

Franchisor Opportunism, Commercial Morality and Good Faith

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Abstract

A recent Australian report has concluded that while the prior disclosure obligations of Australia's regulatory instrument for franchising (the *Franchising Code of Conduct*) are for the most part adequately addressed, there remain concerns because of the 'continuing absence of an explicit overarching standard of conduct for parties entering a franchise agreement'. The *Opportunity not opportunism* report of the Parliamentary Joint Committee on Corporations and Financial Services (December 2008) recommended that the optimal way to provide a deterrent against opportunistic conduct in the franchising sector was 'to explicitly incorporate, in its simplest form, the existing and widely accepted implied duty of parties to a franchise agreement to act in good faith'.

This paper explores the challenges faced in grafting the civil law concept of good faith onto a common law system. It suggests that in Australia and other common law jurisdictions – and even in civil law jurisdictions – good faith is more an elusive ideal than a well settled commercial standard and that issues of definition, scope and application may frustrate its intended application in the franchising context.

Introduction

In 1998 Australia joined the exclusive club of countries which regulate their franchise sectors under specific franchise laws rather than simply relying on underlying commercial laws of general application to all business enterprises, albeit supplemented in many cases by voluntary self regulatory codes of practice.¹ The influential 1997 Fair Trading Report, *Finding a Balance – Towards Fair Trading in Australia*² catalogued a litany of inappropriate conduct in relation to small business in general and franchising in particular that left the government little option but to act. The *Franchising Code of Conduct* (prescribed as a Regulation under the *Trade Practices Act 1974* (Cth)) and the introduction of a business unconscionability provision (under section 51AC of the *Trade Practices Act*) was the legislative response.³ These initiatives, in combination with the general prohibition of misleading and deceptive conduct (under s 52 of the *Trade Practices Act*) extend to Australian franchisees arguably the world's most comprehensive regulatory safety net.

Despite the concerns of UK franchising specialist Martin Mendelsohn that 'the new Australian regulation makes Australia the least desirable destination in the world for franchise systems [and franchisors] should avoid Australia until they had nowhere else to go, and even then it would be a close call'⁴, the Australian experience has been positive. The Australian franchising sector has been prepared to accept regulatory measures to protect the image and credibility of the sector⁵ and the Franchise Council of Australia, the peak industry body, acknowledges that there is 'overwhelming support for the *Code*' which has had a 'beneficial effect on the franchising sector' since its introduction.⁶

Despite the strong regulatory regime in Australia, the pressure for further and better protection continues. The *Fair Trading Report* referred to over twenty previous reports at regular intervals since 1976 – only a few years after the first golden arches were erected in

¹ In 1998 only ten countries had dedicated franchise laws. Today, there are over 30 regulated regimes. See generally Terry, "A Census of International Franchising Regulation" 2007 International Society of Franchising Conference Proceedings.

² *Finding a Balance – Towards Fair Trading in Australia* (House of Representatives Standing Committee on Industry, Science and Technology, May 1997)

³ The *Franchising Code of Conduct* mandates prior disclosure, regulates aspects of the relationship, and requires mediation as a prerequisite to arbitration or litigation. See generally Giles, Redfern and Terry, *Franchising Law and Practice*, Butterworths Australia.

⁴ 'Franchise Regulation – Is The World Going Mad?' (1999) 8(1) Franchise New Zealand Magazine 49.

⁵ Franchising Policy Council, *Review of the Franchising Code of Conduct* (2000), foreword.

⁶ Franchise Council of Australia, Submission to the Review of the Franchising Code of Conduct, 2000.

Australia providing the catalyst for the development of domestic franchising – addressing business conduct issues either generally or in the specific context of franchising. In 2008 alone, there were three parliamentary inquiries – Western Australia⁷ and South Australia⁸ and Federal. The latest and most influential report – *Opportunity not opportunism: improving conduct in Australian Franchising* – of the Federal Parliamentary Joint Committee on Corporations and Financial Services (December 2008) concluded that while the *Code's* prior disclosure obligations are 'for the most part adequately addressed' there remain concerns because of the 'continuing absence of an explicit overarching standard of conduct for parties entering a franchise agreement'. The Committee commented that

...the interdependent nature of the franchise relationship leaves the parties to the agreement vulnerable to opportunistic conduct by either franchisors or franchisees. Franchisee opportunism may take the form of free riding, unauthorised use of franchisors' intellectual property rights, under-performance, or failure to accurately disclose income. However, the franchisor's control over the provisions in the contract enables franchisors to address opportunistic behaviour of this kind by enforcing the terms of the franchise agreements.

Franchisor opportunism has been described as 'predatory conduct and strong arm tactics by franchisors' involving the exploitation of a pre-existing power relationship between the franchising parties, which makes the franchisee 'vulnerable or economically captive to the demands of the franchisor'. There is an inherent and necessary imbalance of power in franchise agreements in favour of the franchisor, but abuse of this power can lead to opportunistic practices including encroachment, kickbacks, churning, non-renewal, transfer, termination at will, and unreasonable unilateral variations to the agreement.

The Committee concluded that the optimal way to provide a deterrent against opportunistic conduct in the franchising sector was 'to explicitly incorporate, in its simplest form, the existing and widely accepted implied duty of parties to a franchise agreement to act in good faith'. It recommended that the following new clause be inserted into the *Franchising Code of Conduct*:

Standard of Conduct

Franchisors, franchisees and prospective franchisees shall act in good faith in relation to all aspects of a franchise agreement.

This paper assesses this recommendation which, although superficially attractive, may not be the panacea its proponents expect it to be. It suggests that in Australia, and throughout

⁷ *Inquiry Into the Operation of Franchise Businesses in Western Australia* – Report to the Western Australian Minister for Small Business, April 2008.

