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# Brazil's STJ Frames Franchising Agreements as "Adhesion Contracts" and Admits Prima Facie Pathological Clauses as Exception to the Competence-Competence Principle

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On 15 September 2016, the Superior Justice Tribunal ("**STJ**" for its Brazilian acronym) of Brazil, in the case "*Odontologia Noroeste LTDA v. GOU – Grupo Odontologico Unificado Franchising LTDA* (REsp. N° 1.602.076 – SP)", affirmed the invalidity of an arbitration clause contained in a franchising agreement based on its pathology for not complying with the requirements of Art. 4, §2 of the Brazilian Arbitration Act ("**BAA**"). Interestingly, Art. 4, §2 applies to adhesion contracts. Therefore, for the purposes of the application of this particular provision of the BAA, this decision can set an important precedent for the future of franchising agreements. In addition, the decision of the STJ concerning the scope of its powers to review the validity and existence of an arbitration agreement also sets an important, yet negative precedent.

The case concerned a franchising agreement for the provision of dental services. Unfortunately, the text of the STJ's decision does not recall the facts of the case and therefore, it was not possible to reproduce them in this post. However, the legal issues decided by the STJ are the main focus this post, which shall be analyzed below.

**Franchising agreements and adhesion contracts under the BAA**

According to the STJ, franchising agreements fall within the definition of adhesion contracts and therefore, are subject to the requirements of Art. 4, §2 of the BAA, which provides that "[i]*n adhesion contracts, an arbitration clause will only be valid* ***if the adhering party takes the initiative to file an arbitration proceeding or if it expressly agrees with its initiation, as long as it is in an attached written document or in boldface type, with a signature or special approval*** *for that clause*."

First, the STJ agreed with the decision of a previous case (AgRg-Ag – 746.597/RJ) in which the STJ indicated that the legal nature of franchising was that of a "*typical contract* […] *of reciprocal and successive performance* […] *in the manner and form provided for adhesion contracts*"; and with regard to Art. 4, §2 specifically, the STJ cited a well-known Brazilian scholar, Carlos Alberto Carmona, who defined an

adhesion contract under Art. 4, §2 of the BAA as contract characterized by "*the lack of equality among the contracting parties* […] *Such contracts presuppose, first of all, the economic superiority of one of the parties, who unilaterally establishes the contractual clauses*." Based on these definitions, the STJ concluded that a franchising agreement is *undeniably* an adhesion contract and therefore, subject to the requirements of Art. 4, §2 of the BAA. One circumstance that the STJ particularly observed was the fact that the franchising agreement had the logo of the franchisor.

**Powers of the Brazilian Judiciary Branch to analyze the validity of an arbitration clause**

The other main issue analyzed by the STJ was the possibility of the Brazilian Judiciary Branch to analyze the validity or existence of the arbitration clause in light of the competence-competence principle. As previously posted in this blog, although the competence-competence principle had its ups and downs in Brazil, it cannot be denied that the principle has been fully recognized. Even in this case the STJ made it clear that "*as a general rule, the jurisprudence of this Superior Court indicates a priority in favor of arbitration to rule on its own jurisdiction, including on matters concerning the validity or nullity of the arbitration clause*." The court also recalled the decision in "*Samarco Mineração v. Jerson Valadares da Cruz* (REsp. N° 1,278,852-MG)", where the STJ made it clear that the competence between an arbitral tribunal and national courts, alternates during different procedural stages. That is, initially, the arbitral tribunal has the competence to decide on the existence and validity of an arbitration clause, and then, once the award is rendered, the national courts can step in.

However, the STJ indicated that, although the "*competence-competence principle must be privileged* […] *for the strengthening of arbitration in the country*," the jurisprudence of the STJ has admitted the existence of pathological clauses, which can be "*analyzed and annulled by the Judiciary Branch even before the arbitration procedure* [starts]." In other words, the STJ admitted that pathological clauses may work as an exception to the general rule set forth by the competence-competence principle, and indicated that this was an exception that helped "*better accommodating the principle of competence-competence in situation close to the limits of the general rule of arbitral priority.*" Finally, the STJ held that the "*Judiciary Branch may, in cases where the arbitration clause is* prima facie *'pathological', i.e. clearly illegal, declare the nullity of such clause, irrespective of the state of the arbitral procedure*," and concluded that the arbitration clause pathology was its illegality, for not complying with the specific requirements of Art. 4, §2 of the BAA, thus annulling the clause.

