

BREACH OF GOOD FAITH IN PERFORMANCE OF THE FRANCHISE CONTRACT: PUNITIVE DAMAGES AND DAMAGES FOR INTANGIBLES

Shannon Kathleen O'Byrne*
Edmonton

This paper explores case law concerning breach of good faith in the franchise contract. Given the relational nature of the franchise contract, the good faith term forbids the franchisor from exploiting the franchisee's classic vulnerability. The paper also illustrates why the franchisor is more susceptible to an award of punitive damages. It concludes by making the novel argument that franchisees should be permitted to recover damages for mental distress and other intangibles resulting from breach of the good faith term.

Cet article analyse la jurisprudence sur la violation de la condition de bonne foi inhérente au contrat de franchisage. Étant donné la nature relationnelle du contrat de franchisage, la condition de bonne foi interdit au franchiseur d'exploiter la vulnérabilité classique du franchisé. Ce document illustre également les raisons pour lesquelles le franchiseur est plus exposé à des dommages punitifs. Il conclut par un argument inédit selon lequel les franchisés devraient avoir droit à des dommages intérêts pour souffrance morale ou pour d'autres préjudices immatériels en cas de violation de la condition de bonne foi.

I. Introduction	432
II. The Nature of the Franchise Contract	436
A. Position of the Commentators	436
B. Position of the Courts	438
C. Case Law	440
D. Good Faith or Utmost Good Faith?	443

*Shannon Kathleen O'Byrne, Professor, Faculty of Law, University of Alberta, Edmonton, Alberta. I would like to thank Mr. Paul Jones for first suggesting this topic. I would also like to thank for their helpful commentary on an earlier draft of this paper Mr. James McGinnis of Parlee McLaws and Dean David Percy of the Faculty of Law, University of Alberta. I would also like to gratefully acknowledge partial research funding assistance from the Foundation for Legal Research as well as the outstanding research assistance of Ms. Marla Teeling. I also extend my appreciation to Dr. Johanne Drouin for her assistance. Errors and omissions remain my own.

III. <i>Potential for Punitive Damages</i>	445
IV. <i>Aggravated Damages and Mental Distress</i>	447
A. <i>The Difference Between Aggravated Damages and General Damages for Mental Distress</i>	448
B. <i>Recovery for Mental Distress when the Plaintiff Cannot Prove a Separate Actionable Wrong</i>	451
1. <i>Exception Based on the Kind of Contract Involved</i>	452
2. <i>Exception Based on Foreseeability Alone</i>	454
3. <i>Exception Based on 'Wallace' Damages</i>	457
C. <i>Can a Corporation Suffer Mental Distress?</i>	461
V. <i>Conclusion</i>	463
<i>Appendix I</i>	466

I. Introduction

Though still in its infancy, franchise litigation has been gaining significant momentum over the last several years¹ particularly in the area of good faith. As Frank Zaid has recently observed, virtually every new franchise case includes a claim that the franchisor has breached its duty of fair dealing, which includes the duty to act in good faith and in accordance with responsible commercial standards.²

The 1991 decision of *Gateway Realty Ltd. v. Arton Holdings Ltd.*³ established the modern foundation for the contractual good faith obligation in common law Canada. Kelly J. stated:

The law requires that parties to a contract exercise their rights under that agreement honestly, fairly and in good faith. This standard is breached when a party acts in a bad faith manner in the performance of its right and obligations under the contract. "Good faith" conduct is the guide to the manner in which the parties should pursue their mutual contractual objectives. Such conduct is breached when a party acts in "bad faith" – a conduct that is contrary to community standards of honesty, reasonableness or fairness. The insistence on a good faith requirement in discretionary conduct in contractual formation, performance, and enforcement is only the fulfillment of the obligation of the courts to do justice in the resolution of disputes between contending parties.⁴

¹ Frank Zaid, "Canadian franchise litigation is proliferating for a variety of reasons", *The Lawyers Weekly* (3 October 2003) 17.

² *Ibid.*

³ *Gateway Realty Ltd. v. Arton Holdings Ltd.* (1991), 106 N.S.R. (2d) 180 (S.C.) [*Gateway*]; aff'd on other grounds (1992), 112 N.S.R. (2d) 180 (C.A.).

⁴ *Ibid.* at para. 39. *Gateway* has been cited with approval in several franchising cases including *Shelanu v. Print Three Franchising Corp.* (2000), 11 B.L.R. (3d) 69 (Ont. S.C.J.) at para. 27 and by the Court of Appeal (varying the trial judgment on other grounds) (2003), 226 D.L.R. (4th) 577 (Ont. C.A.) at para. 70 [*Shelanu*] and *Mr.*

This pronouncement is in stark contrast to the classical view that parties to a contract should bargain keenly and be self-reliant.⁵ The following assessment by Michael Bridge illustrates such a perspective:

Good faith...is an imperfect translation of an ethical standard into legal ideology and legal rules. However much it might stimulate research or encourage inquiry into theories underlying contract law, its appropriate home is the university where it can perform these functions without wreaking practical mischief.⁶

I have argued elsewhere that such a negative characterization of good faith in common law Canada is misplaced.⁷ Good faith in an entrenched part of the *Civil Code of Québec*⁸ and the Uniform Commercial Code,⁹ is consummate with the common law rule that contractual terms can be implied as required by business efficacy; and recognizes the importance of placing at least some limitations on the exercise of contractual discretion¹⁰ by one party over another. The doctrine is constructive because it expressly

Submarine v. Sowdaey, [2002] O.J. No. 4401 (Ont. S.C.J.) (QL) at para. 57 [*Sowdaey*].

⁵ For a description of classical contract law, see Hugh Collins, *The Law of Contract*, 2nd ed, (London: Weidenfeld and Nicolson, 1993) at 1.

⁶ Michael Bridge, "Does Anglo-Canadian Contract Law Need a Doctrine of Good Faith?" (1984) 9 Can. Bus. L.J. 385 at 412. As John Swan succinctly summarizes the matter: "The traditional [Anglo Canadian] common law took a kind of perverted pride in the claim that it had no general notion of good faith, as if admitting that the law could be founded in 'good faith' would be admitting to the presence of some kind of embarrassing social disease." See Swan, "Whither Contracts: A Retrospective and Prospective Overview" in Law Society of Upper Canada, *Law in Transition: Contract Special Lectures* (Toronto: Richard De Boo, 1984) 125 at 148.

⁷ See Shannon O'Byrne, "Good Faith in Contractual Performance: Recent Developments" (1995) 74 Can. Bar Rev. 70.

⁸ For discussion of good faith under the *Civil Code of Québec*, see the scholarship cited by the Quebec Court of Appeal in *Supermarché A.R.G. Inc. c. Provigo Distribution Inc.*, [1997] A.Q. no 3710 (C.A.), including, in note 17: Ginette Leclerc, "La bonne foi dans l'exécution des contrats" (1992) 37 McGill L.J. 1070; J. Pineau, "La philosophie générale du nouveau Code civil du Québec, (1992) 71 R. du B. can. 423; Actes du Colloque sur "La bonne foi: rôle et exigences" (1996) 26 R.D.U.S. 224 et S.B. Lefebvre, "La bonne foi dans la formation du contrat en droit québécois", Thèse de doctorat, Université de Paris II, 1987.

⁹ For discussion of the Uniform Commercial Code (UCC) in a franchising context as well as an explanation of American franchise legislation, see Jane Cohen and Larry Weinberg, "Good Faith and Fair Dealing: A Primer on the Differences between the United States and Canada" (Summer 2002) *Franchise Law Journal* 37. See too Robert Joseph, "Do Franchisors Owe a Duty of Competence?" (1991) 46 Bus. Law. 471 for an analysis of the American covenant of good faith and fair dealing, at 8 and following.

¹⁰ For discussion of this aspect of good faith see, for example, Steven Burton "Breach of Contract and the Common Law Duty to Perform in Good Faith" (1980) 94 *Harvard Law Rev.* 369. For discussion of good faith as a fetter on discretion in the franchise contract, see W. Michael Garner, "The Implied Covenant of Good Faith in

prohibits capriciousness, improper motive, dishonesty, unreasonableness, opportunistic behaviour¹¹ and ambush. As Mr. Justice Meehan of the Ontario Superior Court of Justice observed in a 2002 decision, “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 recognizing the doctrine makes the law more certain, more understandable, and, of course, more fair.”¹²

But whatever general resistance there may still be in common law Canada to the doctrine of good faith, it is most certainly the standard in the franchise contract governed by legislation¹³ and, based on the bulk of current case law, the standard at common law as well.¹⁴

Franchising: A Model for Discretion” (1995) 20 Oklahoma City University Law Review 305.

¹¹ See David Stack, “The Two Standards of Good Faith in Canadian Contract Law” (1999) 62 Sask. L.R. 201 at 201. Stack also comments on the multifarious use to which the good faith doctrine has been put: “...now as a modifier of agreements; now as an excluder of opportunistic conduct; now as a device for forcing parties to come to terms” at 215. Additionally, a function of good faith is to fill the gaps in contracts, *ibid.*

¹² *Elite Specialty Nursing Services Inc. v. Ontario*, [2002] O.J. No. 3009 (S.C.J.)(QL) at para 90.

¹³ Ontario and Alberta both have franchise legislation requiring good faith or, what the legislation terms ‘fair dealing.’ See Alberta’s *Franchises Act*, R.S.A. 2000, c. F-23: s. 7: Every franchise agreement imposes on each party a duty of fair dealing in its performance and enforcement.

s. 18: Any waiver or release by a franchisee of a right given by this Act...is void. In Ontario, see *Arthur Wishart Act (Franchise Disclosure)*, 2000, S.O. 2000 c. 3:

3(1) Every franchise agreement imposes on each party a duty of fair dealing in its performance and enforcement...

(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.

The Ontario legislation also provides that any purported waiver or release by a franchisee is void. See s. 11. For very helpful discussion of the Ontario Act, see Frank Zaid, “Franchise Disclosure Legislation in Ontario, Canada” (2001) 3 International Journal of Franchising and Distribution Law 111. See too Edward Levitt’s comprehensive account in *Canadian Franchise Legislation* (Markham: Butterworths Canada Ltd., 2002) for discussion of the Ontario Act (at 9.01 and following) and Alberta Act (at 5.01 and following). See also the context provided by Markus Cohen, Paul Jones and G. Lee Muirhead “Franchising in Canada/La Franchise au Canada” in *American Bar Association Forum on Franchising* (n.p.: Forum on Franchising, American Bar Association, 2001) at 60 and following.

¹⁴ While there are no Supreme Court of Canada decisions on point, lower courts have been instructive. See for example, *Machias v. Mr. Submarine Ltd.* (2002), 24 B.L.R. (3d) 228 (Ont. S.C.J.) at para. 114 [*Machias*] where the court found that the *Arthur Wishart Act (Franchise Disclosure)* simply codifies the common law requirement of good faith. For similar commentary, see *Country Style Food Services Inc. v. Hotoyan*, [2001] O.J. No. 2889 (S.C.J.)(*Hotoyan*) at para. 54 and the Ontario

Under the *Civil Code of Québec*, there is no reference to the franchise contract. As Silvana Conte observes, the franchise contract is therefore *sui generis* and “subject to the general provisions applicable to contracts in the Civil Code as interpreted by doctrine and the caselaw.”¹⁵ As a result, all franchise contracts contain implicit or implied obligations including those provided for in Articles 6, 7, and 1375 as follows:

Art. 6. Every person is bound to exercise his civil rights in good faith.

Art. 7. No right may be exercised with the intent of injuring another or in an excessive and unreasonable manner which is contrary to the requirements of good faith.

Art. 1375. 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.

On this basis, the duty to act in good faith applies to negotiations, to execution of the contract, to its fulfilment, and to the manner in which it is terminated.¹⁶

Given that the existence of a good faith duty in the franchise contract is relatively well-settled, the focus of this paper will be on discussing what the standard requires in the context of contractual performance, both from a civil and common law perspective. This is a challenging endeavour since it is much easier to define good faith generically than it is to determine what it demands in any given situation. Given this difficulty, Part II approaches the matter by identifying the nature of the franchise contract and, in particular, the vulnerabilities which the franchisee faces at the hands of the franchisor. This part concludes, based on a brief review of the case law, that the duty of good faith forbids – at large – the exploitation of these vulnerabilities. Part III highlights another consequence of the franchise contract being built on inevitable vulnerability, namely, that the party in breach is much more likely to face punitive damages and other forms of judicial recrimination than in the traditional, arms-length commercial relationship. Part IV contends that this same vulnerability sets

Superior Court of Justice in *Shelanu*, *supra* note 4 at para. 25 as well as at the appellate level, *supra* note 4 at para. 64-66. Other cases which have determined that good faith is an implied term of the franchise contract at common law include *McKinlay Motors Ltd. v. Honda Canada Inc.* (1989), 80 Nfld. & P.E.I.R. 200 (Nfld. S.C.T.D.) wherein the court stated: “It is obviously an implied term of such agreement that the parties act toward each other in their business dealings, in good faith” at 211. Note, however, that there are a minority of cases taking the opposite view. See for example, *Estate-Gard Services of Can. Ltd. v. Loewen Mgmt. Corp.* (1989), 38 B.C.L.R. (2d) 362 (C.A.) where the court refused to imply a term as “vague as “good faith and confidence”” at 372.

