

Good Faith in Franchising

Where are we now?

February 2015



The English law of contract is well known for not having a general duty of good faith and the approach to dealing with good faith situations in case law has been piecemeal, in line with the general development of common law. One of the main reasons advanced for this is the uncertainty which would arise if a general duty of good faith was imported into contracts generally.

However, judgments in a number of recent cases have reignited the debate over whether or not English law recognises a general duty of good faith in commercial contracts, including franchise agreements.

This article will consider the line taken by the English Courts in these recent cases, starting with *Yam Seng Pte Limited and International Trade Corporation* ("*Yam Seng*"), followed by a look at the subsequent cases which cited the *Yam Seng* judgment and concluding with the first post *Yam-Seng* case for good faith in the context of franchising (*Carewatch Care Services Limited v Focus Caring Services Limited & Ors* ("*Carewatch*"). This article will then propose a number of key lessons to be learnt.

Case Law Review

Yam Seng – the case that let cat out of the bag

In *Yam Seng*, Yam Seng Pte Limited ("*Yam Seng*") entered into an exclusive distribution agreement with International Trade Corporation ("ITC") to sell Manchester United branded toiletries across duty free outlets in the South East Asian region. The relationship quickly broke down amid accusations that ITC had misled Yam Seng on a number of issues, including its ability to supply the products, the nature of its licence with Manchester United and its dealings with another authorised distributor for the products in the region. Yam Seng argued that its business suffered financial loss as a result of ITC's erratic and, at times, dishonest behaviour. Yam Seng argued successfully that the agreement contained an implied obligation to act in "good faith" and that ITC's breaches were "repudiatory".

Mr Justice Leggatt's judgment includes a detailed summary of English law's uneasy relationship with the concept of a general duty of good faith and argues that the cherished certainty of English common law is not automatically undermined by recognising such general duties. Other common law jurisdictions are, he argues, moving in this direction and English law is "swimming against the tide". He concludes his judgment by noting that contracts involving a longer term relationship and substantial commitment require a high degree of communication, cooperation and predictable performance based on mutual trust and confidence. He observed that these expectations are rarely legislated for in the express terms of contracts, but are implicit in the parties' understanding, and are necessary to give business efficacy to such arrangements. Examples of "relational contracts" in his view included franchise agreements, joint venture agreements and long term distribution agreements.



Subsequent cases

The *Yam Seng* judgment has been referred to in a number of subsequent cases involving "relational" contracts, including the following:

In *Mid Essex Hospital Services NHS Trust* ("*NHS Trust*") and *Compass Group UK and Ireland Limited* ("*Compass*"), Compass' performance in a NHS Trust catering contract was measured by the calculation of service failure points. The NHS Trust was entitled to award those points to Compass and levy deductions from payments due by the NHS Trust. Compass claimed that the NHS Trust had exercised its discretion in this regard in a way which was contrary either to the implied term not to act arbitrarily, capriciously or irrationally, or in breach of an express duty of good faith and which therefore entitled Compass to terminate the contract. However, the Court of Appeal rejected the first instance ruling that there was an implied term of good faith which the NHS Trust had breached. The Court of Appeal ruled that the NHS Trust had breached express terms of the contract when making the deductions and the provisions of the contract dealing with breach were sufficiently clear. The NHS Trust had repaid the amounts charged as a result of the wrongful deductions and had therefore cured its breach before Compass terminated the contract. In essence, there was no need to imply a general duty of good faith.

In *TSG Building Services plc* ("*TSG*") v *South Anglia Housing Ltd* ("*SA*"), TSG provided services to SA's housing stock. The agreement included an express general duty to work in a spirit of trust and fairness but SA also had an express right to terminate at convenience, which it did. TSG argued that this amounted to a breach of an express duty of good faith and that there was an implied duty of good faith regarding the exercise of the right to terminate. The judge rejected TSG's claim and ruled that there should be no linkage between the general express duty of good faith and the right to terminate at convenience - implying such a duty would contradict the express terms of the contract.

In *Bristol Groundschool Limited ("BGS") v Intelligent Data Capture Limited ("IDC")* the parties collaborated with each other for 10 years to produce electronic training manuals for commercial pilots. IDC supplied static artwork for the manuals which BGS then produced and sold. BGS paid for and owned the copyright in the static artwork. BGS commenced proceedings against IDC claiming breach of contract and infringement of copyright. IDC counterclaimed that BGS had breached an implied duty of good faith by downloading materials from IDC's IT systems without authorization. The High Court found that there was such a duty (which BGS had breached) by applying the following test – can the conduct in question be regarded as “commercially unacceptable” by reasonable and honest people in the particular context involved? The judgment referred to and agreed with the analysis of Mr Justice Leggatt in *Yam Seng* and said a duty of good faith “extends beyond, but at very least includes, the requirement of honesty”

In *Hamsard 3147 Limited ("Hamsard") v Boots UK Limited ("Boots")* a long term supply agreement was terminated due to the insolvency of Hamsard. However, the relationship continued on an ad hoc basis once Hamsard emerged from insolvency proceedings, until Boots served notice to terminate the relationship on 9 months' notice - the original agreement required 18 months' notice and contained an express duty of good faith. The judge rejected Hamsard's argument that the 9 month notice period was unreasonable and amounted to a breach of good faith. The judge went on to state that *Yam Seng* was not authority for implying a general obligation of good faith in commercial contracts - a party acting honestly should not have “subordinate its own commercial interests to those of the other contracting party”.