⁸ *Franchises: Final Report of the Sixty-Fifth Economic and Finance Committee of the Parliament of South Australia*, May 2008.

common law jurisdictions generally, good faith is more an elusive ideal than a well settled commercial standard and that issues of definition, scope and application may frustrate its intended application.

‘Not an ordinary commercial contract’

In *Dymocks Franchise Systems (NSW) Pty Ltd v Todd* [2002] 2 All ER (Comm) 849 the Privy Council acknowledged that franchise agreements were ‘not ordinary commercial contracts’. The *Dymocks* case provided the first opportunity in Anglo-Australasian jurisdictions for a superior court to explore the jurisprudential nature of franchising, and the reason why franchising agreements were not ordinary contracts. Unfortunately this opportunity was not taken up and the academic literature addressing this issue was not referred to by the Privy Council. The nature of the franchisor/franchisee relationship and the contract which enshrines it are nevertheless attracting increasing attention,⁹ and there is increasing recognition, academic if not judicial, that franchising is a *relational* contract, which Dr Elizabeth Spencer has described as follows:

Relational contracts are defined by features of incompleteness and longevity. Relational contracts must be flexible, sometimes to the point of being vague. There is often a high level of discretion accorded to the parties, and such contracts therefore rely heavily on reciprocity and on trust that develops over time between the contracting parties.¹⁰

Franchising exists in a world of ‘contractual incompleteness and relational complexity’ in which

... the parties are not strangers; much of their interaction takes place “off the contact”, mediated not by visible terms enforceable by a court, but by a particular balance of cooperation and coercion, communication and strategy.¹¹

These characteristics pose a challenge to regulators. The extra-legal norms which explain relational contracting in the context of contracting equals – where self interest generally leads to acceptable outcomes – are nevertheless not as compelling in the context of the typical business format franchise which is characterised by both a *information* and an *power* imbalance.¹²

⁹ See generally Andrew Terry, “Franchising, Relational Contracts and the *Vibe*” (2005) 33 ABLR 289

¹⁰ Dr Elizabeth Spencer, Submission to the Parliamentary Joint Committee Inquiry, into Franchising, December 2008

¹¹ Gillian K. Hadfield, “Problematic Relations: Franchising and the Law of Incomplete Contracts,” (1990) 42 *Stanford Law Review*, 927,992.

¹² See generally, Dr Elizabeth Spencer, “Standard Form and Relational Aspects of Franchise Contracts”, presented at the 20th Annual International Society of Franchising Conference, Palm Springs, California, February, 2006.

The *information imbalance* which characterises the typical business format franchising relationship is typically redressed by prior disclosure. The case for legislation remedying the information imbalance by mandating prior disclosure is widely accepted today. Prior disclosure obligations are not regarded as a restriction on business but as a ‘common sense and firm basis for doing business within the peculiarly close relationship of a franchise and in accordance with normal business practice.’¹³

The *power imbalance* raises more sensitive issues. The case for legislation addressing the power imbalance has less support as it raises difficult questions of fairness and the appropriate allocation of risk in entrepreneurial activities. UNIDROIT’s *Model Franchise Disclosure Law 2002* for example deliberately deals exclusively with prior disclosure issues and does not trespass into the area of appropriate conduct within the relationship. It can be argued that prior disclosure is the key to franchise reform and that it is the function of the disclosure statement to warn potential franchisees not to enter into agreements that they regard as potentially imposing unduly onerous obligations. There is nevertheless increasing regulatory attention to standards of conduct and relationship issues arising out of the power imbalance and greater acceptance that unduly onerous obligations and opportunistic conduct need to be addressed as part of a regulatory scheme to overcome the limitations of classical contract law in accommodating the realities of the relational franchise model.

Good faith and the franchising relationship

The concept of good faith plays an important role in most legal systems. It is a concept familiar to the civil law in which under the Civil Codes it provides the ultimate point of reference for contractual obligations¹⁴. The common law however has not evolved any general requirement of good faith.¹⁵ As noted by the NSW Supreme Court, good faith does

¹³ Trade Practices Consultative Committee, Parliament of Australia, *Small Business and the Trade Practices Act* (1979) [11.32]

¹⁴ “Bona fides” under the French *Civil Code* and “treu & glauben” under the German *Civil Code*. See Farnsworth EA, ‘Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code’ (1962) 30 *University of Chicago Law Review* 666 at 669, who outlines the classical origins of the ‘venerable shibboleth’ of good faith in Roman law and its passage into the English common law.

¹⁵ Writing in the context of article 6 of China’s Contract Code, the *Uniform Contract Law of the PRC* enacted in March 1999 which provides that the parties must act in accordance with the principles of good faith in performing the contract, Peter Gillies and Gisele Kapterian comment that “this provision has been seen as a direct product of deeply imbedded culture norms that emphasise the resolution of disputes through negotiations held in good faith. There is no such common law principle”. (Chapter 8 *Chinese Contract Law* of Blazey and Chan (ed). The *Chinese Commercial Legal System* 2008 LBC p.181.

not ‘neatly fit into the structure Australian contract law’¹⁶ or for that matter, the common law more generally. However, it does not follow that the common law is ‘the hard headed Dickensian ogre that this would at first sight lead one to believe’¹⁷, for the common law has developed specific solutions to particular problems said to arise by virtue of the nature of classical contract law. A range of general and legislative provisions make provision for specific matters addressing specific contractual fairness issues. Indeed, it has been stated that the ‘mistrust of Anglo-Saxon jurists for the general concept of good faith is equalled only by the imagination which they put towards multiplying particular concepts which lead to the same results’.¹⁸

The ‘device’ increasingly looked to to modify the inflexibility of traditional, classical common law contract theory in relational settings such as the franchise relationship is good faith. Hadfield argues that ‘the doctrinal tool relied on to bring ‘the resolution of franchise contract disputes into line with the realities of the franchise relation[ship]’¹⁹ is invariably the implied term of good faith. However, as noted above, an overarching good faith obligation sits uneasily in the common law and judicial support for this proposition is scant. In Anglo Australasian jurisdictions the proposition of a New Zealand judge, Thomas J, in a dissenting judgment, stands virtually in splendid isolation.