¹⁵ Silvana Conte, “Demystifying Quebec: Civil Law” in *Franchising: Latest Legal and Business Strategies* (Toronto: Insight Information Co., 2003) at 2.

¹⁶ *Ibid.* at 4-5.

the stage for the wronged party (most likely the franchisee) to claim damages for intangibles, including damages for distress, humiliation, and wounded pride. Part V offers some brief conclusions.

II. The Nature of the Franchise Contract

A. Position of the Commentators

Franchise contracts have a number of constant qualities which have been the subject of some academic commentary. While they are certainly *not* fiduciary,¹⁷ franchise contracts possess some fiduciary-like qualities¹⁸ because they are imbued with vulnerability, dependency, inequality, as well as the necessity of trust and cooperation.

These qualities are present in the franchise agreement for several related reasons. First, the prototypical franchisee is the inexperienced, dependent “little guy”.¹⁹ Such a franchisee cannot ordinarily match the

¹⁷ In *Jirna Ltd. v. Mister Donut of Canada Ltd.*, [1975] 1 S.C.R. 2 [*Jirna*], the Supreme Court of Canada clearly stated that the franchise agreement is not ordinarily a fiduciary one though, as the Ontario Superior Court of Justice court points out in *530888 Ontario Ltd. v. Sobey's Inc.* [2001] O.J. No. 318 (S.C.J.)(Q.L.) at para 9: “a commercial relationship is not immune from the imposition of fiduciary duties.” For discussion the fiduciary duty in a franchise context, see Mark Ellis, “Fiduciary Duty and Joint Business Relations” in *Fiduciary Duties – Special Lectures of the Law Society of Upper Canada* (Scarborough: Thomson, 1990) 89 at 118 and following. See also Wendy Earle, “Fiduciary Duties and the Franchise Relationship” (1997) 7(3) *Canadian Corporate Counsel* 39 at 42 for steps to minimize the risk that a franchise contract would give rise to a fiduciary duty.

¹⁸ For the definitive account of the difference among the fiduciary standard, the good faith standard and the unconscionability standard, see P.D. Finn, “The Fiduciary Principle” in T.G. Youdan, ed., *Equity, Fiduciaries and Trusts* (Toronto: Carswell, 1989) at 1.

¹⁹ See Michael J. Herman, “A Good Contract and Responsible Conduct: How the Franchisor Can Maximize Its Remedies Against a Defaulting Franchisee” in *Franchising: Current Issues in Financing, Leasing and Remedies in Default* (Toronto: Insight, 1985) at 2 and Ria Tzimas, “Good Faith and Obligations to Deal Fairly in the Franchise Context” in James C. Morton, *Donuts, Pizza and Gas: Do They Always Go Together?* (n.p.: Canadian Bar Association – Ontario, 1997) at 12. See also Gillian Hadfield, “Problematic Relations: Franchising and the Law of Incomplete Contracts” (1990) 42 *Stan. Law Rev.* 927 at 991-992 who observes that the “typical franchisee is an inexperienced businessperson, seeking to set up a small business but seeking also to reduce the risks of that enterprise. The franchisor, usually an experienced and sophisticated business entity, provides the franchisee with a package of corporate services, a product with a proven track record, and the advantages of a common trademark. As a result, the relationship is essentially a reliance relationship between unequal parties. The franchisee relies on the franchisor’s superior business knowledge and perceives its obligations as following the franchisor’s directives. The franchisor, in

franchisor's access to information, resources, and power. In this way, good faith is used to restrain the franchisor in its dealings with the franchisee.

Second, the franchise contract is an incomplete contract since the parties cannot possibly recite all their right and obligations in advance. As Hadfield notes: "Often, contracts are necessarily and intentionally incomplete because mutual desires for flexible, but bounded, responses to uncertain future conditions limit the scope and precision of verifiable terms."²⁰ The good faith doctrine is deployed to fill in the blanks²¹ as they arise.

Third, and on a related front, the franchise contract is the quintessential relational contract.²² As articulated by the American contracts law scholar Ian Macneil, relational contracts contrast with the instantaneous exchange that characterizes discrete (or 'one-time') contracts like purchasing a car or buying a house. The relational contract is one where the parties have obligations over time and are thereby linked by the norms of reciprocity, flexibility, contractual solidarity, restraint of power, and propriety of means, to name a few examples.²³ Though classical contract law would characterize these norms as both imprecise and inappropriate, recent case law demonstrates that the franchise contract cannot be safely assessed from such a traditional vantage point. Instead, via the obligation of good faith, relational norms form the backdrop of the

a sense burdened by its superior position in a nonetheless mutual exchange, is obligated to develop a successful system and to share its expertise with the franchisee. Even the drafting of the standard form written contract is, because of the relational imbalance, almost necessarily left to the expertise of the franchisor." See also Richard Haigh, "Franchising in the Shadow of Contract Law: A New Fidelity for Business Relations" (1996) Dal. L.J. 5 at 35 who comments on the "overwhelming power imbalance in favour of the franchisor" and Richard Potter, Case Comment: *McKinlay Motors Ltd. v. Honda Canada Inc.* (1990) 46 B.L.R. 111 at 115 who observes that franchise contracts "represent a particular blend of dependency on the part of the franchisee, especially in terms of the franchisee's adhesion to the franchisor's form of franchise agreement."

²⁰ Hadfield, *ibid.* at 927-28.

²¹ Stack, *supra* note 8 at 206.

²² Accord Potter, *supra* note 19 at 115 and Paul Jones in "Alternative Channels of Distribution: Encroachment and the Risk of Being 'Amazoned'" (n.p.: Canadian Franchise Association Legal Symposium, 1998) at 11. See also Hadfield, *supra* note 19 at 955 and Haigh, *supra* note 19 at 36 and following.

²³ Ian R. Macneil, "Values in Contract: Internal and External" (1983) 78 N.W.U.L. Rev. 340 at 347. Macneil's other work on point includes: *The New Social Contract: An Inquiry into Modern Contractual Relations* (New Haven: Yale University Press, 1980); "Relational Contract: What We Do And Do Not Know" (1985) Wis. L.Rev. 483; "Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical and Relational Contract Law" (1978) 72 N.W.U.L. Rev. 854; and "Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a 'Rich Classificatory Apparatus'" (1981) 75 N.W.U. L. Rev. 1018.

franchise agreement and generate its content.

B. Position of the Courts

Like the commentators noted above, courts also recognize the interdependence of the franchisor-franchisee relationship. For example, at the trial level, Mr. Justice Nordheimer in *Shelanu v. Print Three Franchising Corp.*²⁴ (varied on other grounds) stated that:

it is evident to me that the relationship between a franchisor and a franchisee is something more than a pure commercial arrangement between arm's length parties who can only look to their own selves for the protection of their respective interests. I tend to agree with counsel for the plaintiff that the franchisor/franchisee relationship is more akin to that of a partnership.²⁵

Of interest to the judiciary are the vulnerabilities inherent in the franchisor-franchisee relationship, particularly in the franchisee. Most recently, the Ontario Court of Appeal in *Shelanu* has identified several qualities in the typical franchisee which lead to this conclusion: franchisees do not usually have equal bargaining power to the franchisor; franchisees cannot generally bargain for more favourable terms since the franchise agreement is a contract of adhesion; and franchisees are required to submit to inspections and other manners of control by the franchisor.²⁶

In a riveting and analogy-driven passage penned by Mr. Justice Farley in *Head v. Inter Tan Canada Ltd.*, (the *Radio Shack* case),²⁷ the court makes a similar observation:

In any business relationship of a franchise nature there must be some natural symbiosis. From the franchisee's point of view, he must continue to provide a useful function for the franchisor in the nature of those birds who clean the teeth of crocodiles. On the other hand, most good franchisors recognize that they are in a long-term relationship and therefore do not immediately clamp their jaws down on a franchisee who makes one or two errant pecks at the food. This, of course, is a question of degree. However, in my mind, it appears that the crocodile should become increasingly tolerant with the longevity of the relationship and the amount of non-liquid assets that the bird has at stake.²⁸

See also *Country Style Food Services Inc. v. 1304271 Ontario Inc.*²⁹ wherein the court chastises the franchisor for its conduct:

²⁴ *Supra* (Ont. S.C.J.) note 4.

²⁵ *Ibid.* at para. 25.

²⁶ *Supra* (Ont. C.A.) note 4 at para. 66.

²⁷ (1991), 5 O.R. (3d) 192 (Ont.Ct. (Gen.Div.)) [*Head*].

²⁸ *Ibid.* at 203.

When the ship began to sink, the franchisor left its charge afloat in turbulent waters, without a life jacket....Due to its own tenacity, the franchisee managed to survive the flood and reach the shoreline. It was, however, left in a shivering state, vulnerable and uncertain about its future.³⁰

In *9054-0402 Québec inc. c. Centre de santé minceur inc.*, the Québec court's concern about the vulnerability of the franchisee also shines through: "C'était alors trop pour les épaules de Marilena Giacomini [the franchisee]. Elle ne pourrait survivre seule jusque-là."³¹ On a related front, this same court emphasizes the relational value of cooperation that accompanies the good faith obligation when it relies on the following analysis by Nathalie Vézina:

Dans le contexte de la mise en oeuvre du droit à l'exécution, le devoir de bonne foi peut se définir comme celui d'agir avec loyauté, honnêteté et intégrité. Le comportement de bonne foi suppose un "souci de coopération"....[footnotes omitted]."³²

Of course, franchisees can do considerable harm to franchisors through royalty strikes,³³ refusals to abide by the operation systems and standards of the franchisor,³⁴ selling unauthorized

²⁹ (2003), 32 B.L.R. (3d) 207 (Ont. S.J.C.) [*Country Style*].

³⁰ *Ibid.* at paras. 104-105.

³¹ [2000] J.Q. No. 1299 (Court of Québec Civil Division) [*9054-0402 Québec*] at para. 46. AUTHOR TRANSLATION: "It was too much to bear for Marilana Giacomini. She could not survive alone like that."

³² *Ibid.* at para. 47, quoting Nathalie Vézina, « La demeure, le devoir de bonne foi et la sanction extrajudiciaire des droits du créanciers » (1995-96) 26(2) R.D.U.S. 455 et ss., à la p. 457, vol. 26, no 2, page 455 et ss., à la page 457. AUTHOR TRANSLATION: "In the context of performance, good faith requires the parties to act with loyalty, honesty and integrity. Good faith behaviour includes a concern for cooperation...."

³³ See for example the analysis of E. Wolfson, "One Royalty Strike and You're Out" as quoted in *Cash Converters v. 1167430 Ontario Inc.*, [2001] O.J. No 5860 (S.C.J.)(Q.L.) at para. 23:

For franchisors, there is perhaps no greater danger than the possibility that its franchisees will purposely withhold contractual royalty payments and advertising contributions. In the absence of royalty income, the franchisor may be unable to provide the necessary support to franchisees in critical areas such as operations, field support, expansion and product development. Similarly, without the franchisees' advertising contributions, the franchisor may be in no position to fund and carry out the necessary advertising and marketing activities which are so vital to a franchise system's growth and success. In the words of one court, 'royalties are the lifeblood of a franchise system.'

³⁴ See, for example, *Second Cup Ltd. v. Ahsan*, [2001] Q.J. 1763 (Sup. Ct.), reversed in part on other grounds [2003] Q.J. No. 3007 (C.A.), wherein Zerbisias J. granted termination and other remedies to the franchisor based on, *inter alia*, non-compliance of the franchisee with the franchisor's no-smoking policy, at para. 52:

product,³⁵ changing the ‘get-up’ of the business premises³⁶ and purporting to sell or assign the business without the franchisor’s consent,³⁷ just to name a few examples. However, more commonly, the case law focuses on the franchisor’s alleged abuse of its contractual discretion and other forms of bad faith, as discussed below.

