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As legal advisors attempt to demystify the concept of “good faith” in contractual dealings across various jurisdictions globally, the tensions between civil law and common law traditions and their approach to good faith can make this task even more daunting. We consider the fundamentals behind the principle of good faith in international franchising against the backdrop of both legal regimes, highlight the issues with reconciling them, and provide some general practical tips for franchisors.

GOOD FAITH AND INTERNATIONAL FRANCHISING

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Introduction

In recent years, the notion of good faith has been gaining traction in the context of both national and international franchising. In both civil law and common law jurisdictions, courts have sometimes relied on the notion of good faith to compensate for the power imbalance that often exists in a franchise relationship. In most civil law jurisdictions, the duty to act in good faith in commercial dealings is a general and free-standing obligation that arises in addition to the contractual terms between parties. With regard specifically to franchise agreements, recent decisions have arguably extended the implied duty of good faith owed by a franchisor to a franchisee. For a franchisor to fulfil its obligations, courts have held that a franchisor is required to act in good faith throughout the franchise relationship, respond promptly to its franchisees’ concerns regarding competitive threats, as well as generally take steps to protect its brand and franchise network.

Although a statutory duty of good faith applicable to all contracts has not been enacted in common law jurisdictions, many franchise-specific and business relationship statutes provide for a duty of good faith and fair dealing in these types of contracts. Common law courts are also increasingly inclined to recognise a duty of good faith in the performance of commercial contracts. For example, Canadian courts have applied the duty of good faith as a general organising principle of common law contracts, particularly in the context of commercial agreements involving vulnerable parties, such as franchise arrangements.

The notion of good faith has been given various interpretations and has been applied on a case-by-case basis, especially in the context of franchise law. This chapter seeks to provide an overview of the manner in which the duty to act in good faith has been interpreted and applied by courts, particularly in civil and common law jurisdictions. The various difficulties and challenges created by the current state of the law on good faith, particularly as it applies in the franchise context, will also

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be discussed. Finally, the authors will present practical tips for franchisors in order to comply with their duty to act in good faith. It is important to note that although this chapter draws on examples of Canadian case law, the issues addressed in this article commonly arise in cross-border franchising.

Principles of good faith in the civil law tradition

General overview

In many civil law jurisdictions, the duty to act in good faith in commercial dealings is a general and free-standing obligation codified by statute. For example, a fulsome obligation applicable to all contracts exists in Canada's civil law province, Quebec, which imposes a legal requirement for all parties to conduct themselves in good faith during both contractual and pre-contractual dealings. The obligation to act in good faith applies to the execution of the agreement, the fulfilment of the parties' respective obligations, and the way in which the contract is terminated. Therefore, parties are required to act in good faith throughout the entirety of their contractual relationship, in addition to respecting the express terms of their contractual agreement. Moreover, while the notion of good faith is far-reaching and applicable to many situations in the civil law tradition, the principle is not typically viewed as yielding a particular result or outcome, but rather informs the manner in which parties to a contract must conduct themselves, and provides the basis for considering the reasonableness and sufficiency of their actions in a given set of circumstances.

Good faith in franchise agreements

Civil law courts have often characterised franchise agreements as contracts of adhesion given that they typically contain standardised clauses that are not freely negotiated between the parties. Courts have justified reading an implied duty to act in good faith into franchise agreements and have imposed obligations on franchisors that go beyond the terms of the franchise agreement based on the existence of an inherent power imbalance between the franchisor and the franchisee.

Furthermore, the relationship between a franchisor and a franchisee is often described as being of a long-term and relational nature. Therefore, the judiciary is inclined to read in a more robust duty of good faith into franchise agreements considering that such agreements do not always spell out all of the terms between the parties in an explicit manner, as is often the case with long-term relationships. However, courts have also held that there is no fiduciary duty that exists between a franchisor and a franchisee.

In recent decisions, Canadian civil law courts in particular have broadly interpreted, and arguably significantly extended, the duty of good faith owed by a franchisor to a franchisee. Various examples of specific duties that flow from the duty to act in good faith in franchise agreements are discussed below.

Duty to disclose

To act in good faith, franchisors have a pre-contractual duty to furnish accurate and up-to-date information to prospective franchisees regarding their business operations. This requirement is based on the general duty of good faith in contracts, and may in certain cases extend to the fulsome disclosure requirements set forth in specific franchise disclosure laws. In any event, this pre-contractual disclosure is typically required in order to allow franchisees to access information they need in order to make informed investment decisions. The franchisor must therefore disclose all material information that is likely to influence the franchisee's decision in acquiring a franchise, as well as all information that the franchisee needs to operate the franchise.