The norms of the ongoing relationship, of necessity, tend to supplement the express contractual obligations. Good faith is required to ensure that the requisite communication, co-operation, and predictable performance occurs to the advantage of both parties. In short, the obligation seeks to hold the parties to the promise implicit in the continuing relational commercial transaction.²⁰

Outside legislative direction, an obligation of good faith can arise in a franchise agreement in three ways – as an express term of the contract²¹, as a term implied in fact on an *ad hoc* basis

¹⁶ Brereton J in *Hunter Valley Skydiving Centre Pty Ltd v Central Coast Aero Club Ltd* [2008] NSWSC 539 at 48.

¹⁷ Whittaker S and Zimmermann R, ‘Good faith in European Contract Law: Surveying the Legal Landscape’, Chapter 1 of Reinhard Zimmermann and Simon Whittaker (editors), *Good faith in European Contract Law*, 2000 at 45.

¹⁸ Douglas J, ‘Exploring the Recent Uncertainty Surrounding the Implied Duty of Good Faith in Australian Contract Law: the Duty to Act Reasonably - Its Existence, Ambit and Operation’. Paper delivered at the LexisNexis Contract Law Master Class 24 August 2006 by The Hon Justice James Douglas, at 40, quoting Professor Jacques-Henri Michel. Available online: <http://www.cisg.law.pace.edu/cisg/biblio/douglas1.html>.

¹⁹ Hadfield GK, ‘Problematic Relations: Franchising and the Law of Incomplete Contracts’ (1990) 42 *Stanford Law Review* 927 at 984.

²⁰ Thomas J, dissenting, in *Bobux Marketing Ltd v Raynor Marketing Ltd* [2002] 1 NZLR 506 at 517.

²¹ See for example *Automasters Australia Pty Ltd v Bruness Pty Ltd & Anor* [2002] WASC 286, *Bamco Villa Pty Ltd v Montedeen Pty Ltd* [2001] VSC 192. Clauses requiring parties to ‘negotiate in good faith’ are not uncommon in commercial agreements, and although their validity is not conclusively settled in *United*

to give business efficacy to the contract²², or as a term implied in law as a necessary incident of the contract. A fourth possibility – that the obligation of good faith is a principle of construction which is ‘inherent in all common law contract principles’ – would mean that the implication of independent terms requiring good faith is an ‘unnecessary and retrograde step’²³ and has little judicial support.²⁴

The implication in law of a term of good faith as a necessary incident of the contract is not widely supported throughout the common law world. The recent decision of Singapore’s Court of Appeal in *NG Giap Hon v Westcomb Securities Pte Ltd* [2009] SGCA 19, which raised ‘important issues of principle centring around the inherently problematic doctrine of the implied term of good faith’, is broadly typical of the common law’s less than enthusiastic attitude. The Court of Appeal noted that this issue had given rise to ‘significant controversy’ in other common law jurisdictions and was raised in the present appeal for the first time in Singapore. The Court held that a term of good faith should not be implied in law in an agency agreement:

The doctrine of good faith is very much a fledgling doctrine in English and (most certainly) Singapore contract law. Indeed, a cursory survey of the relevant law in other Commonwealth jurisdictions appears to suggest a similar situation. This is, perhaps, not surprising in view of the fact that, even in the academic literature (which has witnessed the most discussion as well as analysis of the doctrine), there are differing views as to what the doctrine of good faith means as well as how it is to be applied. Indeed, the copiousness as well as the variety of (and, perhaps more importantly, the debates in) the academic literature (coupled with the relative dearth of case law) suggest that the doctrine of good faith is far from settled. The case law itself appears to be in a state of flux.

Group Rail Services Limited v Rail Corporation New South Wales [2009] NSWCA 177 the NSW Court of Appeal suggests that such clauses will in most circumstances be valid and enforceable.

²² See for example *Re Kellcove Pty Ltd v A* [1990] FCA 220, *Laurelmount Pty Ltd v Stockdale & Leggo (Queensland) Pty Ltd & Anor* [2001] QCA 212. The High Court of Australia in *Hospital products Ltd v United States Surgical Corp.* (1984) 156 CLR 41 held that for a term to be implied it must be: (i) reasonable and equitable; (ii) necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it; (iii) be so obvious that it ‘goes without saying’; (iv) be capable of clear expression; (v) not contradict any express term of the contract.

²³ Carter JW, Peden E and Tolhurst GJ, *Contract Law in Australia*, (5th ed, 2007), Lexis Nexis, Butterworths, Australia, at 2-01.

²⁴ The New South Wales Court of Appeal in *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15 held that an obligation of good faith is implied in law ‘and does not proceed on a fiction that an intention of the parties is being found by a process of construction’. Per Giles JA at 206 with whom Sheller and Ipp JJA agreed.

