The Collision of Caveat Emptor and Culpa Contrahendo in pre-contractual negotiations of International Franchise Agreements

THE COLLISION OF CAVEAT EMPTOR AND CULPA CONTRAHENDO IN PRECONTRACTUAL NEGOTIATIONS OF INTERNATIONAL FRANCHISE AGREEMENTS

Henry Clay once said, "If you wish to avoid foreign collision, you had better abandon the ocean." For franchise systems that negotiate international master or development agreements in their quest to export their business concepts, they should be mindful of Henry Clay's advice. Far from the standard unit franchise agreements where negotiations may be limited to territorial exclusivity, international master franchise agreements are likely to include negotiated terms in almost every facet of the relationship including, territory, development schedule, royalty splits, choice of law, venue, and dispute resolution. As such, each transaction is fraught with the delicacies of contract negotiation. It is in this context that the common law doctrines of caveat emptor-or buyer beware- can collide head on with the civil law doctrine of culpa contrahendo, or fault in contracting.

Imagine for the moment that a franchisor from a country relying upon the common law is engaged in complex contract negotiations with a potential master franchisee from a county grounded in the civil law. After significant discussions that have yet to produce a definitive master franchise agreement, the negotiations are suddenly terminated by the franchisor for some un-explained reason. While the franchisor may be disappointed that the deal did not materialize, it believes that it has no additional obligations to the master franchisee. If these contract negotiations are judged under the common law it may be correct, but it is just as likely that the common law franchisor could find itself in front of a civil-law court judge in the civil-law jurisdiction of the master franchisee facing a claim for breach of contract or worse, a claim based in tort.

Under the common law tradition parties can engage in contract negotiations in relative freedom. Their negotiations will be generally free from restrictions placed on what they are required to disclose. As between a seller and a buyer, the buyer is expected to have conducted sufficient due diligence in the seller and the business concept before consummating a contract. At the heart of common law contract negotiations is the concept of freedom of negotiation. As explained by E. Allan Farnsworth, in his law review article entitled Pre-contractual liability and *Preliminary Agreements: Fair Dealing and Failed Negotiations*, appearing in 87 Colum L. Rev. 217, 221 (1987), unless there is a definitive written agreement parties are free to negotiate and back-out of contract negotiations with little fear of risk of liability. Professor Farnsworth referred to this theory as the aleatory view of contract negotiations, where a party that enters into negotiations in the hope of benefit must also bear the risk of loss should the negotiations fall through. Under the traditional common-law view an aggrieved party in failed contract negotiations does not have a remedy against the party that broke off the negotiations. Even under the UCC,§§ 1-209 (19), 1-203, and 2-103(1)(b), and §90 of the Restatement of Contracts Second, where there is imposed upon a party to a contract the covenant of good faith and fair dealing in contracts, that duty has not been found to apply to contract negotiations. Some legal scholars have argued that to impose good faith and fair dealing in contract negotiations would result in the lack of full freedom of the parties to negotiate their agreements, which in turn would discourage parties from entering into any contractual negotiations (See Farnsworth supra note 84 at 221).

Conversely, negotiating contracts under the civil law tradition imposes on the parties a duty of good faith in negotiations. These negotiations must be serious and purposeful. If contract negotiations fail then the party preventing the completion of the contract negotiations may be subject to liability to the injured party, if it can be shown that the party that broke off the negotiations acted improperly.

Unlike common law courts, which are loathe to impose a contract upon a party that allegedly could not come to an agreement, and where, generally speaking, the presence of a contract is a pre-condition to a damage recovery, civil-law courts are more willing to find liability for broken or ruptured contract negotiations, even at the preliminary stages of these negotiations. These courts have based their finding of liability on two doctrines: the doctrine of culpa contrahendo and precontractual civil liability~~.~~

First introduced in Germany in 1861, the doctrine of culpa contrahendo focuses on the proposition that parties in the course of their pre-contractual negotiations have a duty of good faith, fair dealing and loyalty to the other party. Under culpa contrahendo the focus is on the relationship of the parties, while the common contract theory focuses on the bargain or contract formation. Under the civil-law damages can be recoverable against the party whose blameworthy conduct prevented the consummation of the contract to the detriment of the innocent party. Depending on the timing of the negotiations or the country where the transaction was deemed to occur, liability can be either in contract or tort. For franchise practitioners that have been weaned on the common law, the concept of culpa contrahendo flies in the face of all of their contract negotiation skills.

This doctrine did not convince the French school of law which was still governed by the concept of freedom of contracting and not contracting, unless good cause for nullification of contract on the grounds of the theory “des vices du consentement”. Pursuant to this last theory, the victim had to prove a legitimate error, a deceitful attitude or violence by the other party, all of which deriving from the precontractual negotiation period.

The first significant evolution of French law resulted from Professor Roubier thesis published in 1911 and commonly known in France as Essai sur la Responsabilité (ROUBIER, thèse de doctorat, Lyon, Essai sur la responsabilité) and 63 years later with the landmark article by Joanna Schmidt dated 1974 (1974 46; Rev. trim. dr. civ) on the sanction of precontractual liability. One of the first cases heard by the French Supreme Court making direct use of tort in pre-contractual negotiation is dated March 20th, 1972 (J.C.P.G. 1973.17.593 (note J. Schmidt)). In this case the seller of an industrial equipment had deliberately prolonged a second negotiation of which it new the near certain failure so as to be able in the meantime to finish a first negotiation.

Ever since, French law requires parties negotiating a contract to deal in good faith with each other during the negotiations stage, or else face liability. Unlike the German theory, which is based in contract, the French law is based in tort as defined by Article 1382 of the French Civil Code. Under French law, liability can arise when one party enters into negotiations without having any intent to contract, yet it creates a reasonable expectation in the other party that a contract will be forthcoming, so that the other party incurs substantial pre -contractual expenses.