C. Case Law

The chart at Appendix I of this paper identifies, in summary form, some of the recent case law where the franchisor has allegedly run afoul of its good faith obligations both at common law and under the Québec Code. For example:

- In *Shelanu*,³⁸ the franchisor was called to task by the Ontario Superior Court of Justice for establishing a second line of franchise that competed with the franchisee; for failing to pay royalty rebates; and acting unreasonably in its promotional programmes. While varying this decision in part, the Ontario Court of Appeal confirmed much of the lower court’s analysis and, furthermore, identified some precise content of the good faith duty. It observed that the duty included a ‘time component’ and that this requires the party under such a duty:

respond promptly to a request from the other party and to make a decision within a reasonable time of receiving that request. Parties under a duty of good

They fail to appreciate the seriousness of their conduct not only with regard to their contractual obligations but also with regard to the effect of their conduct on the entire franchise chain i.e. that a chain is only as strong as its weakest link, that the banner, trademark, image, ambiance and reputation of a franchise operation is part of its formula or system to which all franchisees subscribe and from which they derive mutual and reciprocal benefit.

And at para 62:

In the present circumstances, given the ongoing and repeated breaches of the agreement and the operation system and standards of the Petitioner, Petitioner was not only entitled but obliged to take the present proceedings to protect the integrity and reputation of the chain. Any client who was lost as a result of a bad “Second Cup Experience” in Respondents’ coffee shop was a client lost by the entire chain.

³⁵ Herman, *supra* note 19 at 4. See, for example, *1017933 Ontario Ltd. v. Robin’s Foods*, [1998] O.J. No. 1110 (Ont. Gen. Div.)(Q.L.).

³⁶ Herman, *ibid*.

³⁷ *Ibid*.

³⁸ *Supra* (Ont. S.C.J.) note 4.

faith also have an obligation to make payment of any amounts that are clearly owed to the other party in a timely manner....³⁹

- In *Mr. Submarine Ltd. v. Sowdaey*,⁴⁰ the Ontario Superior Court agreed that the franchisor had properly terminated the franchise agreement but chastised it for seeking damages for royalty and advertising contributions that it would have received absent the termination. According to Hoy J:

I also believe it is unfair and unreasonable for Mr. Sub to claim damages in the amount of \$111,939 and if necessary would be prepared to hold that to do so in the circumstances is a breach of its duty of fair dealing in its enforcement of the Franchise Agreement. This is by no means to suggest that a franchisor cannot usually recover damages from a franchisee for breach of a franchise agreement. The special factor here is that the franchisor is in essence claiming damages because the franchisee's business failed.⁴¹

- In *1005633 Ontario Inc. v. Winchester Arms Ltd.*,⁴² the Ontario court found the corporate franchisor liable for bad faith due to: failure to disclose; failure to provide proper training and support; failure to provide timely delivery of liquor license; and delay in construction of the pub. The individual defendants were *personally* liable as well, not only on the basis of their own wrongdoing, but also because they used the defendant companies as their mere “puppets”;⁴³ failed to respect formalities;⁴⁴ and systematically made the corporate entities judgment proof from the time when litigation was commenced.⁴⁵ For these reasons, the court took the unusual step of lifting the corporate veil.
- In *Provigo*,⁴⁶ the Québec Court of Appeal took issue with the franchisor setting up a new discount grocery store chain which competed with its existing franchisees. It also objected to the franchisor favouring the discount chain over the plaintiff franchisees. In part, this is because the good faith obligation requires the franchisor to be actively solicitous of the franchisee. As the Québec Court of Appeal states:

³⁹ *Ibid.* at para 78.

⁴⁰ *Supra* note 4.

⁴¹ *Supra* note 4 at para. 66.

⁴² (2000), 8 B.L.R. (3d) 176 (Ont. S.C.J.); aff'd (2002), O.J. No. 4711 (C.A.)(Q.L.) [*Winchester*].

⁴³ *Ibid.* at para. 90.

⁴⁴ *Ibid.* at para. 92.

⁴⁵ *Ibid.* at para. 80.

⁴⁶ *Supra* note 8.

L'appelante, liée par une obligation de bonne foi et de loyauté à l'endroit des intimées, avait le devoir devant ce nouveau tournant de travailler de concert avec son franchisé, de lui fournir les outils nécessaires, sinon pour empêcher qu'un préjudice économique ne lui soit causé, du moins pour en minimiser l'impact. Entre, d'une part, l'inaction totale et le maintien d'un statu quo qui risquaient de lui coûter sa place de marché et, d'autre part, l'exercice de son droit de libre concurrence vis-à-vis des tiers, il existe une marge....Elle devait, de concert avec eux, mettre sur pied une réplique commerciale adéquate qui permettait à ces derniers de minimiser leurs pertes et de se repositionner dans un marché en évolution.⁴⁷

The court continues:

C'est donc là où réside essentiellement la faute de l'appelante: le défaut de remplir adéquatement son obligation de collaboration et d'assistance technique, qui se traduit par un manque de loyauté, en omettant de fournir à son cocontractant les outils nécessaires pour résister commercialement à la concurrence, à partir du moment où elle a décidé de poursuivre avec vigueur, en 1990, la segmentation de la commande centrale [Footnotes omitted].⁴⁸

Due to *Provigo* and related case law based on the *Code*, Frédéric Gilbert concludes that "one of the most important implicit obligations incumbent upon the franchisor...consists in the tacit obligation of support and collaboration. Québec case law has also established other tacit obligations such as the franchisor's general obligation of loyalty towards its franchisees."⁴⁹

In sum, the cases in Appendix 1 illustrates that "corporate callousness"⁵⁰ and other forms of bad faith are actionable because such

⁴⁷ *Ibid.* at para. 67. AUTHOR TRANSLATION: "The appellant, bound by a duty of good faith and loyalty toward the franchisee, was obligated, in view of this new turn of events, to work in cooperation with the franchisee and provide it with the tools to avoid or at least minimize any negative economic impact. Between, on one hand, total inaction and maintenance of the *status quo* that risked the franchisee losing its market share, and, on the other hand, exercising its free right to compete with third parties, there exists a middle ground...Provigo had to, in concert with the franchisee, provide an adequate approach to their commercial enterprise so as to permit a minimization of losses as well as repositioning in an evolving market."

⁴⁸ *Ibid.* at para. 68. AUTHOR TRANSLATION: "The fault rests with the appellant for failing to adequately fulfill its obligation to collaborate with and assist the franchisee, evidenced by a lack of loyalty and a failure to provide the necessary tools for the franchisee to withstand the commercial effects of competition, especially after Provigo decided to pursue with vigour, in 1990, segmentation of its operations."

⁴⁹ Frédéric Gilbert, "Franchisor-Franchisee Contractual Obligations in Quebec: The Main Pitfalls" in *Franchising in Quebec: Civil Law For Common Law Practitioners* (np: Toronto: Insight Information Co., 2003), at Appendix B, at B6.

⁵⁰ In *Katotikidis v. Mr. Submarine Ltd.* (2002), 26 B.L.R. (3d) 140 at para. 76 and

conduct is inconsistent with the mandatory values of the parties' contractual alliance.

Though a list of 'do's' and 'don'ts' could be constructed based on the case law described in Appendix I and beyond, such a list would only be of limited utility in assessing the merits of any current dispute. Context is everything. In this regard, there is no better an account of the overarching importance of context than the one articulated by Michael Herman in 1985:

...[I]t seems to me that the judicial decision is really determined by an amalgam of contract and conduct: what does the franchise agreement say, and how do the parties conduct themselves from the pre-contractual discussions right through their efforts to realize on a default? Generally the franchisor is the more sophisticated party and understands the franchise system better than the franchisee; therefore, the court expects that the franchise agreement will clearly delineate the responsibilities and liabilities of the franchisee and the rights and remedies of the franchisor. As well, the courts expect the franchisor to conduct itself in a reasonable and responsible fashion throughout the franchise relationship, and fully in accordance with the conduct prescribed by the franchise agreement. Relatedly, the Court often shows some sympathy for the 'little guy' franchisee, and often does not expect quite the same level of conduct from him. Therefore, where the franchise agreement is vague or incomplete, or where the franchisor's conduct has been less than responsible, the franchisor may well face difficulties in trying to enforce its legal remedies or trying to resist the claims of the franchisee.⁵¹

The Ontario Court of Appeal would wholeheartedly endorse this assessment given its 2003 pronouncement that whether a party has breached its good faith duty "will depend on all the circumstances of the case, including whether the party...conducted itself fairly *throughout the process*."⁵²

Thus far, discussion has focussed on what good faith requires in a franchise contract but arguably, the standard is even higher than that – a matter briefly canvassed in the next section.

D. Good Faith or Utmost Good Faith?

This paper has already noted the Supreme Court of Canada's statement

(2002), 29 B.L.R. (3d) 258 Ont. S.C.J., the franchisor's "corporate callousness" resulted in a punitive damages award.

⁵¹ *Supra* note 19 at 2-3.

⁵² *Shelanu*, *supra* note 4 at para. 74 (emphasis added). It is worthy of note that the Canadian Franchise Association (C.F.A.)'s Code of Ethics takes a similar position in Rule six which states: "Fairness should characterize all dealings between a franchisor and its franchisees.", online <<http://www.cfa.ca/ethics.html>>.

that the franchise relationship is not ordinarily a fiduciary one. However, since that decision, a line of cases has developed which suggests that the standard owed in the franchise contract is one of *utmost* good faith, as opposed to good faith *simpliciter*. This is of concern, of course, if it is applying a fiduciary standard.⁵³

In *Hotoyan*⁵⁴ for example, the court stated that the franchisor/franchisee relationship is one to which “utmost good faith” should apply because it is akin to a partnership.⁵⁵ In *1176560 Ontario Ltd. v. Great Atlantic & Pacific Co. of Canada Ltd.*,⁵⁶ *Bagai v. Sure Corp.*,⁵⁷ *Jumbo Systems v. Short*,⁵⁸ *Machias*,⁵⁹ *Country Style*⁶⁰ and *Winchester*,⁶¹ the standard of utmost good faith is likewise referenced.

Particularly in light of the Ontario Court of Appeal’s clarification in *Shelanu*,⁶² it can be safely concluded that the adjective ‘utmost’ does not invoke the fiduciary standard.⁶³ It would seem that the courts are simply treating the terms ‘good faith’ and ‘utmost good faith’ as equivalents, though unhelpfully, since it creates an avenue of possible confusion.⁶⁴ At most, ‘utmost’ is deployed for emphasis – a form of judicial underlining – and not to signal the more onerous fiduciary standard.

Thus far, the paper has focussed on the vulnerability of the franchisee and how good faith seeks to shelter it from improper use of a discretion and other abuses. The franchisee’s vulnerability gives rise to another consequence for the franchisor – being liable for punitive damages as well as damages for intangibles. The next two parts of the paper explore the common law in this important and emerging area.

⁵³ Additionally, such a new standard would be based on a questionable use of precedent (as persuasively argued by Cohen and Jones, *et al.*, *supra* note 13 at 105) and inconsistent with the statutory standard of mere ‘fair dealing’ and mere ‘good faith.’ See *supra* note 13 for the franchise legislation of Ontario and Alberta.

⁵⁴ *Supra* note 14.

⁵⁵ *Ibid.* at para. 53.

⁵⁶ (2002), 62 O.R. (3d) 535 (S.C.J.) at para. 58.

⁵⁷ (2000), 275 A.R. 370 (Q.B.) at para. 18.

⁵⁸ [2000] O.J. No. 56 (S.C.J.)(Q.L.) at para. 39, *aff’d* (2002), 154 O.A.C. 49.

⁵⁹ *Supra* note 14 at para. 116.

⁶⁰ *Supra* note 29 at para. 40.

⁶¹ *Supra* note 42.

⁶² *Supra* note 4.

⁶³ *Ibid.* at para. 70.

⁶⁴ That is, while all fiduciaries owe a duty of utmost good faith, not everyone who owes a duty of utmost good faith is a fiduciary. See, for example, *Ferme G rald Laplante & Fils Lt e v. Grenville Patron Mutual Fire Insurance Co.* (2002), 61 O.R. (3d) 481 (C.A.) where the court relies on the following pronouncement by Robins J.A.: “The fact that a contract is one of utmost good faith does not however mean that it gives rise to a general fiduciary relationship.”