Among the common law jurisdictions, Australia has generated most discussion.²⁵ There is wide, albeit not unanimous support for the 1999 proposition of Finkelstein J in the Federal Court in *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* [1999] FCA 903 at 34 that ‘in appropriate contracts, perhaps even in all commercial contracts, such a term will ordinarily be implied: not as an ad hoc term (based on the presumed intention of the parties) but as a legal incident of the relationship’.²⁶ In *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NC* [2005] VSCA 228 the Victorian Court of Appeal was reluctant to endorse the implication of a term of good faith as a legal incident of commercial contracts. The Court expressed a preference for ‘ad hoc implication...rather than implication as a matter of law creating a legal incident of contracts of a certain type’.²⁷ The Court nevertheless qualified its reservation and was...

...reluctant to conclude that commercial contracts are a class of contracts carrying an implied term of good faith as a legal incident, so that an obligation of good faith applies indiscriminately to all the rights and powers conferred by a commercial contract. It may, however, be appropriate in a particular case to import such an obligation to protect a vulnerable party from exploitative conduct which subverts the original purpose for which the contract was made.²⁸

Formulating the Concept of Good Faith

Judicial acceptance within the common law world that an implied term of good faith is a necessary incident of a franchise contract is only the beginning. The real challenge is to be found in formulating the concept precisely enough not to cause havoc in the law. The difficulty in defining what has been described as a ‘contextual standard’ and a ‘generalisation of universal application’²⁹ is identifying its precise boundaries. At present, the scope of the duty remains elusive. Although there is an increasing body of case law most judgments advocating recognition of the concept ‘appear incoherent and contain little legal principle’.³⁰ In *Council of the City of Sydney v Goldspar Australia Pty Limited* [2006] FCA 472 Gyles J at

²⁵ In the United Kingdom, franchise agreements are not subject to overarching and overriding duties of good faith under the common law (*Jani-King (GB) Limited v Pula Enterprises & ors* [2007] EWHC 2433 (QB)). In Canada the balance of case law suggests that there is an implied term of good faith in franchise agreements (see generally O’Byrne SK, ‘Breach of Good Faith in Performance of the Franchise Contract: Punitive Damages and Damages for Intangibles’ (2004) 83 *The Canadian Bar Review* 431 at 440) although this issue has been legislated for in the franchise laws of Alberta, Ontario, New Brunswick and Prince Edward Island.

²⁶ The recent cases which Finkelstein J regarded as making this proposition ‘clear’ were *Renard Constructions (ME) Pty Ltd v Minister for Public Works* [1992] 26 NSWLR 234, *Hughes Aircraft Systems International v Airservices Australia* [1997] 146 ALR 1, and *Alcatel Australia v Scarcella* [1998] 44 NSWLR 349.

²⁷ *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228 at 25.

²⁸ *Ibid* 25.

²⁹ *Hughes Aircraft Systems International v Airservices Australia* [1997] FCA 558 Part IV. 3. iii. a.

³⁰ Peden E, *Good faith in the performance of contracts* (2003) Sydney, LexisNexis Butterworths at 65.

166 described the variety of opinions in both the authorities and the commentaries as ‘bewildering’ and noted that approaches vary from the ‘cautious’ to the ‘adventurous’. Paterson argues that ‘Australian case law has relied on synonyms or isolated examples to explain the duty, an approach which leaves much unanswered’.³¹ Such an approach impacts negatively on legal certainty and does not help in setting a standard for franchisees and franchisors to aspire to in their dealings.

meaning of good faith

Perhaps the best known approach to understanding the potential content of a good faith obligation is Summers’ excluder doctrine advanced in his seminal 1968 article.³² Professor Summers saw good faith as a phrase which ‘has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith’.³³ However, this approach fails to provide a clear idea of what observance of the standard would actually require:

[I]t seems tantamount to saying that the good faith duty is breached whenever a judge decides that it has been breached... [which] hardly advances the cause of intellectual inquiry and provides absolutely no guide as to the disposition of future cases except to the extent that they may be on all fours with a decided case.³⁴

The excluder approach does not appear able to provide any real guidance to courts or contracting parties as to whether the supposed duty might be breached by particular actions. This leads to an undesirable lack of certainty in commercial arrangements.

Two more comprehensive formulations which have some support are provided by two distinguished judges writing extra-judicially. Lord Steyn incorporates a subjective element, a ‘threshold requirement ... that the party must act honestly’, as well as an objective element requiring the ‘observance of reasonable commercial standards of fair dealing in the conclusion and performance of the transaction concerned’.³⁵ Sir Anthony Mason states that

...the concept embraces no less than three related notions: (1) an obligation on the parties to co-operate in achieving the contractual objects (loyalty to the promise

³¹ Paterson J M, ‘Good Faith in Commercial Contracts? A Franchising Case Study’ (2001) 29 *Australian Business Law Review* 270 at 273.

³² Summers, R. ‘Good Faith in General Contract Law and the Sales Provisions of the *Uniform Commercial Code*’ (1968) 54 *Virginia Law Review* 195 at 206.

³³ *Ibid* 196.

³⁴ Bridge M, ‘Does Anglo-Canadian Contract Law Need a Doctrine of Good Faith?’ (1984) 9 *Canadian Business Law Journal* 385 at 398.

³⁵ Johan Steyn, “Contract Law: Fulfilling the Reasonable Expectations of Honest Men” (1997) 113 *LQR* 433 at 438.

itself); (2) compliance with honest standards of conduct; and (3) compliance with standards of conduct which are reasonable having regard to the interests of the parties.³⁶

The duty to cooperate to achieve contractual objects is an accepted legal duty for all contracts under the common law. In the words of Griffith CJ in *Butt v M'Donald* (1896) 7 QLJ 68, 'It is a general rule applicable to every contract that each party agrees, by implication, to do all such things as are necessary on his part to enable the other to have the benefit of the contract'. The idea that good faith requires parties to act honestly, and therefore that acting dishonestly connotes bad faith conduct, is uncontroversial.³⁷ A standard of "honesty" nevertheless poses an evidentiary challenge to a franchisee and will not catch many forms of behaviour which although characterised by honest conduct will impact negatively and significantly upon the interests of the contractual counterparty.