***Carewatch* – the first test case for good faith in franchising**

Following Mr Justice Leggatt's comments in *Yam Seng* there was a considerable degree of speculation over the application to his judgment to franchising. In 2014 the *Carewatch* case saw the High Court decide a franchising dispute where the defendants advanced arguments in reliance on *Yam Seng*.

Carewatch centred on the enforceability of post-termination covenants. It is not particularly noteworthy for the decision reached by Mr Justice Henderson on those issues: he upheld the franchisor's covenants in the face of challenges on common law and competition law grounds. Similarly, the judge rejected various allegations that *Carewatch* had breached its express obligations to its franchisees. Of interest here, though, is the outcome of the defendants' submissions that various terms should have been implied into the franchise agreements. One of these in particular was that “the parties would conduct themselves as franchisor and franchisee in good faith...”

Mr Justice Henderson reviewed the law relating to implied terms, confirming that the courts will only imply terms into contractual relationships where it is necessary to do so. He also reiterated that the franchise relationship is much closer to an ordinary commercial relationship than the special relationship of employer and employee, into which terms of trust and confidence can be implied. In relation to *Yam Seng* the judge endorsed the earlier comments of Mr Justice Norris in *Hamsard*.

Looking at the *Carewatch* franchise agreement in particular, Mr Justice Henderson noted that it already contained detailed express terms which dealt with all aspects of the franchise relationship. There was no obvious void that only an implied term could fill. Second, many of the terms the defendants hoped to imply were inconsistent with the express terms of the contract (and so even less likely to be endorsed by the courts). Third, *Carewatch* was “free to have regard to its own commercial interests in deciding how to run its franchise business, provided always that it complied with the express terms of its current franchise agreements”.

Carewatch is good news for franchisors, confirming that the courts continue to adopt a pragmatic commercial approach to franchise disputes and removing some of the uncertainty that had been fostered in the wake of *Yam Seng*. While Mr Justice Henderson did not say that terms of this nature could never be implied into a franchise relationship, the idea of a contractual duty of good faith seems more suited to highly unusual circumstances than to franchising as a whole.



Conclusion and Key Lessons

If the *Yam Seng* judgment was an attempt to let the cat out of the bag, the subsequent rulings in *Compass*, *TSG*, *Hamsard* and *Carewatch* show the English Courts attempting to push it back in. However, whilst the English courts are likely to continue to uphold the traditional, narrow approach to implied terms in the near future, *Bristol Groundschool* shows that this assumption cannot be taken for granted. The concept of good faith underpins many of the franchise specific regulations which apply in jurisdictions across the world (including in common law jurisdictions such as Australia and the US) and it remains to be seen how long English law will continue to "swim against the tide".

Some key lessons include:

- the English Courts will look at express terms first and then consider if an implied term is necessary;
- the English Courts are unlikely to imply obligations of good faith into a contract if by doing so the implied term will contradict express terms;
- the English Courts will interpret narrowly express duties of good faith relating to specific rights and obligations and not extend them to the entire contractual relationship;
- "acting in good faith" should not mean that a party exercising its contractual rights honestly should subordinate its own commercial interests to those of the other contracting party; and
- when it comes to contractual drafting, avoid general duties, or specify what good faith means in the relevant context and be clear about how and when contractual discretion can be exercised.



If you would like to discuss these issues, please contact Gordon Drakes in our Franchising and Licensing team or James Seadon in our Franchise Disputes team.



Gordon Drakes

Senior Associate - London

E: gordon.drakes@fieldfisher.com

T: +44 (0)20 7861 4525



James Seadon

Senior Associate - London

E: james.seadon@fieldfisher.com

T: +44 (0)20 7861 6714



Fieldfisher's franchising practice is rated as the leading practice in the UK and globally by Chambers 2015 and Chambers Global 2014 respectively.

This publication is not a substitute for detailed advice on specific transactions and should not be taken as providing legal advice on any of the topics discussed.

© Copyright Field Fisher Waterhouse LLP 2014. All rights reserved.

Field Fisher Waterhouse LLP is a limited liability partnership registered in England and Wales with registered number OC318472, which is regulated by the Solicitors Regulation Authority. A list of members and their professional qualifications is available for inspection at its registered office, Riverbank House, 2 Swan Lane, London, EC4R 3TT. We use the word "partner" to refer to a member of Field Fisher Waterhouse LLP, or an employee or consultant with equivalent standing and qualifications.