The decision of the STJ to frame franchising agreements under the category of adhesion contracts should be highlighted, since it sets an important precedent for the players in the franchising business. Many franchising contracts with arbitration clauses may run the risk of having such clauses considered as invalid (unless they are amended to comply with Art. 4, §2), and future contracts must be carefully drafted, in order to comply with the requirements of Art. 4, §2 and avoid conflicts for that matter.

Regarding the analysis *vis-à-vis* the powers of the national courts to rule on the validity and existence of an arbitration clause, a negative precedent was set. First, the STJ recognized that *prima facie* pathological clauses are an exception to the negative

effect of the competence-competence principle, which states that "*courts should refrain from engaging into the examination of the arbitrators' jurisdiction before the arbitrators themselves have had an opportunity to do so*" [E. Gaillard, Y. Banifatemi, *Negative Effect of Competence-Competence: The Rule of Priority in Favour of the Arbitrators*, Chapter 8 *in* Enforcement of Arbitration Agreements and International Arbitral Awards: The New York Convention in Practice (E. Gaillard, D. Di Pietro, eds., 2008)]. Although the STJ emphasized that the pathology must be *prima facie* to grant them the power to review the arbitration clause, this holding still goes counter previous decisions where it was recognized that arbitrators should decide first on any issues that might affect the validity of the arbitration clause, as was the case in "*Kwikasair Cargas Expressas S/A et al. v. AIG Venture Holdings Ltd* (Special Appeal N° 1.355.831-SP)," where the STJ held that "[p]*ursuant to Article 8 of the Arbitration Act,* ***the allegation that an arbitration clause is null should be first submitted to the arbitral tribunal. It is not possible for a party to request to the courts the annulment of the arbitration clause before the formation of the arbitral tribunal*** […] ***it is not admissible the premature involvement of the courts in this matter***."

Second, the STJ indicated that the nullity of the arbitration clause can be declared "***irrespective*** *of the stage in which the arbitral procedure is,*" when there is a *prima facie* pathology in the clause, setting a negative precedent for the competence-competence principle in Brazil in general, by recognizing that national courts can interfere even with ongoing arbitral proceedings. Not only this decision is inconsistent with previous STJ case law, such as the *Samarco* and *Kwikasair* cases cited in this post, but it is also inconsistent with new developments in Brazilian arbitration law, as is the case with article 485(VII) of the new Brazilian Code of Civil Procedure (Law N° 13.105/2015), which provides that "[t]*he judge will not decide on the merits when: VII – he/she recognizes the existence of arbitration agreement, or when the arbitral tribunal accepts its jurisdiction,*" and which was recently applied by a lower Brazilian court, as reported in this blog.

The decision on the legal nature of franchising agreements for the purposes of the application of Art. 4, §2 of the BAA is certainly welcomed. It is clear now the precautions to be taken into account by contract drafters in order to avoid disputes and further discussion on this issue, although, nothing is to say that Brazilian jurisprudence on this matter cannot change.

However, the decision on the powers of national courts to analyze and annul arbitration clauses that are alleged as pathological sets an unfortunate negative precedent. In my opinion, the STJ's reasoning for holding that a *prima facie* pathological clause can override the competence-competence principle and that it has practically unlimited powers to interfere with an ongoing arbitration proceeding is incorrect and drifts away from current developments not only in Brazil, but in Latin America as well, seeking to limit as much as possible the interference of national courts with arbitral proceedings.

As mentioned above, the facts of the case are not available in the text of the STJ's decision and therefore, it is not possible to know whether an arbitration proceeding was ongoing, which would make the STJ's decision in this case even more worrying.

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