Lord Steyn's objective element, and Sir Anthony Mason's third requirement, relating to reasonable commercial standards pose more serious difficulties. It has been stated in an Australian case concerning the exercise of a termination clause by a franchisor that 'provided the party exercising the power acts reasonably in all the circumstances, the duty to act fairly and in good faith will ordinarily be satisfied'.³⁸ While reasonableness provides a platform from which to explore the content of the supposed good faith obligation, this approach has been criticised as being 'more confusing than instructive':

There is no precise meaning given, but rather a repetition of well-worn phrases and quotes, without explanation of how and why they fit together. There is, furthermore, no explanation of why "reasonableness" is a justified inclusion in the meaning of good faith, and why it is considered identical to "good faith".³⁹

The situation is not helped by the commonality of meanings surrounding these concepts. In *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234 it was noted that 'in ordinary English usage there has been constant association between the words fair and reasonable. Similarly there is a close association of ideas between the terms unreasonableness, lack of good faith and unconscionability'.⁴⁰ This is of great import to any definition of good faith involving reasonableness, for it can be argued that 'a requirement to satisfy a standard of reasonable behaviour is more demanding than the requirement of good

³⁶ Mason A, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *Law Quarterly Review* 66 at 69

³⁷ See Einstein J in *Aiton v Transfield* [1999] NSWSC 996 at 123.

³⁸ *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* [1999] FCA 903 per Finkelstein J at 37.

³⁹ Peden, *op cit* n 30 at 7.11.

⁴⁰ *Renard* at 265.

faith'.⁴¹ In any event as Bowen LJ cautioned over a century ago in *Mogul Steamship Co. v McGregor, Gow & Co.* (1889) 23 Q.B.D. 5:

I should deem it to be a misfortune to attempt to adopt some standard of judicial "reasonableness" to which commercial adventurers were bound to conform.

The caution of Bowen LJ still retains much of its original force.

The quest for a more specific formulation to accommodate the underlying need for certainty amongst franchising contractors has led to the idea that good faith should preclude opportunistic conduct or the use of contractual terms for purposes antithetical to the contract. In *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310 at 120, Byrne J stated that good faith would oblige 'each party to exercise the powers conferred upon it by the agreement in good faith and reasonably, and not capriciously or for some extraneous purpose'. In fleshing out such a conception however, 'it becomes necessary to enquire about the extent to which selflessness is required'.⁴² While franchise contracts do not embody any sort of fiduciary relationship, it has been said that good faith requires a party to 'recognise and to have due regard to the legitimate interests of both the parties in the enjoyment of the fruits of the contract as delineated by its terms', although the interests of the other party are not paramount.⁴³ If this be the case, the logical question which follows concerns the divining of "legitimate interests". Would such interests be inferred from the contract alone or would exogenous sources of information such as extra-contractual norms developed as part of the ongoing relationship play a role in determining whether legitimate interests had been controverted?

Should the former approach be taken, the weight of the standard form contract drafted in the interests of the stronger franchisor would not assist the franchisee except in cases of obvious abuse, such as in *Australian Competition and Consumer Commission v Simply No-Knead (Franchising) Pty Ltd* [2000] FCA 1365, where the statutory unconscionability provisions provided relief. Hadfield argues that consideration should be given to the continuing relationship and the expectations engendered therein.⁴⁴ This suggests another approach to good faith which is to consider the "reasonable expectations" of parties to a contract. Under

⁴¹ Stapleton J, 'Good Faith in Private Law' (1999) 52 *Current Legal Problems* 1 at 5.

⁴² *Overlook v Foxtel* [2002] NSWSC 17 at 65.

⁴³ Ibid 67. See for example *Mason v. Freedman* [1958] S.C.R. 483 cited in *Shelanu Inc. v. Print Three Franchising Corp.* (2003), 226 D.L.R. (4th) 577 (Ont. C.A).

⁴⁴ See Hadfield, op cit n 11 at 985-6.

this approach a court may be able to take a more balanced approach to franchising disputes by allowing franchisees, who might have had their legitimate expectations of contractual performance frustrated and are not otherwise able to make a case in situations where they do not possess formal “legitimate interests” as specified in a written contract, a valid avenue for redress they otherwise would not have had. However, as noted by Professor Summers, ‘[i]n most cases the party acting in bad faith frustrates the justified expectations of another [and] the ways in which he may do this are numerous and radically diverse’.⁴⁵ Possibly for this reason, the reasonable expectations approach has received little judicial attention.

An important consideration in the use of the reasonable expectations approach as noted by Iglesias is that ‘what a party can reasonably expect must be determined not on subjective hopes, but on economic reality’.⁴⁶ Even the good faith sceptic, Professor Michael Bridge, suggests that the reasonable expectations approach might just fit the necessary requirements for a standard of good faith stating that reference to justified expectations “is much more satisfactory than good faith as a guide to the resolution of practical problems”.⁴⁷ An important concern is the evidentiary burden of proving the reasonable existence of such expectations and ensuring franchisees actual and potential do not get swept up in any false expectations of the power of “good faith”, and all that term connotes. Any approach cloaked in the language of ‘good faith’ may give serve to disappoint franchisees by providing false hope that unsupported subjective hopes may trump hard contractual terms and unforgiving economic reality.

limitations on good faith

Even if the meaning of good faith can be determined with sufficient precision to be practically and commercially useful, an important cluster of issues which the meagre case law has only incompletely addressed surrounds the role of good faith in the context of contractual provisions. Questions arise as to whether a requirement of good faith would be able to impose obligations on contracting parties inconsistent with other terms of the contract, whether the duty can be excluded by the parties, and whether good faith can function as an independent source of obligations or is it limited to bad faith violations of express terms?

