.

If the FOC's provisions are not transparent or are so sophisticated that they hide its intention to not comply with certain expected matters, it may fail the disclosure obligations and give rise to indemnification rights by the potential franchisee.

On the other hand, this principle also benefits the franchisor, as minor or irrelevant omissions or errors in the FOC which do not affect the transparency obligation by not resulting in a substantial modification of the expected or negotiated conditions cannot be used to justify a claim for misconduct by the franchisor. Therefore, even before the execution of the agreement, the parties must act with loyalty, trust, fairness and honesty. Otherwise, the party which has not observed such standards of conduct may be required to compensate the party who acted in accordance with the principle of good faith. The principle of good faith in franchising is primarily reflected in the preparation and submission of the FOC.

(b) Franchise Agreement and Ongoing Relationship

Franchise agreements are not regulated by law. The general rules and principles for construing and interpreting contracts under Brazilian law apply to them. This is why the principle of good faith, as well as other private law principles, are of extreme importance in a franchise transaction.

The franchising agreement should not be considered as a contract of adhesion, since the potential franchisee has had the opportunity to review the FOC and negotiate the terms and conditions of the franchise agreement before executing it. In view of that, even though the prospective franchisee is perceived to have an economic disadvantage, the law evens the playing field. The franchisee cannot therefore be treated as a disabled party and, going forward in the business relationship, should be viewed as an average business party not requiring the protective benefits granted by Brazilian law to weaker parties, such as in the case of consumers or employees.

However, the principle of good faith requires that the terms of the agreement are balanced and do not submit one of the parties to abusive restrictions or penalties

or insurmountable performance hurdles. The agreement cannot be one-sided to such a point that one party has been deprived of its rights or claims while the other does not need to perform. The law does not require that agreements be equally balanced, since it is expected that different obligations will attract different levels of performance. The principles of good faith and social function indeed require that the terms of the agreement are compatible and proportional to permit the parties to perform their part to achieve the goals of the agreement and confer proper remedies for breach.

The standards of the principle of good faith subsist through all phases of the transaction and even survive termination, which means that the contracting parties must observe and act in accordance with such standards before and during the term of the agreement, as well as after its termination.

In general terms, the franchisor and franchisee must perform their contractual obligations in a loyal and fair manner, which may be exemplified as a duty to cooperate, to protect each other's interests, to give information and submit reports and accounts.

An example of such cooperation could be the provisions of franchise agreements related to training of personnel and inspection. Such procedures must be carefully observed by the franchisor, since they represent the main way the franchisee obtains the information necessary to develop its business.

Failure to disclose relevant information during a contractual term will generally not result in invalidity of the contract, but, depending on the degree or impact of such failure, may result in a compensation through damages. Thus, a party, who neglects his duty to disclose relevant information to the other party during a contractual term, may be punished by an obligation to compensate the other party for the loss suffered as a result of his neglect in this respect.

Some general rules on interpretation of agreements also should be taken into consideration when drafting a contract from a perspective of good faith. Generally, an unclear clause will be interpreted in favor of the party not having drafted it. Also, Brazilian courts tend to interpret contractual provisions from a general perspective of fairness and reasonableness.

(c) Termination

The principle of good faith may play an important role in the drafting of termination provisions and subsequently in the application of termination options.

In Brazil, it is generally permissible to terminate the agreement due to a breach by the other side. Especially as far as breaches by the franchisee are concerned, the principle of good faith will, in effect, require good cause for termination, as a termination without good cause is likely to be rejected by a court on the basis that it is abusive. Such good cause for termination should be material in order to actually trigger the termination. Minor operational or standards misconducts can hardly justify a claim for termination with good cause, unless they are material, repetitive and can be evidenced to affect the franchisor's standards or reputation.

The key consideration is that a franchise is an ongoing relationship and operational failures can occasionally happen, so that certain aspects of the business should allow a chance for the franchisee to cure the failure before termination.

Under the Brazilian law, there are two kinds of breach of an agreement. The first is a general breach of the contract without any express termination right and the second is a breach with an express termination right, where the breach automatically triggers termination.

In the first instance, where the breach results from infringement of a contractual provision but does not trigger a termination right listed in the contract, such termination, if resisted by the other side, will depend upon a court decision recognizing the termination and releasing the parties from the agreement. If not expressly listed in the termination provision, a breach may give a party who can show a compelling reason a right to terminate the contract prematurely. The reason for termination would have to be material and not foreseeable at the time of entering into the agreement.

The second possibility, more common in franchise agreements, is that all termination causes are expressly listed in the contract and the occurrence of such express cause will trigger termination automatically and directly. Under civil law and practice, the cause expressly listed in the agreement may terminate the agreement without the need of any court confirmatory decision.