In addition, liability can be found if the contract negotiations are well advanced and one party arbitrarily breaks off contract negotiations. In her article *Pre-Contractual Liability in English and French Law* (Kluwer 2002), Professor Paula Giliker noted that the most common categories of claims relating to preliminary negotiations under French law are (1) unjustified and abusive rupture of negotiations; (2) negotiations without a serious intent to contract; (3) failure to cooperate; (4) the misuse of information gained in confidence; (5) entry into negotiations with the goal of preventing the other party from negotiating with a third party; (6) conducting parallel negotiations in bad faith; and (7) failure to disclose essential and material facts.

This type of liability has gained complementary strength on December 31st 1989 with the enactment of a law commonly named “Loi Doubin” which, although it does not expressly refer to franchising, was passed to apply to franchising-like contractual situations where a party accepts to be subject to restrictions to its freedom of commerce. The law imposes on the other party the obligation to provide a disclosure document (also refered to as "DIP" or "Document d'information précontractuelle"). Since this date, thousands of cases have been heard before the French courts on the issue of pre-contractual liability of franchisor towards the candidate franchisee even though a contract has been ultimately executed. The Franchisee can still present a tort claim on the grounds of pre-contractual liability. This has created a maze of court decisions, generally protective of the candidate franchisee, the three last significant decisions of the French Supreme Court dated 4th of October 2011, 31st of January 2012 and n 12th of June 2012, which have created a presumption of pre-contractual liability of a franchisor if the financial estimates provided by franchisor do not match the effect turnover of concerned franchisees.

Most civil-law countries follow the German and French models of liability for aborted contract negotiations. The Italian Civil Code, Article 1337 expressly establishes a duty of good faith in contract negotiations. Under Swiss law contract negotiations create between the parties a legal relationship that is called "[t]he pre-contractual relationship, (See International Chamber of Commerce Formation of contracts and Pre-contractual Liability 69 (1990)). In these types of cases, since there is no contract formation, whether the claim is characterized as a contract or tort may determine, using a conflict of law analysis, what country's law will be followed in the case.

While, generally speaking, the common law allows parties to engage in unimpeded contract negotiations even if they end with no consummation of a contract, some U.S. courts have found pre-contractual liability in certain situations. The three most popular theories are (i) restitution, based on unjust enrichment; (ii) misrepresentation, involving misinformation given during the negotiations regarding the intention to come to terms on a contract; and (iii) promissory estoppel, where one party relied to its detriment on a promise made by the other party in order to induce the latter to negotiate. The leading case involving the failure of pre-contractual negotiations, where a court was willing to grant reliance damages to the plaintiff, was the case of *Hofmann v. Red Owl Store*, 133 N.W. 2d 267 (Wis. Sup Ct. 1965). In that case a supermarket chain promised to sell the claimant a franchise, first advising the claimant to sell his bakery, move to another town, open a smaller grocery store as a means to gaining experience, and buy a lot the chain had selected for the potential franchise location. The franchisor then told the claimant to sell his small grocery store, which was operating at a profit, only to break off negotiations for the franchise shortly thereafter. The court held that the claimant was entitled to reliance damages because the franchisor's conduct induced the claimant to act to his detriment. Under each of these theories a successful plaintiff may recover reliance damages, but not expectation damages, which is premised on a party having reached an agreement.

Despite these theories of recovery for the most part courts in the U.S. have not often found for a plaintiff where they were cut off from negotiations and where there was no preliminary agreement put in place. In a 2007 study Alan Schwartz and Robert S. Scott found that in cases alleging reliance damages based on broken pre-contractual negotiations, in 87% of the 30 cases sampled the courts denied liability, whether premised on promissory estoppel, quantum meruit, or negligent misrepresentation (" See Precontracual liability and Preliminary Agreements, Alan Schwartz and Robert S. Scott,120 Harvard Law Review No 3, 661-707).

In the absence of any of the conditions necessary to prevail on the theories stated above, the common law view of contract negotiations is that a party to pre-contractual negotiations, may break off the negotiations at any time for any reason, including no reason at all, without facing liability.

Civil-law jurisdictions generally restrict a damage recovery to reliance damages that are intended to put an injured party back into the position they were in before the negotiations started. While lost profits are usually not recoverable, the French have a concept known as loss of chance, or "perte de chance," to conclude the contract. If a court subscribes to this damage theory then it may award a party a portion of the anticipated benefit of the contract. (See Paula Giliker "Pre-Contractual Liability in English and French Law" (Kluwer 2002, note 12 at page 130).

Conclusion

When negotiating international master agreements with parties located in civil-law jurisdictions the franchisor must keep an eye to the laws and culture of that country, and not assume that its common law principle of caveat emptor will insulate it from liability in the event of failed contract negotiations. Quite to the contrary, if a franchisor intends to negotiate a master franchise agreement in a country that is grounded in the civil-law then it behooves it to engage in preliminary discussions with the potential master franchisee to address the possibility of ruptured negotiations. In those situations the parties should etermine 1) what law will govern the contract negotiations and the contract itself; 2) whether the parties will put in place a preliminary agreement, and what will be the scope of that agreement-is it intended to be legally binding, or is it intended to be merely an agreement to negotiate; and 3) whether either party will be granted any exclusivity in the contract negotiations in order to shield that party from the other party engaging in parallel negotiations. While nothing will act as a safe harbor against claims for wrongful termination of contract negotiations, knowing the duties imposed upon them in advance of these negotiations will make those negotiations less problematic.

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