⁴⁵ Summers, op cit n 32 at 267.

⁴⁶ Iglesias J, ‘Applying the implied covenant of good faith and fair dealing to franchises’ (2004) 40 *Houston Law Review* 1425 at 1450.

⁴⁷ Bridge, op cit n.34 at 400.

In *Ingot Capital Investments v Macquarie Equity Capital Markets [No. 6]* [2007] NSWSC 124 the New South Wales Supreme Court stated:

[I]t is plain that no duty of good faith can be implied where the duty...is inconsistent with an express term of the contract... [E]ven if there is no direct conflict between the term sought to be implied and any express term of the contract, the express terms of the contract as a whole may negate the implication.⁴⁸

Determining whether a contract taken as a whole might limit the operation of a good faith obligation may prove a complex exercise in legal sophistry for as explained by Greenwood J in *Luce Optical v Budget Specs (Franchising)* [2005] FCA 1486 at 59:

Good faith is an incident of every commercial contract unless the duty is excluded expressly or by necessary implications and that duty operates as a fetter upon the exercise of discretion and powers conferred by the contract...⁴⁹

The next set of questions concern the contractual exclusion of the operation of an obligation of good faith. While an implied term of good faith cannot defeat the use of clause expressly excluding it the question of whether “entire agreement” clauses have the effect of excluding the implied obligation of good faith is less certain.⁵⁰ Finn J in *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* (2003) 128 FCR 1 at 208 considered that under Australian law, an “entire agreement” clause does not preclude implications ad hoc, and found ‘arresting’ the suggestion that an entire agreement clause is ‘of itself sufficient to constitute an express exclusion of an implied duty of good faith and fair dealing where that implication would otherwise have been made by law’.⁵¹

A third set of questions which arises is whether an obligation of good faith can arise independently of contractual terms. This question is yet to be authoritatively resolved. Professor Peden suggests that ‘in Australia there is reluctance to require an obligation of good faith or cooperation that is independent of express terms of the contract’ and to ‘state there is

⁴⁸ At para 594, citing the NSW Court of Appeal in *Vodafone* at 194: ‘It is sufficient to ask whether an implied obligation of good faith and reasonableness with the content upon which the judge rested his finding of breach is inconsistent with the terms of the contract...’.

⁴⁹ Citing Finkelstein J in *Pacific Brands Sports & Leisure Pty Ltd v Underworks Pty Ltd* [2005] FCA 288 who ‘gathered together a range of cases and articles, reflecting American jurisprudence’ in this area.

⁵⁰ *Hart v MacDonald* (1910) 10 CLR 417 is authority for the proposition that a ‘whole of agreement clause will not exclude terms implied by law’.

⁵¹ If the recommendation of the Federal Report for a good faith obligation is added to the *Franchising Code of Conduct* the issue of express exclusion will not arise. An obligation to act in good faith will then be a legislated public duty which cannot be excluded, contracted out of or waived. The question of the role for good faith in the face of inconsistent contractual provisions will nevertheless remain an important issue to be worked through.

a term requiring good faith without some obligation on which to attach it would be to place the obligation in a “vacuum”⁵².

the reality of good faith

While the Singapore Court of Appeal does not speak for the common law world its reason for not endorsing an implied duty of good faith in the Singapore context resonates more widely. In *NG Giap Hon v Westcomb Securities Pte Ltd* [2009] SGCA 19 the Court of Appeal stated that

...it is not surprising that the doctrine of good faith continues to be a fledgling one in the Commonwealth. Much clarification is required, even on a theoretical level. Needless to say, until the theoretical foundations as well as the structure of this doctrine are settled, it would be inadvisable (to say the least) to even attempt to apply it in the practical sphere.

Although the *Opportunity not opportunism* report optimistically accepted that ‘while an abstract formulation of a generalised concept of good faith may be indistinct the courts have demonstrated that they are able to know it when they see it, and more properly, they know a breach of it when they see it’⁵³, the Singapore Court of Appeal provides salutary caution that the content and application of good faith remains ambiguous and uncertain. Whittaker and Zimmermann have cautioned that, even under the civil law, good faith is not a legal rule ‘with specific requirements that have to be checked but may be called an ‘open’ norm [the content of which] cannot be established in an abstract manner but takes shape only by the way in which it is applied’.⁵⁴ While defining good faith is an improbable exercise in a civil

⁵² Peden, op cit n.xxx at 6.18. See also *Pacific Brands Sport & Leisure Pty Ltd v Underworks Pty Ltd* [2005] FCA 288 at 64. In *Overlook v Foxtel* [2002] NSWSC 17 the essential question was ‘whether the relevant implied obligation of good faith inhibits one party in the performance of “an act which the law would ordinarily permit to it do” in exercise of “the ordinary freedom of a commercial enterprise to pursue a commercial opportunity”’. Barrett J accepted that there was scope for the operation of an implied obligation of good faith in circumstances which did not involve the exercise of a contractual power or performance of a contractual obligation. Indeed the influence of good faith would be greatly reduced if this limitation was absolute.

⁵³ Federal Report, 8.7, citing the South Australian Report at op cit n 8 at 9.

⁵⁴ Whittaker and Zimmermann op cit n 17 at 31

law jurisdiction and an extensively challenging exercise in a common law jurisdiction,⁵⁵ it is nevertheless of a lesser degree of difficulty than determining what the obligation demands in a particular case. This is a challenge which faces both the civil law and the common law.