III. Potential for Punitive Damages

Punitive damages are rare in the commercial arena and, according to the Supreme Court of Canada in *Whiten v. Pilot Insurance Co.*,⁶⁵ are awarded only where there has been “malicious, oppressive and high-handed” misconduct that “offends the court’s sense of decency.”⁶⁶ The court in *Whiten* provided a set of principles governing the awarding of punitives which the Ontario Superior Court of Justice in *Katotikidis v. Mr. Submarine Ltd.*⁶⁷ has summarized in the following terms:

- the general objectives of punitive damages are punishment (in the sense of retribution), deterrence of the wrongdoers and others, and denunciation.
- punitive damages are generally only given where the misconduct would otherwise go unpunished or other penalties are likely inadequate to achieve the objectives or retribution, deterrence and denunciation.
- the primary vehicle of punishment is the criminal law ... and ... punitive damages should be resorted to only in exceptional cases and with restraint.
- punitive damages should be rational. The court should relate the facts of the particular case to the underlying purpose of punitive damages and ask itself how, in particular, an award would further one or other of the objectives of the law, and determine the lowest award that would serve the purpose.
- the governing rule for quantum is proportionality. The overall award, that is to say compensatory damages plus punitive damages plus any other punishment related to the same misconduct should be rationally related to the objectives for which punitive damages are awarded. When awarded, they should be proportional to such factors as the harm caused, the degree of misconduct, the relative vulnerability of the plaintiff and any advantage or profit gained by the defendant.⁶⁸

To secure punitive damages in a breach of contract action, the plaintiff must not only establish outrageous conduct by the defendant. It must also establish that the defendant committed an independent actionable wrong, i.e: separate and apart from the breach being sued upon.⁶⁹ In *Whiten*, for

⁶⁵ [2002] 1 S.C.R. 595 [*Whiten*].

⁶⁶ *Ibid.* at para. 36.

⁶⁷ *Supra* note 50 at (2002) 26 B.L.R. (3d) 140 (Ont. S.C.J.).

⁶⁸ *Ibid.* at para 61. For a summary of the facts and result in *Katotikidis*, see Appendix 1 to this article.

⁶⁹ *Whiten*, *supra* note 65 at para. 78. I have argued elsewhere that the requirement for a separate actionable wrong is based on a misreading of *Vorvis v. Insurance Corporation of British Columbia*, [1989] 1 S.C.R. 1085. See Shannon O’Byrne and Evaristas Osheionebo, “Punitive Damages and the Requirement for an Independent Actionable Wrong: *Whiten v. Pilot Insurance Co.*” (2002) 25 *Advocates’ Quarterly* 496.

example, the insured sued the insurer for refusing to pay the loss – a breach of the insurance contract.⁷⁰ The separate actionable wrong was breach of an implied covenant to act in good faith in handling the claim.⁷¹ The malicious conduct which offended the court's sense of decency was found in the insurer accusing the insured of arson all in the face of an independent insurance adjuster's report as well as the opinion of other experts that the fire was accidental.⁷² In short, the insurer was attempting to force a vulnerable insured to settle her claim at much less than it was truly worth.

In the classic commercial relationship, one party has only limited opportunity to engage in conduct which merits punishment and this provides part of the explanation as to why punitives are relatively uncommon. But where good faith duties are owed – as in the insurance contract or franchise contract – the relationship is more interdependent and relational, with one party having discretion to exercise in a way that can do harm to the other side.

In the 2004 decision of *Triple 3 Holdings Inc. v. Jan*,⁷³ for example, the court awarded \$350,000 in punitive damages against the franchisor.⁷⁴ In a highly egregious pattern of conduct, the franchisor: gave its franchisee possession of newly constructed premises after lengthy delay; supplied defective and used equipment; harassed the plaintiffs for non-existent rental arrears; extracted additional money from the plaintiffs by threatening to have them locked out of the franchise; ultimately instructed the bailiff to lock them out; and resold the franchise out from under the plaintiffs when they had an application pending for relief against forfeiture. Additionally, the franchisor provided no credit to the plaintiffs for the sale of the franchise, though it was obligated to do so. As yet another example of outrageous conduct, the franchisor's representatives pushed the franchisee around physically.⁷⁵ The court agreed that a high punitive damages award would be consistent with the principles of *Whiten* because the plaintiffs were vulnerable, the defendants' conduct was planned and deliberate, and the defendants profited from their misconduct. As the court observed: "Commercial activities cannot be conducted like piracy on the high seas. It is not 'victory to the strong' and 'push off' to the weak. The court will not countenance such conduct..."⁷⁶

John Sotos, in "What's Wrong with Franchising", identifies several methods employed by businesses masquerading as legitimate franchise

⁷⁰ *Whiten*, *ibid.*

⁷¹ *Ibid.* at paras. 78-79.

⁷² *Ibid.* at para 137.

⁷³ [2004] O.J. 2749 (S.C.).

⁷⁴ *Ibid.* at para. 51.

⁷⁵ *Ibid.* at para. 35.

⁷⁶ *Ibid.* at para. 39.

systems to “fleece the unsuspecting public.”⁷⁷ It would seem that such exploitation not only would be a breach of good faith, it would also attract punitive damages if the circumstances were sufficiently extreme. These practices include franchisors charging huge mark-ups on mandatory purchases of equipment, goods and services as a way of “gouging” franchisees and franchisors using advertising contributions for other purposes, thereby depriving the franchisee of potential sales.⁷⁸

IV. Aggravated Damages and Mental Distress

Aggravated damages have occasionally have been sought in franchise litigation. In *Capital City Auto Ltd. v. BMW Canada Inc.*,⁷⁹ for example, aggravated damages were requested by the operator of a dealer franchise but the court disallowed them without detailed reasons.⁸⁰ Likewise, there is no reported case of a franchisee securing damages for mental distress from a franchisor in a breach of good faith action.

Given that damages for intangibles are regularly awarded for breach of good faith in the insurance⁸¹ and employment contexts,⁸² this absence in franchise law is perhaps anomalous. Accordingly, the main purpose of this section is to explore the argument that damages for mental distress and other intangibles *should* be available in a franchise contract action, as when, for example, the franchisor treats the franchisee in bad faith. Further to this end, section A discusses the differences between aggravated damages and general damages for mental distress. Section B provides an account of when courts will permit recovery for mental distress absent an independent actionable wrong as well as apply those principles to the franchise contract. Section C considers the question of whether a corporation can suffer mental distress and the general availability of such a claim when the franchise in question is conducted through a corporate vehicle.

⁷⁷ John M. Sotos, “What’s Wrong with Franchising” (1993) 10 Business & the Law 33 at 34

⁷⁸ *Ibid.*

⁷⁹ [1991] B.C.J. No. 3644 (Q.L.).

⁸⁰ *Ibid.* at para. 1.

⁸¹ See, for example, *Eddie v. Unum Life Insurance Co. of America* (1999), 177 D.L.R. (4th) 738 (B.C.C.A.), wherein the court awarded the plaintiff \$15,000 in aggravated damages due to the insurer’s “egregious” conduct and failure to pay benefits.

⁸² See *infra* for discussion of the leading case from the Supreme Court of Canada: *Wallace v. United Grain Growers Ltd.*, [1997] 3 S.C.R. 701 [*Wallace*].

A. The Difference Between Aggravated Damages and General Damages for Mental Distress

As with punitive damages, to secure an award for aggravated damages, the plaintiff must establish an independent actionable wrong.⁸³ This is not necessarily a challenging matter in contracts where a good faith duty is owed because the Supreme Court of Canada in *Whiten* has confirmed that a good faith obligation is distinct from the obligation to honour the contract.⁸⁴ As defined by the Supreme Court, aggravated damages “take into account the additional harm caused to the plaintiff’s feelings by the reprehensible or outrageous conduct on the part of the defendant.”⁸⁵ They are strictly compensatory and, as Waddams notes in the *Law of Damages*, attribute legal significance to “intangible injuries, such as distress and humiliation that may have been caused by the defendant’s insulting behaviour.”⁸⁶ In this way, the court assesses aggravated damages only in light of the defendant’s actual conduct at time of breach.

Given the vulnerability of the franchisee and the franchisor’s established duty of good faith, perhaps aggravated damages should gain a stronger foothold in franchise law than current case law would suggest. Certainly if the court had not been sufficiently offended to award punitive damages in the *Katotikidis* case, aggravated damages would have been available, given that the franchisor had committed an independent actionable wrong and acted outrageously.

General damages for mental distress are similar to aggravated damages in that the objective is to recompense a plaintiff who has suffered upset, rather than punish the defendant. However, according to Harvin

⁸³ *Ibid.* at para. 73. For a recent statement from the Ontario Court of Appeal to this effect, see *Lyons v. Canada Life Assurance Co.* (2002), 42 C.C.L.I. (3d) 164 (Ont. C.A.) at para. 11.

⁸⁴ *Whiten*, *supra* note 65. See also Craig Brown et al, *Insurance Law in Canada* (Scarborough: Thomson Canada Ltd., 2002) at 10-26.

⁸⁵ *Whiten*, *ibid.* at para. 116.

⁸⁶ Stephen Waddams, *The Law of Damages* (Toronto: Canada Law Book, 1983) at 562-63, quoted with approval by the Supreme Court of Canada in *Vorvis*, *supra* note 69 at para. 16. This same passage is found in the 3rd edition as well (Toronto: Canada Law Book, 1997) at 483. An even more fulsome definition of aggravated damages is offered by the British Columbia Court of Appeal in *Huff v. Price*, (1990) 76 D.L.R. (4th) 138 at 153 (B.C.C.A.) as follows:

[A]ggravated damages are an award, or an augmentation of an award, of compensatory damages for non-pecuniary losses. They are designed to compensate the plaintiff, and they are measured by the plaintiff’s suffering. Such intangible elements as pain, anguish, grief, humiliation, wounded pride, damaged self confidence or self esteem, loss of faith in friends or colleagues, and similar matters....

Pitch and Ronald Synder,⁸⁷ these two heads of damage measure the defendant's conduct from different perspectives. General damages for mental distress will only be awarded where they pass the test for remoteness⁸⁸ stated in *Hadley v. Baxendale*.⁸⁹ It therefore does not matter whether the defendant does something at time of breach that is outrageous or not. The plaintiff's action for mental distress is entitled to succeed. Conversely, aggravated damages are appropriate *whether or not* mental distress arising from breach was in the parties' reasonable contemplation at time of contract.⁹⁰ Remoteness would presumably be assessed taking into account the circumstances present on the date of the breach.⁹¹ In short, aggravated damages compensate for humiliation and distress which flow from the "mode of and motive for the defendant's conduct rather than from the breach *per se*."⁹² These are subtle distinctions but do advance a coherent and important distinction. One head of damages (i.e. aggravated damages) assesses the conduct of defendant at the time of breach and compensates the plaintiff for the additional emotional harm it caused. The other head of damages (i.e. general damages for mental distress) assesses the matter from the perspective of the parties at the time of contract. The question of foreseeability for the recovery of general damages for mental distress and what recent case law requires in this regard is discussed in more detail later in this paper.

The difference between aggravated and general damages for mental distress proposed above is not free from controversy. Courts are notoriously inconsistent in the terminology they use as well as in their opinions as to the differences between the various monikers. For example, the British Columbia Court of Appeal stated in *Warrington v. Great-West Life Assurance Co.*:

In Canada, it is problematic to define the relationship between damages for mental distress and so-called "aggravated damages", and to differentiate between those and

⁸⁷ Harvin Pitch and Donald Synder, *Damages for Breach of Contract*, 2nd ed., loose-leaf (Scarborough: Thomson-Carswell, 1989).

⁸⁸ *Ibid.* at para 4.3(a).

⁸⁹ *Hadley v. Baxendale*, [1843-60] All E.R. 461 at 465. Briefly stated, the remoteness test would ask: at the time of contract, was it reasonably in the contemplation of the parties that mental distress would likely result from a breach or, alternatively, that such damages would flow as a result of special circumstances known and communicated?

⁹⁰ Pitch, *supra* note 87.

⁹¹ This is how aggravated damages are assessed according to employment law, for example. See Geoffrey England and Roderick Wood, updating authors, *Employment Law in Canada*, 3rd ed., vol 2, loose-leaf (Toronto: Butterworths, 1988) at para. 16.51.