Given the general nature of the good faith obligation in civil law, there is no specific disclosure checklist that must be satisfied in each franchise context; however, a franchisor is required to exercise discretion and judgment in making its pre-contractual disclosures. As such, any facts or occurrences known to the franchisor that may impact a franchisee's decision to contract must be brought to light in a timely manner.

Duty to collaborate and provide technical and commercial support

According to case law, franchisors are required to collaborate with their franchisees, meaning that franchisors must act in a reasonable manner and diligently towards their franchisees. Similarly, franchisors are required to provide technical and commercial assistance to their franchisees throughout the course of their relationship. The rationale is that the franchisor possesses a certain level of know-how and expertise required to thrive in its domain and must therefore support its franchisees to counterbalance the 'asymmetry of knowledge' that exists between the franchisor and the franchisee. This entails that the franchisor must provide its franchisees with the tools that will enable them to (i) develop their business, (ii) prevent economic loss or at least minimise its impact, and (iii) resist competition from other franchise networks.

Duty to compete fairly with the franchisee

The duty to act in good faith would not preclude a franchisor from competing with its franchisees (assuming, of course, the absence of contractual obligations to this effect in favour of the franchisee). However, the franchisor owes an obligation of loyalty towards its franchisees in that, if a franchisor opts to compete with its franchisee, it must ensure that it continues to perform its legal obligations towards the latter and that it acts in such a way that the franchisee may continue to enjoy the benefits of its franchise.

Duty to protect the franchise brand

Civil law courts have also held that a franchisor has a duty to protect its brand and network that goes beyond the explicit terms of the franchise agreement. This is a duty that is owed not only to each individual franchisee, but also to the entire franchise network as a whole. To fulfil this duty, a franchisor is required to (i) act in good faith throughout the franchise relationship, (ii) respond promptly to its franchisees' concerns regarding competitive threats, and (iii) generally take steps to provide adequate brand management and protect its brand and franchise network. What must be avoided by franchisors is a maintenance of the status quo or a 'business as usual' attitude in the face of significant changes in the market. If the franchisor demonstrates that it has made concrete efforts in protecting and enhancing its brand, and yet in spite of these efforts, competitors have encroached on the franchisee's business, the franchisee will likely have no basis for a complaint.

In line with its duty to protect the franchise brand, the franchisor is also required to 'police' the franchise network, meaning that franchisors must actively monitor and endeavour to curtail relationships with delinquent or 'free-riding' franchisees in order to ensure the viability and profitability of the franchise network as a whole.

Principles of good faith in the common law tradition

General overview

Unlike in the civil law tradition, a freestanding general duty of good faith in contracts does not specifically exist under common law. Common law courts have traditionally described the concept of good faith as 'inherently repugnant to the adversarial position of the parties' and 'unworkable in practice'. However, good faith and the role of implied contractual terms are gaining traction,

particularly under Canadian common law. Canadian courts have recently held that contractual parties have a duty to act honestly in contractual performance, which is a manifestation of an ‘organizing principle of good faith performance in contracts’. Parties must therefore refrain from lying or otherwise knowingly misleading each other about matters directly linked to the performance of the contract. It has essentially been found that a basic level of honesty is required so as to guarantee the ‘proper functioning of commerce’.

Although courts have provided helpful tools to understand the current state of the good faith notion at common law, it remains unclear whether a good faith obligation is being imposed as a matter of law, as a matter of contractual terms implied by law or facts, or as a matter of contract interpretation.

Good faith in franchise agreements

As is the case in civil law jurisdictions, vulnerable contractual parties, such as franchisees, have often been given special consideration under the common law. Despite the lack of a general freestanding obligation, a duty to act in good faith has been recognised in certain common law cases in the context of a franchisor–franchisee relationship. Courts have found that a franchise agreement is a type of contract of adhesion, implying long-term partnerships that require mutual cooperation and consideration. Courts have therefore taken these factors into account when interpreting the scope of the duties to act honestly and in good faith as they apply to franchisors and franchisees. Courts have also cautioned that the determination as to whether a duty of good faith has been breached will be contingent upon all of the surrounding circumstances of a particular case – i.e., the specific conduct that would be expected of a party must be considered on a case-by-case basis.