However, even in relation to the express termination cause, the termination by the franchisor must be supported by a careful balancing of the cause and the procedure implemented for termination. It is advisable to list the curable causes and non-curable instances. Curable causes are those where the franchisee must be informed of the possibility of termination if the franchisee does not correct or rectify its conduct within a certain time period and termination may be triggered only after the franchisee has been provided with a time to cure and failed to do so. Non-curable causes are those which may trigger the termination directly and automatically so that any occurrence will result in immediate termination irrespective of any notice or prior notice to cure.

Termination causes must always be material, in the sense that the event triggering termination is relevant and sufficiently serious to impede the continuance of the agreement. The terminating party acts in good faith if it gives to the defaulting party, a notice to cure or to remediate its default, if curable.

In addition, the party desiring to terminate the agreement, acting in good faith, must demonstrate that (i) it has duly complied with its terms and obligations; (ii) the other party has violated or breached the obligations; and (iii) the violation or the breach was material.

In determining whether there is good cause to terminate, the terminating party shall take into account, before terminating, the relevance of the business, the employees involved, the investments made by the other party or other repercussions and consequences, as a sign of good faith

The principle of good faith survives the termination of the franchise agreement in order to guarantee that the parties, who were involved in the franchise transaction, continue to act in a loyal, honest, trustful and fair manner with respect to the

franchise business with which they used to be involved; under penalty of giving rise to an eventual indemnification claim. Such observance must be present in the franchisee's obligations of confidentiality and non-competition, for instance. The same goes for the franchisor's instructions with respect to the phasing out or repurchase of the franchisee's inventory and equipments, for instance.

(d) Renewal

Franchise agreements are entered into for a term. There is no obligation to renew them, unless provided for in the agreement.

The principle of good faith could also – following the obligations of loyalty, honesty, trust, fairness and disclosure of relevant information between the parties during the term of the agreement - affect the terms of renewal of a franchise agreement or, more likely, give rise to a claim for damages if the franchisor has acted in a way as to give the franchisee strong reason to expect a renewal and it subsequently refuses to renew the contract.

It is imperative that the provisions concerning possible renewal are carefully drafted not to give the perception by the franchisee that there is a right to renew when such a right does not exist. Ambiguity in this provision may be judged in favor of the franchisee, so that the FOC and the agreement should be especially clear and precise in this regard.

(e) Third Parties

Regarding third parties' rights, the general rule of good faith requires third parties to refrain from willfully interfering or damaging the contracting parties performance and continuance with the agreement.

Therefore, third parties --- knowing about the agreement --- may not, in any case, interfere in the franchise in a way that could prejudice the maintenance and performance of the agreement by the parties, as well as the standards of the franchise business. This is particularly important in relation to competitors of the franchisor who should respect the existence of the franchise and not attempt to convince the franchisee to terminate the franchise or convert its unity to other brands. Likewise, other franchisees should not influence the performance negatively to convince the franchisor to terminate an existing agreement to grant another franchise in the territory, for instance.

(f) Cases

Brazilian courts have already considered the good faith principle in relation to franchises. Although Brazil is a civil law country and precedents have no authority on subsequent cases, the leading cases will certainly help guide future decisions as examples of good decisions on similar matters.

The 2nd Civil Court of Appeals of the State of Rio de Janeiro in Diego Rasga Calazans vs. DWB Projetos E Empreendimentos Ltda,<sup>67</sup> decided that the franchisor breached the good faith principle, based on frustration of the franchisee's good business, since the franchisor had given up the franchise business after the execution of the agreement and opened an establishment in the same place where

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<sup>67</sup> Appeal No. 2007.001.47396 – September 26, 2007.

the franchisee intended to open its franchise. The discontinuance of the franchise system and the territory invasion were viewed as a breach of the good faith obligation.

The principle of good-faith may also be addressed on the resolution of another recent ruling in franchise litigation by the 15th Civil Court of Appeal of the State of Rio de Janeiro<sup>68</sup> in Sports Nutrition Center Importadora e Exportadora Ltda. vs. Eduardo Da Silva Dias Martins. The 15th Civil Court of Appeals decided that the franchisor acted in good faith during all phases of the business by being transparent with the franchisee and by disclosing all necessary information for the execution of the franchise agreement. For this reason, the request of the franchisee for an indemnification due to the lack of information provided by the franchisor was not granted.

