

Quebec Court Rejects Franchisor's *Bankruptcy and Insolvency Act* Proposal

Noah Leszcz

October 17, 2017

In a recent case out of Quebec, Liquid Nutrition Franchising Corporation (the Franchisor) was deemed to have made an assignment pursuant to the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 (BIA), after failing to obtain approval of its BIA proposal.¹ Specifically, in May 2017, the Quebec Superior Court denied the Franchisor's Trustee's motion for approval of the Franchisor's proposal to its creditors (the Proposal). The Court's refusal to approve the Proposal resulted from a motion by two franchisees (the Claimants).

The Court refused to approve the Proposal because the director of the Franchisor would have benefited from the Proposal and been released from liability for claims against him by the franchisee Claimants. This case demonstrates that a franchisor cannot use the BIA to achieve an inequitable result with respect to its franchisees in a proposal proceeding.

To understand the reasoning behind the decision, it is helpful to examine the relationship between the Franchisor and its franchisees, as well as the rationale behind the Proposal.

The Background

The Franchisor, along with its parent corporation, Liquid Nutrition Group Inc. (LNGI), offer franchises for health food and drink retail outlets. The Claimants alleged that the Franchisor and LNGI had been inducing franchisees to purchase franchises based on misleading or false representations.

For this reason, the Claimants, along with several other disgruntled franchisees, had previously filed separate lawsuits against the Franchisor and LNGI, totalling several millions of dollars under various heads of damages including claims under the *Arthur Wishart Act (Franchise Disclosure)*, 2000, S.O. 2000, c. 3 (the *Wishart Act*). One of the claims was initiated by a franchisee known as 2308818 Ontario Limited (2308818) and Kurt Khan (collectively, the 230 Creditors).

In the face of several franchisee lawsuits, the Franchisor decided to make the Proposal to compromise its liabilities. If the Proposal was approved, the Franchisor and LNGI would not only compromise their debts and liabilities, but also release the directors and officers from any personal liability they may have had under the *Wishart Act* in the aforementioned actions.

The Claimants alleged that the Proposal was a scheme put forward by Chamandy, a director and officer of

Cassels

the Franchisor and LNGI, for his own personal benefit. It is important to note that LNGI, the parent of the Franchisor, was the largest creditor of the Franchisor, but could not vote in favour of the Proposal because it was a “related person” under the BIA. Its claim was also subordinated to all other claims against the Franchisor. As such, it would not have received any dividends under the Proposal.

The Franchisor reached out to its second largest creditors, the 230 Creditors, and offered \$210,000 to settle the 230 Creditors’ \$2.3 million claim against the Franchisor, if the 230 Creditors voted in favour of the Proposal. The settlement funds were paid into trust, and if the Proposal was approved by the Franchisor’s creditors, the funds would be paid to the 230 Creditors. The 230 Creditors also agreed to transfer and assign any entitlement the 230 Creditors had to dividends under the Proposal to a party related to the debtor.

The Trustee valued the 230 Creditors’ claim at the full amount of \$2.3 million. The remainder of the claims that had been accepted by the Trustee were valued at \$390,000. As such, the 230 Creditors would receive a substantial portion of the dividends under the Proposal.

Chamandy was funding the \$150,000 offered to the Franchisor’s creditors under the Proposal.

By virtue of the assignment by the 230 Creditors, Chamandy would receive a substantial portion of the \$150,000 Proposal payment back in the form of a dividend and the Franchisor’s other creditors would receive pennies on the dollar.

In essence, by settling the claim of the 230 Creditors, and the 230 Creditors’ assignment of their entitlement to dividends, Chamandy ensured that he would no longer be personally liable for the *Wishart Act* claim, and that he would personally receive a substantial portion of the dividends payable under the Proposal.

The Rejection of the Proposal

Under the BIA, related persons, as defined in the BIA, are not entitled to vote in favour of a proposal. As such LNGI, despite being the largest creditor of the Franchisor, was not entitled to vote in favour of the Proposal.

The question was then raised: was the 230 Creditors’ vote in favour of the Proposal their own vote, in their capacity as creditor, or rather, in their capacity as agents for Chamandy? If the 230 Creditors were voting in their capacity as agent for Chamandy, then Chamandy was in control of the claim of the 230 Creditors and was in the same position as a creditor voting in favour of the Proposal. Further, without the 230 Creditors’ vote in favour of the Proposal, the Proposal would not have been approved as the Claimants would have been able to vote down the Proposal.

The Court’s reasoned analysis succinctly summarized the series of events: “Chamandy enters into a series of contracts pursuant to which he literally purchases the third party’s rights, title and interests into a very

substantial claim (more than 2.3 million) for roughly 10% of its face value. In exchange for cash, 2308818 agrees to vote its full unliquidated claim in favour of the Proposal as well as surrendering its right into any dividend resulting from the approval of the Proposal. In the opinion of the undersigned, Chamandy is now in full control of the 2308818 claim and, therefore, Chamandy is in the exact same position of a person voting in favour of the Proposal.”²

Accordingly, the Court declared that the 230 Creditors were voting as agent for Chamandy, that Chamandy was in control of the claim of the 230 Creditors and was in the same position as a creditor voting in favour of the Proposal. The Claimants were therefore successful, and the motion to approve the Proposal was dismissed. As a result, the Court declared that the Franchisor was deemed to have made an assignment under the BIA.

The Takeaway from Franchisors

The decision in *Liquid Nutrition* provides some guidance to franchisors that are attempting to work through potential insolvency issues. Franchisors will have to be extremely careful when attempting to craft solutions to deal with outstanding litigation, as the purchase and settlement of claims may not permit the franchisor to generate support for any BIA proposal they make. Courts will closely examine such transactions and will consider the interest of all creditors in determining whether such proposals are accepted.

¹ A proposal is an offer by a debtor to its creditors to compromise its debts and often involves the payment of a percentage of what is owed over a specific period of time, or to extend the amount of time to pay off the debt, or a combination of both. Creditors vote to accept or reject the proposal. Following a successful vote, the trustee must apply to a court for approval of the proposal.

² Proposition de Liquid Nutrition Franchising Corporation, 2017 QCCS 1928 (CanLII) at para 68.