Legislating a Good Faith Obligation

The Australian recommendation is to legislatively mandate good faith in the franchising context by adding to the *Franchising Code of Conduct* the requirement that “Franchisors, franchisees, and prospective franchisees shall act in good faith in relation to all aspects of a franchise agreement”. There are a limited number of international precedents in common law jurisdictions as in well as civil law jurisdictions where good faith exists as an underlying principle for contracts generally. China, Italy, Korea, and four Canadian provinces specifically address good faith. Other regulated regimes, such as Australia under the current *Franchising Code of Conduct*, do not address general standards of conduct but nevertheless specifically address particular conduct issues in relation to, for example, termination and transfer. Beyond the general or specific conduct provisions of dedicated franchise laws the underlying laws of general application may of course have a significant impact in prescribing general ethical standard. In Australia for example the statutory prohibitions of “misleading conduct” and “unconscionable conduct” under the *Trade Practices Act 1974* (Cth) have been particularly influential in raising standards of conduct within the franchising sector.⁵⁶

⁵⁵ The *Opportunity not opportunism* report included a definition suggested by Competitive Foods Australia Ltd, a territorial subfranchisor of YUM Brands’ KFC franchise in Western Australia. (YUM’s refusal to renew CFAC’s franchise agreements was a not insignificant factor in the establishment of the three Australian franchising inquiries in 2008):

Obligations to act in good faith

- (1) A franchisor and a franchisee shall act towards each other in good faith in the exercise of any rights or powers arising under, or in relation to, a franchise or the renewal of a franchise.
- (2) For the purposes of sub-clause (1), a good faith in relation to conduct by a franchisor or a franchisee means that the party has acted:
 - (a) honestly and reasonably; and
 - (b) with regard to the interests of the other parties to the franchise, in all the circumstances, including without limitation:
 - (c) the commercial and business objects of the franchise;
 - (d) the legitimate business interests of each of the parties, and what is reasonably necessary for the protection of those interests;
 - (e) the respective financial and non-financial contributions made by each of the parties to the establishment and conduct of the franchised business;
 - (f) the risks taken by each of the parties in the establishment and conduct of the franchised business;
 - (g) the alternative courses of action available to the parties in respect of the matter under consideration; and
 - (h) the usual practices in the industry to which the franchise relates.

⁵⁶ See generally Giles, Redfern and Terry, op cit n3

China's 2007 *Commercial Franchise Regulation* requires that: 'Franchising activities shall be conducted in compliance with the principles of free will, fair dealing, honesty, and good faith' (article 4). Korea's *Fair Franchise Transactions Act 2002* provides that 'In engaging in the operation of a franchise the franchising parties shall perform their respective duties based on the principles of trust and good faith' (article 4). Italy's 2004 *Rules on the Regulation of Franchising* lay down a duty of good faith in relation to precontractual behaviour: "The franchisor must exercise loyalty, fairness and good faiths at all times in its dealings with the prospective franchise ..." (article 6). Malaysia's *Franchise Act 1998* does not impose a specific good faith obligation but nevertheless requires that "A franchisor and a franchisee shall act in an honest and lawful manner and shall endeavour to pursue the best franchise business practice of the time and place." (s.29(1)).

The most useful analogy from an Australian perspective is that of Canada. The *Uniform Franchise Act 2005*, a model law, provides that:

3. Fair dealing

(1) Every franchise agreement imposes on each party a duty of fair dealing in the performance and enforcement of the agreement, including in the exercise of a right under the agreement.

Right of action

(2) A party to a franchise agreement has a right of action for damages against another party to the franchise agreement who breaches the duty of fair dealing.

Interpretation

(3) For the purpose of this section, the duty of fair dealing includes the duty to act in good faith and in accordance with reasonable commercial standards.

This provision specifically exists in the laws of Alberta⁵⁷ New Brunswick,⁵⁸ Ontario⁵⁹ and Prince Edward Island⁶⁰ but, as Shannon O'Byrne argues, a good faith obligation exists in the other provinces either as part of the common law⁶¹ or, in Quebec, a civil law jurisdiction, under the *Civil Code* which includes the requirement that "the parties shall conduct themselves in good faith both at the time the obligation is created and at the time it is performed or extinguished" (at 1375) and which subjects contracts generally to a good faith obligation.⁶²

⁵⁷ Alberta's *Franchises Act 2005* contains only the requirement of "fair dealing" which is not defined (s7).

⁵⁸ *Franchises Act 2007*.

⁵⁹ *Arthur Wishart Act (Franchise Disclosure) 2000*.

⁶⁰ *Franchises Act 2005*.

⁶¹ Shannon O'Byrne "Breach of Good Faith in Performance of the Franchise Contract: Punitive Damages and Damages for Intangibles" [2004] 83 *The Canadian Bar Review* 431 at 434

⁶² *Ibid* at 435

The good faith obligation in Canada – whether arising from the common law, from the dedicated franchise laws or from the Quebec Civil Code – has been applied in a variety of circumstances seemingly without controversy although the Supreme Court of Canada has not yet had the opportunity to consider its application, scope and operations in a franchising context.⁶³ It is argued that the doctrine is “constructive because it expressly prohibits capriciousness improper motive, dishonesty, unreasonableness, opportunistic behaviour and ambush”.⁶⁴ Meehan J in the Ontario Superior Court of Justice has indeed observed that “explicit recognition of the duty of good faith in performance of a contract simplifies and clarifies the law. Contrary to the views of its detractors ... explicitly recognising the doctrine makes the law more certain, more understandable, and, of course, more fair”.⁶⁵ These views are not, as noted elsewhere, held by all commentators, and the benign Canadian experience is not mirrored in the United States. Section 1-203 of the *Uniform Commercial Code* provides that “... every contract a duty within this *Act* imposes an obligation of good faith in its performance or enforcement”.⁶⁶ Section 1-203 provides the best known example of a legislated underlying good faith obligation but the franchising case law clearly suggests that the substantive difficulties of meaning, application and scope are not removed by the legislative direction. Pitegoff and Garner suggest that