⁹² Bruce Feldthusen and Neil Vidmar, "Recent Developments in the Canadian Law of Punitive Damages" (1990) 16 Can. Bus. L.J. 241 at 256.

punitive damages. This difficulty seems to be the result of the intertwining of punitive and aggravated damages in various judicial and academic pronouncements, even after the two were authoritatively severed — in England by the House of Lords in *Rookes v. Barnard*, [1964] A.C. 1129 H.L. and in Canada by the Supreme Court in *Vorvis*, *supra*. Speaking for the majority in *Vorvis*, McIntyre, J. first of all equated damages for mental distress with aggravated damages: see the reference at p. 1092 to “damages for mental distress, properly characterized as aggravated damages”. This pronouncement has sometimes been overlooked in subsequent cases....⁹³

While one can certainly understand the court’s wish to clarify this area, the move to collapse mental distress into aggravated damages is ultimately confusing since it uses the same term (‘aggravated damages’) to refer to compensation for emotional upset where a separate actionable wrong *is* required and compensation for upset where a separate actionable wrong *is not* required. In *Warrington*, for example, the plaintiff was given aggravated damages for mental distress not because he had established the separate actionable wrong but because a disability insurance policy, in the court’s words, “is one of the few contracts in which damages for mental distress are recoverable when they are proven to result from the breach of contract.”⁹⁴ The Supreme Court of Canada caused similar confusion in *Wallace*⁹⁵ where it awarded damages for mental distress to the plaintiff as a kind of damage for intangibles but not on the basis of a separate actionable wrong. As Pitch and Synder point out, the majority in *Wallace* incorrectly combined damages for mental distress and aggravated damages under the category of aggravated damages.⁹⁶ What they should have done is apply their analysis to each type of damage individually.

In the interests of maintaining a distinction between the distinct requirements of each type of damages, this paper will use ‘aggravated damages’ to refer to distress which must be accompanied by an independent actionable wrong and general damages for mental distress as the kind of distress which has no such requirement.

The difference between aggravated damages and damages for mental distress is a point of some debate, but successful claims of this nature are clearly rare in the commercial arena. Not only would mental distress not generally be foreseeable in the classic, arms-length commercial contract, contract law is not traditionally intended to compensate for such loss. As the English court has recently stated in *Johnson v. Gore Wood & Co.*⁹⁷

⁹³ *Warrington v. Great-West Life Assurance Co.* (1996), 139 D.L.R. (4th) 18 (B.C.C.A.) at para. 16 [*Warrington*].

⁹⁴ *Ibid.* at para. 22.

⁹⁵ *Supra* note 82.

⁹⁶ *Supra* note 87 at 4-5, their footnote 8.2A.

⁹⁷ [2001] 1 All E.R. 481 (H.L.).

“Contract-breaking is treated as an incident of commercial life which players in the game are expected to meet with mental fortitude.”⁹⁸ This echoes the court’s decision in *Watts v. Morrow*⁹⁹ where it is stated that “a contract breaker is not in general liable for any distress, frustration, anxiety, displeasure, vexation, tension or aggravation which his breach of contract may cause to the innocent party.”¹⁰⁰

At the same time, other courts have openly challenged this traditional assumption in contracts law. As Chief Justice Mason of Australian High Court has stated in *Baltic Shipping Co. v. Dillon*:¹⁰¹

But one might ask why the injured party [to a contract] should be deemed to take the risk of damage of a particular kind when the fundamental principle on which damages are awarded at common law is that the injured party is to be restored to the position (not merely the financial position) in which the party would have been had the actionable wrong not have taken place. Add to that the fact that anxiety and injured feelings are recognized as heads of compensable damage, at least outside the realm of the law of contract. Add as well the circumstance that the general rule has been undermined by the exceptions which have been engrafted upon it. We are then left with a rule which rests on flimsy policy foundations and conceptually is at odds with the important principle governing the recovery of damages, the more so now that the approaches in tort and contract are converging.¹⁰²

Indeed, the courts have developed numerous exceptions to the principle that intangibles are not compensable in a breach of contract action. And furthermore, as in *Warrington*, such damages are functionally considered to be distinct from aggravated damages since they have been awarded even absent the independent actionable wrong requirement of *Whiten*. This is a matter discussed in the following section.

B. Recovery for Mental Distress when the Plaintiff Cannot Prove a Separate Actionable Wrong

When the defendant’s objectionable conduct is less than an independent actionable wrong, the case law reveals at least three strategies for awarding damages for mental distress notwithstanding. These strategies have not yet been reconciled by the courts and therefore make this area of law problematic to summarize.

⁹⁸ *Ibid.* at para. 84.

⁹⁹ *Watts v. Morrow*, [1991] 1 WLR 1421 (C.A.).

¹⁰⁰ *Ibid.* at 1445.

¹⁰¹ [1992-1993] 176 C.L.R. 344 (H.C. of A.).

¹⁰² *Ibid.* at para. 38. Note however that the Chief Justice ultimately retreated from this position out of fear of opening the floodgates, at p. 365.

1. Exception Based on the Kind of Contract Involved

The first strategy is to create exceptions to the general rule. As the court in *Warrington* notes, the law gradually began to award damages for mental distress in situations where “freedom from mental distress or even actual enjoyment was the very thing contracted for and not provided.”¹⁰³

More recently, the House of Lords in *Farley v. Skinner*¹⁰⁴ has expanded the circumstances in which mental distress is available in a breach of contract action. Lord Steyn, for example, stated that mental distress is recoverable not only when peace of mind is the *very object* of the contract but also when peace of mind is simply an *important* part of the contract.¹⁰⁵ Since *Farley* is likely to have importance in Canada, a brief account of the case follows.

In *Farley*, the plaintiff contemplated buying a retirement home in the country-side. As part of his investigation, he hired a surveyor to determine, *inter alia*, whether the home was on a flight path and affected by aircraft noise. Acting negligently and in breach of contract, the surveyor reported no significant aircraft noise. On this basis, the plaintiff purchased the property but, much to his disappointment, the property was very affected by the nearby airport. As Lord Steyn summarizes the matter:

In fact, the property was not far away from a navigation beacon (the Mayfield Stack) and at certain busy times, especially in the morning, the early evening, and at weekends, aircraft waiting to land at Gatwick would be stacked up maintaining a spiral course around the beacon until there was a landing slot at the airport. Aircraft frequently passed directly over, or nearly over, the position of the house.... The house was undoubtedly affected by aircraft noise.¹⁰⁶

At trial, the court awarded non-pecuniary damages for the surveyor's failure to detect the aircraft noise but these were reversed by the Court of Appeal. The House of Lords restored the trial judge's award, with four of the five judges offering separate reasons for that outcome.

All the law lords, including Lord Steyn, agreed that the starting point for analysis was Lord Bingham's analysis in *Watts v. Morrow*.¹⁰⁷ Lord Steyn quoted from *Watts* the rule against recovery for distress in contract, as well as the following passage from that same decision:

¹⁰³ *Supra* note 93 at para. 13. These kind of contracts were also recognized by the Supreme Court of Canada in *Whiten*, *supra* note 65 at para. 115. There the court stated that “peace of mind” contracts as more likely to found mental distress damages.

¹⁰⁴ *Farley v. Skinner*, [2001] 3 W.L.R. 899 (H.L.) [*Farley*].

¹⁰⁵ *Ibid.* at para. 24.

¹⁰⁶ *Ibid.* at para. 6

¹⁰⁷ *Supra* note 99 at p. 1445.

...

(2) But the rule is not absolute. Where the very object of a contract is to provide pleasure, relaxation, peace of mind or freedom from molestation, damages will be awarded if the fruit of the contract is not provided or if the contrary result is procured instead. If the law did not cater for this exceptional category of case it would be defective....

(3) In cases not falling within this exceptional category, damages are in my view recoverable for physical inconvenience and discomfort caused by the breach and mental suffering directly related to that inconvenience and discomfort. If those effects are foreseeably suffered during a period when defects are repaired I am prepared to accept that they sound in damages even though the cost of the repairs is not recoverable as such. But I also agree that awards should be restrained, and that the awards in this case far exceeded a reasonable award for the injury shown to have been suffered. (Numbering introduced).¹⁰⁸

Most germane for the purpose of franchise law is Lord Steyn's analysis, which focuses on proposition (2) above (re: contracts whose very object is to provide pleasure, relaxation, peace of mind or freedom from molestation.) Lord Steyn rejected a narrow interpretation of the words 'very object' since it could produce an unfair outcome. In this regard, Lord Steyn was persuaded by the following passage from an article by David Capper:

A ruling that intangible interests only qualify for legal protection where they are the "very object of the contract" is tantamount to a ruling that contracts where these interest are merely important, but not the central object of the contract, are in part unenforceable. It is very difficult to see what policy objection there can be to parties to a contract agreeing that these interests are to be protected via contracts where the central object is something else.¹⁰⁹

Based on this kind of analysis, Lord Steyn ruled that it is sufficient that intangibles (such pleasure, relaxation or peace of mind) are a "major or important object of the contract..."¹¹⁰

Since the plaintiff's contract with the surveyor fit this description, Lord Steyn restored the trial judge's award for 'discomfort' in the amount of 10,000 pounds sterling.¹¹¹ He also admonished that the size of the trial

¹⁰⁸ *Farley*, *supra* note 104 at para 14, citing *Watts v. Morrow*, *supra* note 99 at p. 1445 per Bingham L.J.

¹⁰⁹ Lord Steyn quoting David Capper, "Damages for Distress and Disappointment – The Limits of *Watts v. Morrow*" (2000) 116 LQR 553 at 556, *supra* note 104 at para. 24.

¹¹⁰ *Farley*, *supra* note 104 at para. 24. The other Law Lords came to the same conclusion but for varying reasons.

¹¹¹ *Ibid.* at para. 28.

judge's award appeared on the very top end of appropriate, however, noting: "I consider that awards in this area should be restrained and modest. It is important that logical and beneficial developments in this corner of the law should not contribute to the creation of a society bent on litigation."¹¹²

Applying this analysis to the franchise situation, it could be argued that peace of mind is an *important* part of the franchise contract, either independently or as an incident of a good faith duty. There is a strong argument that the good faith obligation includes a promise not to cause the franchisee unnecessary distress or anxiety. Put in the negative, it forbids the parties from being obstructionist, uncooperative and unresponsive. Like the insurance contract (where a good faith duty is also owed), the franchise contract affects the franchisee's personal interests – both financial and emotional. As already noted, the relational quality of the franchise contract signals an obligation to work together, to cooperate, and to give due regard to the other's interest. Based on *Farley*, when the franchisor fails to respect these important contractual commitments, the franchisee is entitled to a modest amount of damages for mental distress or discomfort – provided it was a reasonably foreseeable consequence of breach.¹¹³

2. Exception Based on Foreseeability Alone

The second, and related, strategy to secure damages for mental distress is to treat the matter as a question going to foreseeability under one of the branches of *Hadley v. Baxendale* – either under the arm which permits recovery for generally foreseeable consequences or the arm which permits recovery based on the special circumstances of the case so known and communicated.

¹¹² *Ibid.*

¹¹³ Note that *Farley* has been applied by the British Columbia Court of Appeal in *Wharton v. Tom Harris Chevrolet Oldsmobile Cadillac Ltd.* (2002), 97 B.C.L.R. (3d) 307 (C.A.). On the basis of *Farley*, the court confirmed the trial judge's award to the plaintiff for "frustration, anxiety and inconvenience" due to the defendant's delivery of a defective luxury automobile. The amount awarded was \$5,000. See also *Vavra v. Victoria Ford Alliance Ltd.*, [2003] B.C.J. No. 1957 (Q.L.) where the plaintiff was awarded damages for "frustration, anxiety, interference with and loss of amenity, of her leisure lifestyle." By way of contrast, in *Chambers v. Ryan Warranty Services*, [2003] O.T.C. 329 – which does not mention *Farley* at all – the Ontario Superior Court would not award mental distress damages in a consumer product warranty case because the plaintiff had damaged his own vehicle by driving it when it was overheated, thereby causing his own loss. Second, even if the defendant were liable for the loss, damages for mental distress would not be recoverable because the contract "does not fall within the category of cases where 'peace of mind' is the very matter contracted for between the parties." at para 47.