Another example is in the resolution on trial by The 6th Civil Court of the State of Rio de Janeiro<sup>69</sup> in Oberto Rodriguez vs. Irwin Industrial e Comercial Ltda. The court decided that the franchisee should indemnify the franchisor, because the franchisee did not act in good faith when he did not take the expected care of the franchisor's products and allowed for re-distribution of the products to other retailers. The Court understood that the franchisee breached the exclusivity clause of the franchising agreement and the good faith principle by allowing third parties to sell the franchisor's exclusive products. Although this is a decision by a trial court which may be reviewed on appeal, it does show a reasonable application of the principle by the court.

## **6. Conclusion**

The new concept of good faith in the general law of contracts in Brazil provides the parties with an additional duty to act and demonstrate transparency, honesty and fairness in all phases of the relationship.

In a franchise, the parties will need to be careful to apply this principle on an ongoing basis. The case law which will guide the application of the good faith duty in the future seems to be evolving to assist both the franchisor and the franchisee, without assuming that the franchisor's economic power will necessarily require a more protective interpretation in favor of the franchisees.

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<sup>68</sup> Civil Appeal No. 2007.001.03555 – April 17, 2007.

<sup>69</sup> Ordinary Suit No.1998.001.049034-5 – March 5, 2001.

## D. France

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### 1. Introduction

"Good faith" means different things to different people. In laymen's terms, it has been described as:

*"Principle of good faith: negotiations and contractual relations should be characterised by honesty and fairness, by the intention to carry out contractual obligations, and with no intention to seek an unfair advantage or purposefully act to the detriment of the other party"*<sup>70</sup>

The principle of good faith (la "bonne foi") is one of the pillars of French Civil Law. It has been included in the French Civil Code since 1802 and applies in civil as well as in commercial matters, between natural persons or legal persons or entities, during the pre contractual negotiations, at the time of implementation of the agreement and after its termination. This principle is enforced by French courts and used by them as a tool to reinstate equality between the parties. A breach of the duty of good faith may lead to damages.

There is no specific legislation governing franchising in France . The 1989 *loi Doubin*<sup>71</sup> deals only with the obligation for the franchisor to disclose a limited set of information to prospective franchisees. All other aspects of the franchise agreement are dealt with by civil or commercial Law.

### 2. Sources of the Duty

*"Contracts, whether they have a specific denomination or not, are subject to general rules which are the subject matter of the Title"*<sup>72</sup>

Therefore one must have a good knowledge and command of the french law on contracts as defined in the Civil Code<sup>73</sup> when negotiating and drafting commercial agreements. There is no obligation that a contract be in writing or in a particular form. A letter of intent may be treated as a legally enforceable contract.

When French courts interpret contracts, they take into account not just a linguistic analysis of the contract but also other factors, such as the reasonable expectations of the parties given the nature of the contract and what would be fair and reasonable:

*"Agreements lawfully entered into take the place of the law for those who have made them. They may be revoked only by mutual consent, or for causes*

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<sup>70</sup> In "English Legal terminology – Legal concepts in language" - Helen Gubby – Boom Juridische uitgebvers, Den Haag 2004 p 159.

<sup>71</sup> codified under article L330.3 of the Code of Commerce.

<sup>72</sup> (Article 1107 of Civil Code)

<sup>73</sup> (Articles 1101 to 1369-11)

*authorized by law. They must be performed in good faith<sup>74</sup> “agreements are binding not only as to what is therein expressed, but also as to all the consequences which equity, usage or statute give to the obligation according to its nature”<sup>75</sup>*

### **3. Scope of the Duty**

There is no legal definition of “good faith” which must then be understood with the general meaning of an obligation of loyalty or fidelity to a person, a promise, an engagement.

There are thousands of reported Court cases enforcing the legal principle of acting and performing in good faith, whatever the type of agreement<sup>76</sup> and awarding damages.

Modern law is imposing more and more obligations or restrictions on the parties due to Public Order, protection of the consumer, fair dealing, and competition, but the principles of good faith and the terms of the agreement still are fundamental, especially as far as distribution agreements are concerned.

#### **(a) Pre sales disclosure**

The Commercial Code<sup>77</sup> requires

*Any person who grants to another person the license to use a trade name, a trade mark or a logo, subject to the commitment of exclusivity or quasi exclusivity for the exercise of the latter’s activities shall, prior to the execution of any agreement negotiated in the two parties mutual interest, furnish to the other party a document giving honest information permitting the other party to make an informed decision.*

*This document, the contents of which shall be provided for by a decree shall contain, among other things, information on the age and the experience of the Licensor’s business, the status and the possibilities of growth of the Market, the importance of the retail network, the term, renewal, termination and conditions of transfer of the agreement and the scope of any exclusivities granted.*

*When payment of any monies shall be demanded prior to the execution of the agreement hereabove mentioned, especially in order to be granted the rights of exclusivity of a Territory, the undertakings made in consideration of such payments shall be described in writing as well as the reciprocal obligations of the parties in case of forfeiture.*

*The document provided for under paragraph 1 as well as the proposed agreement shall be delivered in writing at least twenty days before the*

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<sup>74</sup> (Article 1134 of Civil Code)

<sup>75</sup> (Article 1135 of Civil Code)

<sup>76</sup> For example, employment agreements (as in Cass Soc 4 June 2002) or publishing contracts (as in CA Paris 9 September 1998 – Cass Civ 11 January 2000)).