...although the covenant of good faith and fair dealing probably is law in most jurisdictions, there are very few cases where that principle, by itself, has led to a ruling favourable to a franchisee. Several courts have held that no cause of action exists for an alleged violation of the covenant in the absence of an allegation of violation in bad faith of an express term of agreement.⁶⁷

The meaning of the concept remains uncertain and the issue of whether it can operate as an independent source of obligations independently of contractual provisions remains undetermined. As the Singapore Court of Appeal has recently observed, “substantive

⁶³ See generally, O’Byrne Op cit n 61 at 434.

⁶⁴ O’Byrne op cit n 61 citing David Stack, “The Two Standards of Good Faith in Canadian Contract Law” (1999) 62 Sask. LR 201 at 201.

⁶⁵ *Elite Specialty Nursing Services Inc. v Ontario*, [2002] O.J. No.3009 (S.C.J)(QL) at para 90. (Cited by O’Byrne op cit n 61).

⁶⁶ An implied covenant of good faith and fair dealing is also articulated in Section 205 of the *Restatement (2nd) of Contracts*.

⁶⁷ Pitegoff TM and Garner WM, ‘Franchise Relationship Laws’ Chapter 5 in Barkoff RM and Seldon AC (eds) *Fundamentals of Franchising* (3rd ed, 2008), American Bar Association at 224.

difficulties with the doctrine of good faith [exist] even in jurisdictions where it has been legislatively mandated”.⁶⁸

Such considerations are implicit in New Zealand’s recent decisions not to introduce franchise specific regulation “at this time”.⁶⁹ In relation to the mooted proposal to mandate “good faith” the Cabinet paper expressly refers to the uncertainty and added potential for litigation that would be created by such an obligation:

‘Good faith’ is a term which is not unusual in relational contracts. However, there is no consistent or accepted definition of good faith and the courts in New Zealand have been cautious about implying a general duty of good faith into contracts. There are diverging judicial views about whether good faith is to be implied either in all commercial contracts, types of commercial contracts (eg. franchises), or on a case by case basis, what the precise content of good faith obligations might be, what would constitute a breach of these obligations, and what the consequences should be.

The common law is therefore unclear and if good faith was legislated for, it would likely take some time before the court established the key principles that would underpin such an obligation in the context of franchising.

Conclusion

The omnipresent problem with good faith is that it is, in the words of Professor Michael Bridge, “an imperfect translation of an ethical standard into legal ideology and legal rules”.⁷⁰ This is an issue which transcends legal systems. Although the “good faith debate” is frequently presented in a civil law versus common law context the positions are not as entrenched as commonly assumed. Whittaker and Zimmermann for example argue that “The position in English law appears to be much less unequivocal than a continental lawyer faced with some of these general propositions might be led to expect. Conversely, the civilian approach is much less uniform than a common law lawyer might be led to believe.”⁷¹ The enduring and common issue for any system that embraces good faith as a guiding proposition is ultimately to determine its meaning, its scope, its limitations. Irrespective of the heritage of the legal system which embraces the concept it “is not a legal rule with specific requirements that have to be checked but may be called an ‘open’ norm. It cannot be established in an

⁶⁸ *Ng Giap Hon v Westcomb Securities Pte Ltd* [2009] SGCA 19 at 59

⁶⁹ Cabinet Paper, Ministry of Economic Development, 11 June 2009, Outcomes of the *Review of Franchising Regulations* (para 57,58).

⁷⁰ Op cit n 34

⁷¹ Op cit n 17

abstract manner but takes shape only by the way in which it is applied.⁷² Good faith, as Mackaay and Leblanc argue, is “an open-ended concept or principle rather than a specific rule” and “the mould in which have been fashioned a range of more specific concepts that have started to lead a life of their own in case law and legal scholarship”.⁷³

The concept of “good faith” has gained traction as the solution to all real and imagined ills within the franchising sector. For those agitating for reform it has assumed symbolic significance and, if introduced, would be argued to accommodate circumstances beyond any appropriate sphere of influence. “Good faith” is a seductive concept for franchisees and for the franchise regulators but it will not be interpreted by the courts to provide the universal solvent for the resolution of franchising disputes enacted, would propel the sector into an era of uncertainty disputation and ‘litigations with breaches of good faith being sought to be applied to an indeterminate range of real and imagined grievances.’⁷⁴ As the authors have written elsewhere, “If franchisor opportunism is a problem warranting legislative intervention this should be addressed by carefully crafted legislative responses rather than by defaulting to an undefined and overreaching standard of indeterminate scope and application.”⁷⁵

⁷² Whittaker and Zimmermann, op cit n 17 at 31.

⁷³ Ejan Mackaay and Violette Leblanc, “The law and economics of good faith in the civil law of contract”, 2003 European Association of Law and Economics Conference, Nancy France 18-20 September 2003.

⁷⁴ Canadian franchise lawyer, Frank Zaid has observed that virtually every new franchise case includes a claim that the franchisor has breached its deal of good faith “Canadian franchise litigation is proliferating for a variety of reasons”. *The Lawyers Weekly* (3 October 2003) 17.

⁷⁵ Terry and Di Lernia, “*Franchising and the Quest for the Holy Grail: Good Faith or Good Intentions*” (2009) 33 Melbourne University Law Review (forthcoming).