In *Newell v. Canadian Pacific Airlines, Ltd.*,¹¹⁴ for example, one of the plaintiffs' dogs died in the cargo of a Canadian Pacific airplane and the other dog suffered serious injury – due to being packed beside dry ice. In an action for breach of contract, the plaintiffs also sought general damages for “anguish, loss of enjoyment of life and sadness” which resulted from the defendants' breach. The court awarded such damages because the defendants knew about the plaintiffs' deep attachment to their animals. Based on *Hadley v. Baxendale*, the court found that the defendants were well aware of the special circumstances of the case and therefore awarded general damages in the sum of \$500.¹¹⁵

This approach to mental distress was endorsed by Madam Justice Wilson, in her dissent in *Vorvis*¹¹⁶ but according to Pitch and Snyder, mere foreseeability is generally not enough – courts also tend to demand that there be a special relationship between the parties as well.¹¹⁷ Lord Steyn in *Farley*, for example, states that not only must mental distress be reasonably foreseeable, “the right of recovery is dependent on the cases falling fairly within the principles governing special exceptions.”¹¹⁸ The Supreme Court of Canada makes a similar statement in *Wallace*,¹¹⁹ a matter which is discussed in the following section.

There are, however, numerous examples of courts awarding mental distress damages based on foreseeability alone, both prior to and after *Wallace*. For a *post-Wallace* example, see the 2001 decision of *Page v.*

¹¹⁴ (1977), 14 O.R. (2d) 752 (Co. Ct.).

¹¹⁵ *Ibid.* at 771. Note that this decision could also be rationalized on the basis of *Watts v. Morrow*, *supra* note 99 or *Farley*, *supra* note 104.

¹¹⁶ *Supra* note 69. According to Justice Wilson in para. 46: “It is my view that the established principles of contract law set out in *Hadley v. Baxendale* provide the proper test for the recovery of damages for mental suffering. The principles are well-settled and their broad application would appear preferable to decision-making based on a priori and inflexible categories of damages. The issue in assessing damages is not whether the plaintiff got what he bargained for, i.e., pleasure or peace of mind (although this is obviously relevant to whether or not there has been a breach) but whether he should be compensated for damage the defendant should reasonably have anticipated that he would suffer as a consequence of the breach.” This is also the approach advocated by Andrew Phang, “The Crumbling Edifice? – The Award of Contractual Damages for Mental Distress” [2003] J.B.L. 341.

¹¹⁷ *Supra* note 87 at para. 4(b)(i) and following.

¹¹⁸ *Farley*, *supra* note 104 at para. 16; see also the discussion in section A. above.

¹¹⁹ *Supra* note 82. According to Justice Iacobucci for the majority, at para. 73: “An employment contract is not one in which peace of mind is the very matter contracted for (see e.g. *Jarvis v. Swans Tours Ltd.*, [1973] 1 Q.B. 233 (Eng. C.A.)) and so, absent an independently actionable wrong, the foreseeability of mental distress or the fact that the parties contemplated its occurrence is of no consequence, subject to what I say on employer conduct below.”

Russell.¹²⁰ Here, Justice Gallant followed the Alberta Court of Appeal's 1996 analysis in *Kempling v. Hearthstone Manor Corp.*,¹²¹ and awarded the plaintiffs the sum of \$1,000 for their unhappiness, frustration, and inconvenience as a result of defendant's construction delays. As the court observes:

A question arises as to whether any damages claimed by Russells [plaintiffs] for breach of the contracts are too remote. The starting case is *Hadley v. Baxendale* (1854), 9 Exch. 341, 156 E.R. 145 (Exch.). In short, the first rule is Page [sic] ought to receive damages which may fairly and reasonably be considered either arising naturally from the breach itself, or as may reasonably be supposed to have been in the contemplation of both parties, at the time that they made their contract, as the probable result of the breach of it. Picard J.A., in *Kempling v. Hearthstone Manor Corp.*, [1996] A.J. No. 654 stated that it was her view that the rule in *Hadley v. Baxendale* includes the means to test and limit liability where the claim arises through special circumstances known to the parties. The claimant must prove the causal link between the breach and the mental suffering or distress and the foreseeability of that injury. "A breach of contract will often result in unhappiness, frustration, inconvenience, anger and even malevolence. The rule is not intended to assure compensation in those cases. The rule allows a court to award damages but does not mandate doing so." I respectfully adopt the reasoning of Picard J.A.¹²²

Though it remains unsettled whether a court will permit recovery for mental distress based on foreseeability alone or whether it will require that the contract fall within a special category, this issue is unlikely to affect the outcome in a franchise dispute. If foreseeability is the only test for mental distress, a plaintiff franchisee should be able to

¹²⁰ [2001] A.J. No. 1640 (Q.B.) (Q.L.).

¹²¹ (1996), 137 D.L.R. (4th) 12 (C.A.) [Damages of \$7500 were upheld upon appeal]. For other pre-*Wallace* examples, see *Gourlay v. Osmond* (1991), 104 N.S.R. (2d) 155 (S.C.T.D.) [where the husband was awarded aggravated damages of \$1,000, and wife \$5,000 for mental distress]; *Nova Scotia (Minister of Housing) v. Langille* (1994), 133 N.S.R. (2d) 219 (S.C.T.D.) [Damages of \$3,000, awarded at trial, were increased to \$6,000 on appeal]; *Shillingford v. Dalbridge Group Inc.*, [1997] 3 W.W.R. 645 (Alta. Q.B.) [Damages of \$6,000 for mental anguish]; *Stoddard v. Atwil Enterprises Ltd.* (1991), 105 N.S.R. (2d) 315 (S.C.T.D.) [Non-pecuniary damages for mental suffering in the amount of \$3,000]; and *Taylor v. Gill*, [1991] 3 W.W.R. 727 (Alta Q.B.) [\$7,500 damages awarded for mental suffering].

¹²² *Page v. Russell*, *supra* note 120 at para. 39. See also, the 2002 Ontario Superior Court decision of *Turczinski v. Dupont Heating & Air Conditioning Ltd.*, [2002] O.J. No. 2295, where the court awarded the plaintiff \$3,500 for mental distress in a breach of contract action based on the foreseeability. Dupont knew that Turczinski suffered from a obvious and long-standing mental disorder and that breach of contract would worsen her condition beyond the extent of the pecuniary loss. According to the court, at paras. 175 - 176:

succeed on the right facts. Given the typical vulnerability that a franchisee faces at the hands of the franchisor, it is reasonably foreseeable that harsh treatment (including wrongful termination of the franchise contract) would cause mental distress. Alternatively, if the franchise contract must fit within a special category, there is solid argument that it could do so. As noted in the previous section, the franchise contract has strong parallels with contracts promising peace of mind, either independently or as an obligation associated with good faith. Mental distress damages should be available to the plaintiff on that basis.

3. Exception Based on 'Wallace' Damages

General damages for emotional distress are recoverable in a wrongful dismissal action even in the absence of the classically-required independent actionable wrong. This is a matter of great potential relevance to franchise law, particularly given the strong parallels which the Ontario Court of Appeal has already observed between the employment and franchise contract.¹²³

Historically, the wrongfully dismissed employee could not seek damages for mental distress. In *Addis v. Gramophone*,¹²⁴ for example, the court refused such compensation based, *inter alia*, on remoteness – non-financial injuries were not within the parties contemplation at the

Since *Brown v. Waterloo Regional Board of Commissioners of Police* (1983), 43 O.R. (2d) 113 damages are available for mental distress arising from a breach of contract. Weatherston J.A. adopted as correct the following from the Restatement of the Law of Contracts:

There is sufficient authority to justify the statement that damages will be awarded for mental suffering caused by the wanton or reckless breach of a contract to render a performance of such a character that the promisor had reason to know when the contract was made that a breach would cause such suffering, for reasons other than pecuniary loss.

In other words, such damages are available where the promisor had reason to know at the time the contract was entered into that a breach would result in such suffering for reasons other than the pecuniary loss.

See also *Cudmore v. Home Chec Canada Ltd.*, [2001] 3 W.W.R. 541 (Man. Q.B.) [where the court awarded damages of \$5,000 for “anxiety, stress, emotional disturbance and inconvenience”]; and *Sinha v. Sinha* (2002), 306 A.R. 250 (Q.B.) [where general damages were awarded for worry, upset and frustration].

¹²³ See *Shelanu*, *supra* note 4 at paras. 64-65. For further discussion of this point, see *infra*.

¹²⁴ [1909] A.C. 488 (H.L.).

time of contract.¹²⁵

In *Wallace*,¹²⁶ however, the Supreme Court of Canada recently held that even where a wrongfully dismissed employee *cannot* establish an independently actionable wrong upon which to found an aggravated damages claim, recovery for mental distress is still available where the employer has failed to treat the employee in good faith upon dismissal. Justice Iacobucci for the majority stated:

...I note that the loss of one's job is always a traumatic event. However, when termination is accompanied by acts of bad faith in the manner of discharge, the results can be especially devastating. In my opinion, to ensure that employees receive adequate protection, employers ought to be held to an obligation of good faith and fair dealing in the manner of dismissal, the breach of which will be compensated for by adding to the length of the notice period.¹²⁷

Though the majority's decision in *Wallace* deserves criticism for its lack of expansiveness, such a critique is not necessary to the thesis of this paper.¹²⁸ The essential point for now is that Canada's highest court is according legal recognition to a wide range of emotional suffering in a breach of contract action. As Justice Iacobucci stated:

injuries such as humiliation, embarrassment and damages to one's sense of self-worth and self-esteem might all be worthy of compensation depending upon the circumstances of the case....I recognize that bad faith conduct which affects employment prospects may be worthy of considerably more compensation than that which does not, but in both cases damage has resulted that should be compensable.¹²⁹

Though Justice Iacobucci's remedy for the poorly treated employee (in the form of an extended notice period) is novel, his Lordship's judicial solicitousness of such an employee is not. Like courts before him, Justice Iacobucci recognized that employees are a vulnerable group¹³⁰ that require

¹²⁵ *Ibid.* at 501.

¹²⁶ *Supra* note 82.

¹²⁷ *Ibid.* at para. 95.

¹²⁸ For such a critique, see for example, Jamie Cassels, *Remedies: The Law of Damages* (Toronto : Irwin Law, 2000) at 222 and following, Lee Stuesser, "Wrongful Dismissal – Playing Hardball: *Wallace v. United Grain Growers*" (1997-98) 25 Man. L.J. 547; John Swan, "Damages for Wrongful Dismissal: Lessons from *Wallace v. United Grain Growers Ltd.*" (1998) 6 C.L.E.L.J. 313; and Shannon O'Byrne, "Bad Faith – Contracts of Employment – *Wallace v. United Grain Growers Ltd.*" (1998) 77 Can. Bar Rev. 492.

¹²⁹ *Wallace*, *supra* note 82 at paras. 103-104.

¹³⁰ *Ibid.* at para. 93.

legal protection. As Dickson C.J. noted in an earlier case:

Work is one of the most fundamental aspects in a person's life, providing the individual with a means of financial support and, as importantly, a contributory role in society. A person's employment is an essential component of his or her sense of identity, self-worth and emotional well-being.¹³¹

See also the British Columbia Court of Appeal's analysis in *Deildal v. Tod Mountain Development Ltd.*, wherein Braidwood J.A. stated:

The contract under consideration here is not a simple commercial exchange in the marketplace of goods and services. A contract of employment is typically of longer term and more personal in nature than most contracts, and involves greater mutual dependence and trust, with a correspondingly greater opportunity for harm or abuse.¹³²

The Ontario Court of Appeal in *Shelanu* has recently picked up the theme of employee vulnerability that runs through the *Wallace* decision and applied it to the franchise contract. The court's objective in doing so is to demonstrate that in both kinds of contracts, a duty of good faith is accordingly owed. As Justice Weiler noted:

The relative position of the parties [ie: employer-employee] as outlined by Iacobucci J. in *Wallace* also exists in the typical franchisor-franchisee relationship. First, it is unusual for a franchisee to be in the position of being equal in bargaining power to the franchisor... The second characteristic, inability to negotiate more favourable terms, is met by the fact that a franchise agreement is a contract of adhesion. As I have indicated, a contract of adhesion is a contract in which the essential clauses were not freely negotiated but were drawn up by one of the parties on its behalf and imposed on the other. Further, insofar as access to information is concerned, the franchisee is dependent on the franchisor for information about the franchise, its location and projected cash flow, and is typically required to take a training program devised by the franchisor. The third characteristic, namely that the relationship continues to be affected by the power imbalance, is also met by the fact the franchisee is required to submit to inspections of its premises and audits of its books on demand, to comply with operation bulletins, and, often is dependent on, or required to buy, equipment or product from the franchisor. It is hardly surprising, therefore, that a

¹³¹ In *Reference Re Public Service Employee Relations Act (Alta.)*, [1987] 1 S.C.R. 313 at 368, quoted in *Wallace*, *supra* note 82 at para. 93.