<sup>77</sup> Article L330-3

*execution of the agreement or, if the case arises, before payment of the monies described at the paragraph hereabove.*

Although this legislation was adopted in 1989, there are very few reported Court cases .

A court ruled that by not complying with its duty to give “honest information” in its Pre Sales Disclosure Document (PSDD), a franchisor had breached its duty to act in good faith : *“even if a Franchisor is not legally compelled to prepare a study of the local market and even if a candidate should make his own studies, when such study is given, article L330-3 and the obligation to negotiate in good faith which is a general principle, make it mandatory for the Franchisor to make such study (of the local market) in good faith”*. The court allowed termination of the franchise agreement for lack of pre-contractual information and awarded damages to the former franchisee of 34,400 euros plus costs.<sup>78</sup>

This decision was quashed by the Cour de Cassation, France’s highest court, on the grounds the failure to provide the required pre-contractual information may lead to the nullity of the Franchise Agreement but cannot be a good cause for termination of the agreement.<sup>79</sup>

This is consistent with the view of the Cour de Cassation that a franchise agreement can be declared null and void only if the lack of pre sales information misled the Franchisee.<sup>80</sup> The court does not want the lower courts to automatically rule in favor of the franchisee without referring to the general principles governing agreements.

On the contrary, the Cour de Cassation upheld a lower court which ruled that a franchisor had the obligation to give specific and loyal information on the system to the candidates, who were misled in their financial expectations.<sup>81</sup>

Franchisors and their counsels should therefore always carefully draft their PSDD so that their duty of good faith and honest information cannot be challenged.

(b) During the term, during renewal or upon termination

There are very few reported cases in France dealing with good faith in the implementation of the franchise agreement. Good faith (or lack of good faith) can be used by a franchisor as a good reason to refuse renewal of a franchise agreement by a franchisee, generally due to non compliance or lack of compliance by the franchisee of its financial obligations (late payment of royalties, lack of reporting, etc).

A lower court ruled in favour of a franchisee by finding that, although the franchisor was aware of flaws and defects in its system, it had not fully informed the franchise network on that matter, had breached its duty of ongoing training and

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<sup>78</sup> (CA Orléans Com. 26 October 2006 – Theraform/ Madame X)

<sup>79</sup> (Cass Com 12 February 2008 nr 07-10462)

<sup>80</sup> (Cass Com 19 October 1999 – Cass Com 21 November 2000 – Cass Com 24 September 2003)

<sup>81</sup> (Cass Com 20 October 1998 nr 96-13159)

therefore acted in bad faith, and awarded 66,600 euros in damages to the franchisee.<sup>82</sup>

Most recently, on 9 October 2007, the Cour de Cassation ruled that “*agreements must be executed in good faith*” but that there had not been any breach of this principle by a franchisor who terminated a franchise agreement “*due to lack of compliance by its Franchisee of its financial commitments.*”<sup>83</sup>

Nothing prevents a court from playing a leading role in a franchise dispute. A franchisor in the travel industry recently decided to create its own website thus preventing its franchisees from collecting royalties on the web turnover. The franchisees immediately sued for breach of contract. The First Instance Commercial Court of Bobigny commented that “*All Agreements in force must be operated in good faith by the Franchisor according to their provisions but in the interest of all parties, such provisions may be discussed taking into account the creation of the Web Site so that the balance of the agreement is kept.*”<sup>84</sup> The Court sought a practical solution, adding that it may appoint a “referee” at the Parties request. (Tribunal de Commerce de Bobigny 29 January 2008).

#### **4. Conclusion**

Acting in good faith at all stages is mandatory. Although there are no pre-trial discoveries or jury trials in France in civil and commercial matters, the parties should be very careful at all stages of negotiations.

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<sup>82</sup> (CA Douai 6 September 2007 nr 06/1777 – SA Phildar)

<sup>83</sup> (Cass Com 9 October 2007 – nr 05-14118)

<sup>84</sup> Tribunal de Commerce de Bobigny 29 January 2008.