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Gross Loss for Franchisee's Claim of "Net Losses"

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Introduction

The decision of the Alberta Court of Queen's Bench in *1777543 Alberta Ltd v. Got Mold Disaster Recovery Services Inc.*, 2019 ABQB 259 ("***Got Mold***") provides guidance on how a franchisee is to calculate "net losses" after cancelling their franchise agreement.

Pursuant to Section 13(b) of the *Franchises Act*, R.S.A. 200, c. F-23 (the "***Act***"), a franchisee can cancel (in Ontario and other franchise law provinces this is referred to as "rescission") their franchise agreement within two years if the franchise failed to give the prospective franchisee a disclosure document (case law has also deemed that a deficient disclosure document will also constitute non-disclosure), in accordance with s. 4 of the *Act*. Section 14(2) of the *Act* requires the franchisor to compensate the franchisee for its "net loss" from the acquisition, set up, and operation of the franchise.

Background Facts

The parties 1777453 Alberta Ltd. ("**177**") and Got Mold Disaster Recovery Services Inc. ("**GMDRS**") entered into a franchisee agreement for a term of five years on October 21, 2013, which was subsequently rescinded by 177 on February 27, 2015. Upon rescission 177 claimed net losses in acquiring, setting up, and operating the franchise in the amount of $200,394.27, which GMDRS refused to pay. By the time the matter reached the Court, the sole issue that remained was whether there were actual losses and, if so, what the quantum of those losses were.

The Expert Evidence

Most importantly, the Court determined that it will rely on the expert evidence led by the parties in determining "net loss", where such determination is not a simple matter.

The Court focused on analyzing the evidence of the two different expert witnesses, who each explained how they calculated the net losses 177 suffered for the acquisition, set up, and operation of the franchise. The losses claimed by the experts differed by approximately $200,000.00. While both experts agreed that a determination of net loss requires an off-setting of the expenses against the revenue of a business, GMDRS's expert engaged in additional rationalizing and normalizing of the expenses 177 claimed.

177's expert determined the franchisee's losses by calculating the difference between 177's expenses versus revenues; however, this is where his analysis more or less ended. 177's expert relied solely upon the financial statements provided by 177 and nothing more. The result was a relatively basic analysis to come to the conclusion that 177 suffered a net loss in the amount of $199,637.00. 177's expert did not review 177's general ledgers, invoices issued for the expenses claimed or cheques issued as payment for invoices.

On the other hand, GMDSR's expert, analyzed numerous pieces of evidence including affidavits and undertakings from the directors of 177, financial statements, and even 177's expert's report. Through this analysis GMDSR's expert identified a number of problematic claimed expenses from 177.

Included in 177's ledgers were expenses for things such as management or accounting fees, where the owners provided services to 177 at abnormal and above-market rates. GMDSR'S expert reasoned that these expenses should be reduced in calculating losses because the owners charging above market rates for services was really just a different way of distributing profits or providing dividends to the owners. For instance, if an owner charged $100,000.00 for marketing services, yet commercial practices in the area indicated the exact same service would only cost $50,000.00 from outside hires, then in reality the "expense" was only $50,000.00. Essentially, GMDSR's expert's methodology involved rationalizing the expenses to determine whether their values were commercially reasonable and normal.

GMDSR's expert also included one other important caveat in his analysis of net losses for 177. He argued that the calculation of profits versus losses for 177 didn't stop when the franchise agreement terminated, as 177 had actually continued in the mold business after terminating the Agreement. GMDSR's expert argued that 177's current profits were relevant to the calculation of net losses as the knowledge, knowhow, and acquisition costs associated with operating a mold business, which 177 obtained from the franchise agreement, were now being used to contribute to the profits in their new business.

<u>The Final Decision</u>

The first issue determined by the Court was the time frame to use in calculating any losses and profits, *i.e.*, whether the calculation of "net losses" should include or exclude the profits 177 had obtained since opening their new mold business, being subsequent to the cancellation of the franchise agreement. The Court agreed with GDSMR's expert and stated that the *Act* is not meant to give franchisees a windfall by allowing them to obtain resources from a franchisor and then use those resources to start their own business in the same field. As a result, 177's profits in their new mold business were to be included in the calculation of "net loss".

The second issue determined by the Court was whether or not to "normalize" and "rationalize" 177's expenses based on regular commercial practice. Here, the Court again accepted the evidence of GMSDR's expert and concluded that it only made sense to properly normalize and

rationalize expenses, as to not do so may allow for parties to claim windfalls by allowing directors or shareholders to receive payments disguised as expenses and then claim those expenses as losses.

Ultimately, based on the overstated expenses from 177 and the profits they received from operating their new business, the Court determined that 177 did not in fact suffer any net losses and they did not receive any damages.

Practice Takeaways

The takeaway from the Got Mold case is twofold, that (at least in Alberta) calculating net losses requires:

1) normalizing a franchisee's balance sheet to accurately reflect the true expenses; and

2) that the franchisee account for their profits following the cancellation of the franchise agreement, if their future profits are connected to the resources acquired through the franchise agreement. The analysis for net losses does not end simply on the date the agreement ended, the timeline is not as clear as that and may involve analyzing profits post-agreement too.

Before commencing claims lawyers (at least in Alberta) need to therefore assess these two issues.

Note however must be taken that in Ontario, and perhaps some other provinces with franchise legislation, the *Arthur Wishart Act (Franchise Disclosure) 2000,* S.O. 2000, c. 3 (the "***Wishart Act***") does not expressly provide for the netting out of losses the profits received by the franchisee from the operation of the franchised business, either before or after, the rescission of the franchise agreement. Firstly, following the decision of *2189205 Ontario Inc. v. Springdale Pizza Depot Ltd.*, the Court of Appeal for Ontario held that a franchisee can be compensated for damages under subsections 6(6)(a), (b) and (c) regardless of whether or not the franchisee suffered any losses. Further in *2122994 Ontario Inc. v. Lettieri*, the Ontario Court of Appeal for Ontario also affirmed that a franchisee does not have to take into account its profits since the *Wishart Act* is not a net loss regime.