¹³² (1997), 91 B.C.A.C. 214 at para. 77, leave to appeal to the S.C.C. dismissed, [1997] S.C.C.A. No. 338, quoted with approval in *Wallace* by McLaughlin J., dissenting in part, at para. 139. Note that in *Deildal*, the court found that the employment contract contained an implied term of good faith, something that the majority Supreme Court of Canada in *Wallace* was not prepared to do.

number of courts... have recognized that a duty of good faith exists at common law in the context of a franchisor-franchisee relationship.¹³³

In short, the franchisor classically enjoys superior bargaining power, greater access to information, and a large supervisory role over the franchisee. The franchisee, by way of contrast, is classically vulnerable to the exercise of power by the franchisor¹³⁴ and has tied his financial and emotional well-being to the franchise operation in question. Though franchisees are ordinarily classified as independent contractors,¹³⁵ the strong analogies between the employment context and the franchise context are undeniable. On this basis, and building on *Wallace*, there is a persuasive argument that the mistreated franchisee – particularly the one whose business is wrongfully terminated – is entitled to general damages for mental distress. Not only does the franchisee potentially stand to lose her livelihood and possibly her life savings,¹³⁶ her dignity and sense of self-worth are also in play. Some modest compensation for any mental distress may well be available based on breach of the good faith covenant.¹³⁷

¹³³ *Supra* note 4 at para. 66.

¹³⁴ As Lawrence Weinberg observed in “How and Why Franchise Disputes Arise: The Origins of the Species” in *Legal, Practical and Tactical Issues in Franchising Disputes* (Toronto: The Canadian Institute, 1994) at 18-19:

most franchise agreements and franchise systems seek to place numerous controls on the way in which the franchisee operates, and this can range from things such as dictating everyday operating procedures, determining the level of inventory to be maintained, to even prescribing the amount of money that a franchisee can take out of the business by way of salary.

¹³⁵ *Ibid.* at 18. See also Weinberg’s analysis of the exceptions to this general proposition at 19.

¹³⁶ Tom Karvanis, “Issues in Franchise Litigation” in *Franchising: The 1988 Institute of Continuing Legal Education* (Canadian Bar Association – Ontario) 1 at 15. See also Weinberg, *supra* note 134 at 5, who noted:

For both the franchisor and the franchisee, failure can be devastating. The franchisee can easily lose everything, as the franchise purchase is often financed on the security of all the franchisee’s personal assets, including the family home. A sufficient number of franchisor bankruptcies has occurred over the last number of years to clearly show that the failure of the franchisor is a distinct possibility, for instance upon the failure of a certain number of franchisee.

¹³⁷ Of course, a franchisee could not ask for the *Wallace* remedy of extending the employment notice period since this has no general relevance to the franchise contract.

C. Can a Corporation Suffer Mental Distress?

There is clear authority for the proposition that when a plaintiff is a corporation, it cannot receive damages based on distress and humiliation.¹³⁸ The rationale is that a corporation is inanimate and cannot experience these kinds of emotions. Such a prohibition poses an obstacle to recovery of aggravated damages and general damages for mental distress for the franchise that is conducted through a corporate vehicle.

There may be collateral ways for a corporate franchisee and those individuals behind it to secure mental distress damages. The first is to argue the injustice of a defendant being responsible for causing mental distress when the plaintiff franchisee is an individual but 'getting away' with the same conduct on the fortuity that the plaintiff is a corporation. This is unlikely to succeed since if the named plaintiff has not suffered the kind of damages claimed, it should not be compensable. A second way is to argue that those individuals *behind* the corporate franchisee feel distress for poor treatment just as much as if they had not operated through a corporation. On this basis, it would be argued that when the franchisee is a closely-held, 'mom and pop' corporation, the rigours of *Salomon v. Salomon*¹³⁹ should be relaxed and permit the individuals behind the corporate franchisee to recover intangible damages personally, provided they are plaintiffs to the action. While it is true that those who take the benefit of incorporation must also bear the burdens of incorporation, it could be argued, based on *Kosmopoulos v. Constitution Insurance Co.*,¹⁴⁰ that it would be too flagrantly opposed to justice to enforce the separate entities principle. However, given the overall judicial reluctance to compromise corporate law principles by lifting the corporate veil too readily, it may be more fruitful to argue that the franchisor has committed a tort against the

¹³⁸ See, for example, *Walker v. CFTO Ltd.* (1987), 37 D.L.R. (4th) 224 (Ont. C.A.) (a defamation case), which has also been followed in non-defamation cases as well, including *Hide-Away Resort Ltd. v. Van der Wal* (1999), 29 C.E.L.R. (N.S.) 235 (S.C.). See also *Pinewood Recording Studios Ltd. v. City Tower Dev. Corp.* (1998), 61 B.C.L.R. (3d) 110 (C.A.) at para 72 and cases cited therein. Note that the court in *Corporate Classic Caterers v. Dynapro Systems Inc.* (1997), 33 C.C.E.L. (2d) 58 (B.C.S.C.) shows slightly more flexibility, observing that "while it may be possible to award aggravated damages to a corporate plaintiff, it is more common for the personal plaintiff to secure them."

For an unusual American case which *does* award mental distress damages to the corporation, however, see *Smith v. Hoyer*, 697 P.2d 761 (Col. 1984). Here, both the individual and corporate plaintiff were awarded damages for mental distress for the bank's conduct in foreclosing on properties, having previously committed not to do so. The corporation's award for mental anguish was based exclusively on the individual plaintiff's upset and suffering, at 765.

¹³⁹ [1897] A.C. 22 (H.L.).

¹⁴⁰ [1987] 1 S.C.R. 2.

individuals behind the franchisee corporation and proceed to recovery on that direct basis.

The argument in tort is that the individuals behind the closely-held corporate franchisee are the franchisor's neighbours.¹⁴¹ These are individuals so closely and directly affected by the franchisor's action that it should reasonably have them in its contemplation when conducting itself. While there may be an important policy reason to negate this *prima facie* duty – namely the *Salomon* principle – the other view is that franchisors who treat individuals harshly should be held accountable. Furthermore, since the duty would only be owed where the franchisee corporation is closely held, there is little concern about unlimited liability to an indeterminate class.¹⁴² However, even assuming that this argument can be successfully made – and its success is not certain – the individual plaintiff faces one more potential difficulty.

According to *Koerfer v. Davies (c.o.b. Caerleton Farms)*,¹⁴³ mental distress arising out of negligence (as opposed to mental distress arising out of contract) is only recoverable where the plaintiff suffers from a recognizable psychiatric illness. Distress and humiliation are not enough.¹⁴⁴ More recent cases, such as *Mason v. Westside Cemeteries Ltd.*¹⁴⁵ challenge this proposition in highly persuasive terms:

In tort cases, courts have for the most part refused to award damages for emotional upset unless this has caused physical symptoms or some recognizable psychiatric illness. It has repeatedly been said that grief alone is not compensable in damages.... It is difficult to rationalize awarding damages for physical scratches and bruises of a minor nature but refusing damages for deep emotional distress which falls short of a psychiatric condition. Trivial physical injury attracts trivial damages. It would seem logical to deal with trivial emotional injury on the same basis, rather than by denying the claim altogether. Judges and juries are routinely required to fix monetary damages based on pain and suffering even though it is well known that the degree of pain is a subjective thing incapable of concrete measurement. It is recognized that emotional pain is just as real as physical pain and may, indeed, be more debilitating. I cannot see any reason to deny compensation for the emotional pain of a person who, although suffering, does not degenerate emotionally to the

¹⁴¹ The Supreme Court of Canada in *Hercules Managements Ltd. v. Ernst & Young*, [1997] 2 S.C.R. 165 has reconfirmed that the test for negligence is a two-step process: (1) is there a sufficient relation of proximity between the parties establishing a *prima facie* duty and if so (2) are there any considerations that should limit that *prima facie* duty, or eliminate it entirely?

¹⁴² For discussion of this concern in the area of negligent misstatement, see *ibid.*

¹⁴³ [1994] O.J. No. 1408 (C.A.) (Q.L.).

¹⁴⁴ *Ibid.* at para. 4.

¹⁴⁵ (1996), 135 D.L.R. (4th) 361 (Ont. Gen. Div.). *Mason* involved the emotionally traumatic instance of a cemetery losing the cremated remains of the plaintiff's parents.

point of actual psychiatric illness. Surely emotional distress is a more foreseeable result from a negligent act than is a psychiatric illness...But what is the logical difference between a scar on the flesh and a scar on the mind? If a scar on the flesh is compensable although it causes no pecuniary loss why should a scar on the mind be any less compensable?¹⁴⁶

The status of *Mason* is an open question. In *Vanek v. Great Atlantic & Pacific Co. of Canada*,¹⁴⁷ for example, the Ontario Court of Appeal had an opportunity to determine that matter, albeit in *obiter*, but decided to leave reconsideration of the “recognizable psychiatric illness factor” to another case.¹⁴⁸

V. Conclusion

The Supreme Court of Canada in *Whiten*¹⁴⁹ correctly observed that the vulnerability of one party in relation to another is generally not a concern of contracts law. As Justice Binnie observed: “Most participants enter the marketplace knowing it is fuelled by the aggressive pursuit of self-interest.”¹⁵⁰ But as the court also recognizes, laissez-faire sharp practice is not legally permissible in all contractual relationships. The employment contract, for example, holds the employer to a good faith standard and provides compensation for emotional distress should the employee be harshly treated on dismissal.¹⁵¹ On a related front, where peace of mind or actual enjoyment is the “very thing contracted for,”¹⁵² Canadian courts have permitted recovery for intangibles when that contractual term alone is breached. In *Farley*, the House of Lords has recently been even more expansive – it is sufficient that peace of mind is an *important* part of the contract.¹⁵³ As emphasized in this paper, *Farley* is a welcome development in the case law because it holds the parties to the full bargain instead of treating the contract as if it were only partially enforceable.

Given the relational nature of the franchise contract and, in particular, the vulnerability of the franchisee, it is more likely that punitive damages will be awarded in this context than in the classical arms-length commercial contract. This is simply a question of logistics – one party has

¹⁴⁶ *Ibid.* at para. 54, quoting from *McDermott v. Ramadanovic Estate* (1988), 44 C.C.L.T. 249 (B.C.S.C.) as per Southin J.

¹⁴⁷ (1999), 180 D.L.R. (4th) 748 (Ont. C.A.), leave to appeal refused, [2000] S.C.C.A. No. 50.

¹⁴⁸ *Ibid.* at para. 68.

¹⁴⁹ *Whiten*, *supra* note 65.

¹⁵⁰ *Ibid.* at para. 115.

¹⁵¹ *Wallace*, *supra* note 82.

¹⁵² *Warrington*, *supra* note 93 at para. 13.

¹⁵³ *Farley*, *supra* note 104.

more ample opportunity to conduct itself outrageously than is usually the case.

Also given the relational nature of the franchise contract – and the opportunity to inflict suffering on the other side – it would seem that aggravated damages and general damages for mental distress should be more readily available than they currently are. According to the scheme outlined in this paper, aggravated damages compensate the franchisee for ill-treatment by the franchisor at time of breach. If the franchisor breaches the contract in a way that causes the franchisee grief, humiliation or distress, and has committed an independent actionable wrong, this is compensable under *Whiten*.

As for general damages for mental distress, it could be argued that the franchise contract – as an incident of good faith – contains a promise that one party would not cause the other party unnecessary distress or anxiety. Because the good faith term signals a commitment of mutual support and cooperation, one party to the franchise contract (typically the franchisor) is not entitled to abandon the other in a ‘sinking ship’¹⁵⁴ nor, like crocodiles, “clamp their jaws down”¹⁵⁵ on the other party. Likewise, the franchisor cannot overburden the shoulders of the franchisee and leave her in circumstances where she cannot survive alone.¹⁵⁶ In short, the franchisor’s covenant not to inflict distress is bought and paid for by the franchisee. When it is breached and causes the innocent franchisee reasonably foreseeable anxiety and emotional upset, a modest sum as recompense should be awarded.

A closely related way of achieving this same end of recovery for mental distress is to argue, based on *Farley*, that peace of mind (again, as an incident of good faith) is an *important* part of the franchise contract and that therefore, damages for intangibles should be available. As this paper has emphasized, the franchisor is generally in a vastly superior position when it comes to resources and information. It largely decides the terms of the contract and has a large supervisory role over the franchisee during the duration of the contract. Not only is the franchisee vulnerable in this relationship, his or her financial interests are typically tied up in the operation and, given the importance of work to one’s sense of self and personal dignity – his or her emotional interests are likewise in play. In such a context, part of what the franchisee covenants for and what the franchisor promises to provide is peace of mind and freedom from undue or unnecessary distress or turmoil. Viewed from this perspective, the argument is not that contract law should lose some of its tough-mindedness by permitting recovery

¹⁵⁴ *Country Style*, *supra* note 29.