Moreover, unlike in the civil law tradition, common law courts are divided as to whether terms can be implied in a contract by reason of the duties of good faith and honest performance where there is otherwise no indication that contracting parties agreed to an implied term or where the term sought to be implied was found to be inconsistent with the express terms of the contract.

Although the approach of common law courts to the duty of good faith in franchise agreements has been inconsistent at times, the content of the duty of good faith in the franchise context may be summarised as follows:

- the franchisor must exercise its powers under the franchise agreement in good faith and with due regard to the interests of the franchisee;
- the franchisor must observe standards of ‘honesty, fairness and reasonableness’ and take into account the interests of its franchisees;
- the parties must not act in such a way that ‘eviscerates or defeats the objectives of the agreement’ or ‘destroys the rights of the franchisee to enjoy the fruits of the contract’;
- neither party must substantially reduce the benefit of the bargain for the other, or cause significant harm to the other, in a manner contrary to the original intention and expectation of the parties; and
- where the franchisor is given discretion under the franchise agreement, it must be exercised reasonably and with proper justification, and may not be done subjectively, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.

While common law courts have not been as explicit as civil law courts with regard to the duties that flow from the ‘organizing principle of good faith’, many franchise and business relationship statutes impose a duty of fair dealing on parties to such agreements.

Statutory duty of fair dealing in franchise relationships

Franchise legislation in many jurisdictions imposes a general obligation of fair dealing on the parties in the performance and enforcement of their franchise agreement; for example, Canadian franchise disclosure laws set out such duties. To fulfil this duty, franchisors must perform and enforce the franchise agreement in a manner that takes into account the interests of franchisees. More specifically, when contemplating system-wide changes, a franchisor must consider the interests of the entire franchise network, as opposed to the interests of individual franchisees. Additionally, before making system-wide changes, franchisors should engage in ‘meaningful consultation’ with their franchisees; it has even been suggested that engaging in a nonbinding consultation process can allow a franchisor to potentially ‘build an evidentiary record that can be deployed . . . in defence of allegations of bad faith’.

Furthermore, franchisors are usually subject to stringent statutory pre-contractual disclosure obligations, which require them to provide a franchise disclosure document to every proposed franchisee before the sale of a franchise. In the context of the renewal of franchise agreements, Canadian common law courts have held that a franchisor will have breached its duty of fair dealing if it unduly withholds information so as to preclude a franchisee from exercising its right to renewal. The duty of fair dealing also prevents franchisors from exercising termination rights in an unreasonable or abusive manner.

Although case law has provided some guidance as to how the statutory duty of fair dealing should be interpreted, the extent of this codified common law obligation is far from settled. Still, given that the duty of fair dealing does not generally ‘override’ unequivocal contractual provisions in the common law tradition, the breadth and scope of this duty may be mitigated by clearly drafted provisions of a franchise agreement.

Challenges created by the duty of good faith

There are several difficulties and challenges that arise as a result of the current state of the law on good faith, particularly as it applies in the franchise context. These issues include a lack of a uniform definition of the notion of good faith, limited guidance on the practical application of the notion of good faith, as well as difficulty in reconciling an implied duty of good faith with the freedom of contract of parties to a franchise relationship.

Lack of a uniform definition of the notion of good faith

As discussed above, the civil law and common law traditions have very different approaches in characterising the notion of good faith. In each case, the duty of good faith, as it applies in the context of franchise agreements, plays a different role. On the one hand, in civil law jurisdictions, the duty to act in good faith appears to imply a positive obligation to take affirmative steps to, inter alia, support franchisees throughout the franchise relationship and be responsive to threats faced by the franchise brand against competition. On the other hand, the common law duty of honest performance, which originates from a general ‘organizing principle of good faith’, seems to call for a negative obligation for franchisors to refrain from acting in a capricious manner towards franchisees. Perhaps more importantly, while the distinction between the application of the principle of good faith in these diverging legal traditions may not always be described as simply, it is generally accepted that the notion of good faith in civil law would impose more significant expectations and obligations on a franchisor, and likely sooner, than would similar concepts under common law.

Practical application of the notion of good faith

The concept of good faith remains difficult to apply in practice. Courts have used sweeping terms such as ‘loyalty’, ‘reasonableness’, ‘collaboration’ and ‘honesty’ to describe the notion of good faith. Although courts have stated that the duty of good faith is not a ‘panacea’, and that a franchisor is not required to guarantee the success of its franchisee’s business, courts have provided limited guidance as to the practical application of the notion of good faith and the duties that flow from this notion, including in the context of franchise agreements, as well as other categories of contracts involving vulnerable parties.

Moreover, many of the cases that have shaped franchisors’ good faith obligations in both civil law and common law jurisdictions rely heavily on the factual circumstances arising in a particular context, which suggests that they may be rightfully distinguished in all but a few cases. It has even been posited that the malleable nature of the notion of good faith has given rise to inconsistent ‘ad hoc jurisprudence’. The extent to which these cases may be applied to franchisors and franchisees at large is therefore debatable.

Implied duty of good faith versus the freedom of contract

Some authors contend that the far-reaching nature of the obligation of good faith, particularly in the civil law tradition, unduly interferes with the parties’ freedom of contract and may lead to uncertainty and unpredictability in commercial relationships. Where a duty of good faith is read into franchise agreements, it makes it difficult for franchisors to anticipate the types of obligations they must uphold. Indeed, in certain circumstances, a franchisor who has otherwise respected the explicit terms of its contract with a franchisee may be found to have breached its duty to act in good faith. This lack of certainty can be quite disturbing in practice.

Practical suggestions for franchisors

While the meaning of good faith is likely to continue to significantly evolve in response to current trends and future litigation, franchisors are encouraged to perform and enforce the terms of their franchise agreements in a manner consistent with the principles presented in this chapter. Regardless of where their franchise network is operating, franchisors should proceed with caution as the fundamental principles of good faith and honesty will undoubtedly continue to inform their conduct throughout their relationship with franchisees. More particularly, franchisors may consider implementing some or all of the following practical tips, with a view to complying with the duty to act in good faith and circumscribing the scope of their obligations that may lead to claims of unfair practices or conduct inconsistent with the requirements of good faith in any particular circumstances:

- ensure that they have carefully studied the good faith requirements in each jurisdiction where they wish to operate and, in particular, consider that their good faith obligations will likely prove to be more cumbersome in civil law jurisdictions;
- to avoid interpretative ambiguity and mitigate the risk that courts will read in more onerous obligations for a brand than were intended, franchisors should critically review their franchise agreements with a view to removing statements pertaining to the significant value and goodwill of their trademarks and business model, as well as any provisions that may be construed as commitments to enhance or engage in continued development of their brand;
- include provisions in the franchise agreement pursuant to which franchisees expressly acknowledge and agree that the franchisor is entitled to make decisions and take actions in the exercise of its discretion or rights with respect to an individual franchisee with a view to protecting or otherwise benefiting the franchised system or network generally;

- considering the significant operational requirements often imposed on franchisees that are central to their contractual compliance, franchisors should be mindful of possible corollary obligations for them to enforce these obligations across the franchised network. As a result, franchisors may consider including in their franchise agreements specific defaults and termination rights where franchisees fail to comply with imperative operating requirements or otherwise engage in behaviour that may tarnish the reputation of the franchised network, and franchisors should not be too reluctant to exercise their rights under such provisions;
- act responsibly and not fail to take timely steps to protect their franchised networks when threatened, including as a result of competitive threats in the market, by offering some attempt at resolving genuine concerns of franchisees about the viability of the franchised system or the future of the franchised business. If a franchisor is in a position to demonstrate that it genuinely took some measure of response in order to assist its franchised network in Lapointe Rosenstein Marchand Melançon LLP - Bruno Floriani, Marissa Carnevale and Tanya Nakhoul dealing with competitive forces, it is unlikely that its conduct will be met with severe scrutiny; and
- avoid drastically changing tack during the course of renewal discussions and refrain from engaging in conduct that could be seen as provoking an arbitrary impasse in the renewal process.

Other steps to mitigate risks for franchisors may also be explored and will vary based on a franchisor's operations and market segment. Specific solutions may need to be adapted based on the nature of any given business and its approach to franchising.

Conclusion

The obligation to act in good faith, as it applies in the context of franchise agreements, is a burgeoning field. In light of the developing recognition of the duty to act in good faith in both common law and civil law jurisdictions, it will not be surprising if the trend continues in cases where one party's conduct is inherently unreasonable, unfair or otherwise offends the basic tenets of commercial dealings. Given the recent shifts in the scope of protections recognised for franchisees in various jurisdictions worldwide, it will be important for franchisors conducting business both nationally and internationally to monitor and comply with their good faith obligations for the foreseeable future.

This chapter is taken from Lexology GTDT's Practice Guide to Franchise, examining key themes topical to cross border franchising.