¹⁵⁵ *Head*, *supra* note 27 at 203.

¹⁵⁶ 9054-0402 *Québec*, *supra* note 31 at para. 46.

for intangibles. It is simply advocating that contract law continue to more fully recognize and enforce the promises which the parties have freely chosen.

*Appendix I**Breach Of Good Faith In Contractual Performance : A Sampling Of Recent Franchise Cases*

Year and Jurisdiction	Case Name	Nature of Bad Faith Alleged	Outcome
2004 Ontario S.C.J.	<i>Triple 3 Holdings v. Jan</i> , [2004] O.J. 2749 (S.C.)	In a highly egregious pattern of conduct, the franchisor: gave its franchisee possession of newly constructed premises after lengthy delay; supplied defective and used equipment; harassed the plaintiffs for non-existent rental arrears; extracted additional money from the plaintiffs by threatening to have them locked out of the franchise; ultimately instructed the bailiff to lock them out; and resold the franchise out from under the plaintiffs when they had an application pending for relief against forfeiture. Additionally, the franchisor provided no credit to the plaintiffs for the sale of the franchise, though it was obligated to do so. As yet another example of outrageous conduct, the franchisor's representatives pushed the franchisee around physically.	Action succeeded. Court awarded \$350,000 in punitive damages plus \$224,457 in other damages. The court agreed that a high punitive damages award would be consistent with the principles of <i>Whiten</i> because the plaintiffs were vulnerable, the defendants' conduct was planned and deliberate, and the defendants profited from their misconduct.
2000 Ontario S.C.J.	<i>Shelanu Inc. v. Print Three Franchising Corp.</i> (2002), 11 B.L.R. (3d) 69 (Ont. S.C.J.)	Franchisor, <i>inter alia</i> , unilaterally established a second line of franchise which competed with its current franchise's operation, failed to pay royalty rebates as agreed, and acted unreasonably in its promotional programmes. Franchisee sought damages and declaration that franchisee agreement was at an end as of May 6, 1997. Franchisor denied breach and counterclaimed for damages based on franchisee's breach of a non-compete clause.	Action succeeded; counterclaim dismissed. Contract rescinded. Damages awarded in the sum of \$369,000.

Year and Jurisdiction	Case Name	Nature of Bad Faith Alleged	Outcome
2003 Ontario C.A.	<i>Shelanu Inc. v. Print Three Franchising Corp.</i> (2003), 226 D.L.R. (4th) 577 (Ont. C.A)	Appeal and cross-appeal allowed in part. Franchisor did breach its duty to pay franchisee royalty rebates and did act unreasonably in its promotional programmes. Franchisor had good faith duty to make timely payments and exercise its discretion in a reasonable manner. However, the court of appeal reversed the TJ's finding that the franchisor was in breach for establishing a second line of franchise since it was not a competing line and did not cause the franchisee's losses. There was no fundamental breach.	Appeal and cross-appeal allowed in part. Franchisee not entitled to rescission as there was no fundamental breach. Franchisee not entitled to recover any royalties paid after a given date but was entitled to receive credit for royalty rebates wrongfully withheld by franchisor. Franchisor was entitled to certain advertising fees as well as damages for breach of non-compete clause by franchisee. Franchisee's damage award adjusted accordingly.
2003 Ontario S.C.J.	<i>Country Style Food Services Inc. v. 1304271 Ontario Ltd.</i> (2003), 32 B.L.R. (3d) 207 (Ont. S.C.J.)	Franchisee leased premises from franchisor who was in a head lease with the landlord. The lease document included a site plan for a commercial building to be constructed near the franchise operation. The landlord subsequently constructed a building significantly different from the one in the site plan, resulting in reduced access and traffic flow to franchisee's restaurant. The franchisee withheld rent and other sums, and the franchisor sued for breach. Franchisee counter-claimed, <i>inter alia</i> , against franchisor for breach of duty of good faith and misrepresentation.	Counterclaim allowed. Damages of \$400,000 awarded against franchisor and landlord, jointly and severally. The franchisee had to rely on the franchisor to pursue action against the landlord for varying the site plan to the franchisee's detriment. As the court stated: "the totality of the evidence propels the conclusion that Country Style turned its back on the franchisee when the latter needed it most. For whatever reason, it did not deal with its own franchisee in good faith" at para. 50

Year and Jurisdiction	Case Name	Nature of Bad Faith Alleged	Outcome
2003 Ontario S.C.J.	<i>1193430 Ontario Inc. v. Boa-Franc (1983) Ltée</i> (2003), 68 O.R. (3d) 382 (Ont. S.C.J.)	The defendant was a manufacturer of <i>pre-finished</i> hardwood flooring products. The plaintiff, a distributor for the defendant's products, sued when the defendant terminated, without notice, its exclusive distributorship agreement after the plaintiff's shares were sold to a company that made <i>unfinished</i> hardwood. The defendant had a legitimate interest in the transaction that left the plaintiff distributor wholly owned by a company that made a similar product, and the plaintiff knew that they had such an interest. The plaintiff distributor deliberately attempted to conceal the share purchase from the defendant manufacturer.	The plaintiff's duty of good faith required it to inform the defendant of the transaction. The failure to so inform the defendant was a breach of good faith, as was the later attempt to conceal the nature of the transaction when the defendant asked about it. The breach of duty of good faith gave the defendant just cause to terminate the distributorship agreement without notice.
2002 Ontario S.C.J.	<i>Katotikidis v. Mr. Submarine Ltd.</i> (2002), 26 B.L.R. (3d) 140 (Ont. Sup. Ct.) and (2002), 29 B.L.R. (3d) 258 (Ont. S.C.J.)	Franchisor abandoned plaintiffs at failing operation and offered a new franchise to a 3rd party when it had already committed to the plaintiffs. As well, the franchisor insisted that the plaintiffs honour a non-competition clause.	Action succeeded. Compensatory damages of \$524,521 (minus a 25 percent contingency). Punitive damages of \$10,000 for showing "callous disregard for the rights of its own franchisees." As the court stated in para. 70: "It is clear that unless powers of magnitude demonstrated by the franchise agreement are harnessed or at the very least tempered by implied obligations of fair dealing and good faith...their unrestrained exercise will inevitably lead to oppressive consequences."

Year and Jurisdiction	Case Name	Nature of Bad Faith Alleged	Outcome
2000 Ontario S.C.J.	<i>Jumbo Systems v. Short</i> , [2000] O.J. No. 56 (S.C.J.)	Franchisor sued for royalty arrears and advertising levies. Franchisee counterclaimed because, <i>inter alia</i> , franchisor recommended a franchise location without disclosing a secret \$50,000 tenant inducement paid by landlord to franchisor. Poor location was a cause of franchisee's lack of success. Franchisor also failed to disclose rebate income. Franchisee sought rescission of franchise agreement; individuals sought release from personal guarantees.	Court agreed that franchise location was based on secret inducement (which should have been disclosed). It agreed that poor location was a cause of the franchise's lack of success. Franchisee's counterclaim related to this dismissed due to waiver. Franchisee had earlier entered into a settlement agreement with franchisor and elected to continue the relationship. Rebates were contemplated by franchise agreement and failure to disclose them did not cause franchise to fail.
2002 Ontario C.A.	aff'd (2002), 154 O.A.C. 49.		Court of Appeal affirmed with brief reasons.
2002 Ontario S.C.J.	<i>Mr. Submarine v. Sowdaey</i> (2002), O.T.C. 915 (S.C.J.)	Franchisor sued franchisee and guarantor for breach of franchise agreement. Due to numerous breaches of agreement by franchisee, franchisor terminated and sought past royalties as well as future royalties. Franchisee counterclaimed, <i>inter alia</i> , for breach of franchisor's duty to deal fairly by terminating franchisee.	Counterclaim failed. Though some of the franchisor's conduct was unreasonable and unfair, continued operational non-performance by the franchisee justified termination. Franchisor entitled to past royalties but claim for future royalties also dismissed as being unfair, unreasonable and possibly a breach of fair dealing in its enforcement of the franchise contract. Cannot claim damages because franchisee's business failed.

Year and Jurisdiction	Case Name	Nature of Bad Faith Alleged	Outcome
2001 Ontario S.C.J.	<i>530888 Ontario Ltd. v. Sobeys Inc.</i> (2001), 12 B.L.R. (3d) 267 (S.C.J.).	Franchisee sought interlocutory injunction restraining franchisor from terminating its sublease. Both the sublease and franchise agreement were coming to an end.	Motion for an interlocutory injunction failed. No breach of fair dealing not to renew an expiring relationship.
2001 Ontario S.C.J.	<i>Country Style Food Services Inc. v. Hotoyan</i> , [2001] O.J. No. 2889 (S.C.J.).	Franchisor claimed against franchisee on a promissory note. Franchisee counterclaimed for release from this liability based on franchisor's bad faith in, <i>inter alia</i> , opening a new outlet and thereby causing financial loss to the franchisor.	Franchisor awarded judgment. Franchisor did not act in bad faith. The new outlet did not cause the franchisor's losses which were already well established.
2000 Ontario S.C.J.	<i>1005633 Ontario Inc. v. Winchester Arms Ltd.</i> (2000), 8 B.L.R. (3d) 176 (Ont. S.C.J.)	Franchisee claimed corporate franchisor and individual defendants (who were officers and shareholders of corporate franchisor and related companies) acted in bad faith due, <i>inter alia</i> , to precontractual misrepresentation, failure to provide proper training and support, failure to provide timely delivery of liquor license and delay in construction of the pub.	Corporate defendant liable. Individual defendants also personally liable (jointly and severally) based on own wrongdoing as well as on the basis of lifting the corporate veil. Individual defendants used defendant companies as their 'mere puppets'; failed to respect formalities; and systematically made the corporate entities judgment proof from the time when litigation was commenced. Court ordered contract rescinded plus return of franchise fee and reimbursement of plaintiffs construction costs as well as their out of pocket expenses.
2002 Ontario C.A.	aff'd (2002), O.J. No. 4711 (Q.L.)		TJ's decision affirmed in brief reasons.

Year and Jurisdiction	Case Name	Nature of Bad Faith Alleged	Outcome
1995 Manitoba Q.B. C.A.	<i>Imasco Retail Inc. (c.o.b. Shoppers Drug Mart v. Blanaru</i> , [1995] 9 W.W.R. 44 (Q.B.) [1997] 2 W.W.R. 295 (C.A.)	Franchisee was prohibited by the franchise contract from carrying on a separate business but did so secretly and to the financial detriment of the franchisor.	Franchisee conducted itself fraudulently. Secret profits were to the account of the franchisor. However, since the franchisor only sought a share based on the franchise contract's profit formula, award adjusted accordingly. C.A. affirmed with very brief reasons.
1997, 1998 Québec C.A.	<i>Supermarché A.R.G. Inc. c. Provigo Distribution Inc.</i> , [1997] A.Q. no 3710 (C.A.)	Franchisor, Provigo created a new concept of stores that competed directly with the existing franchisee A.R.G. Provigo remained in control of both the new Heritage stores and A.R.G.'s publicity and pricing. A.R.G. could not compete with Heritage's lower prices and superior marketing.	The franchisor had an obligation of loyalty towards the franchisee, and was obligated to consult the franchisee in the decision-making process. A tacit duty of good faith and support was owed by the franchisor to the franchisee. Damages in the amount of \$2,997,883 were awarded to the franchisee.
2000 Court of Québec, Civ. Div.	<i>9054-0402 Québec inc. c. Centre de santé minceur inc.</i> , [2000] J.Q. No. 1299	Franchisee alleged that false representations as to profitability of the venture and assistance to be provided by the franchisor were made.	The Court held that the franchisor had tacit obligations, even if they were not expressly provided for in the franchise contract. Representations made by the franchisor may give rise to implicit obligations, including assistance and support for the franchisee.
1995 Court of Québec	<i>2632-7502 Québec Inc. v. Pizza Pizza Canada Inc.</i> , J.E. 95-1568	Franchisor purported to resile from the franchise contract.	The franchisor could not unilaterally terminate the franchise agreement, without having recourse to a tribunal. Moreover, the franchisor has a duty to act in good faith and to be equitable in its dealings with the franchisee.

