Cassels

Alberta Court of Appeal Provides Guidance on Net Loss Calculation on Rescission

05/26/2021

A recent decision of the Court of Appeal of Alberta provides guidance on the calculation of net losses on rescission, including charges for services provided by principals and whether profits earned by a franchisee following the rescission can be taken into account.

Summary and Implications

In *1777453 Alberta Ltd. v Got Mold Disaster Recovery Services Inc.,*[1] the Court of Appeal of Alberta considered the calculation of expenses claimed by a franchisee that rescinded a franchise agreement under the Alberta *Franchises Act*. The Court held that the reasonableness of the expenses should be assessed, including any amounts paid to the principals of a franchisee for services they provided, and specifically, they should reflect market value for similar services.

The Court also held that future profits earned by a franchisee cannot be used to offset losses that a franchisee may have incurred for the purposes of calculating compensation payable to the franchisee in connection with a rescission.

Although the Court declined to take into account a franchisee's future profits in calculating net losses, the decision arguably leaves open the argument that intangibles received during the franchise relationship could be taken into account. Intangibles received during the franchise relationship, such as training, have value and therefore should be taken into account when calculating net losses. This is particularly true if the intangibles are likely to contribute to the future profits of the franchisee. The decision did not address this point, so it may be open for someone to argue in the future.

Background of the Case and Findings

1777453 Alberta Ltd. (the Franchisee) operated a mold remediation business as a franchisee of Got Mold Disaster Recovery Services Inc. (the Franchisor). The Franchisor did not disclose as required by the *Franchises Act* (Alberta).[2] The Franchisee provided notice of rescission within the time period allowed.

Under Section 14(2) of the *Franchises Act*, on rescission, a franchisor is to "compensate the franchisee for any net losses that the franchisee has incurred in acquiring, setting up and operating the franchised

business." As liability was acknowledged by the Franchisor, the dispute between the parties related to the amount of compensation.

The matter was originally heard by way of a special chambers hearing.[3]

In determining net losses, the Chambers Judge stated that damages were to be assessed on the basis of reliance damages as opposed to expectation damages for breach of contract. The Chambers Judge stated: "Reliance damages are concerned with wasted expenditures and are intended to put the plaintiff back in the same position it would have been had the agreement never been executed."

The Chambers Judge then went on to consider whether or not profits made by the Franchisee following the rescission can be taken into account in determining net losses. The Chambers Judge held that they could and stated:

This would mean that a franchisee may have an obligation to account for a profit earned after the period of a franchise agreement if those profits are connected to the assets, training and knowledge the franchisee obtained through the franchise agreement.

As well, in assessing the expenses claimed by the Franchisee, the Chambers Judge reviewed payments made to three principals of the Franchisee for management, accounting and advertising services. The Chambers Judge held that the expenses must be reasonable, including not being above market value or rates for similar services. In this regard, the Chambers Judge accepted evidence provided by an expert witness for the Franchisor on the market value of the services and reduced the amounts claimed as expenses to the market equivalent of those services.

The matter was then appealed to the Court of Appeal of Alberta.

In reviewing the purpose of the relevant provisions, the Court of Appeal stated:

At the end of the day, an award of net losses under s. 14(2) of the Act is intended to return a franchisee who suffers net losses to the financial position the franchisee was in prior to entering the franchise agreement. In our view, what is contemplated by s. 14(2) is simply that "net losses" are to be calculated as the difference between the revenue generated by the franchisee during the currency of the franchise agreement and the expenses incurred to acquire, set up and operate the franchised business during that same period of time. Relating net losses to profits realized by the franchised business makes the analysis more complicated than the statute contemplated. What is contemplated is a deficit whereby the costs of acquiring, setting up and operating the franchised business exceed revenues earned during the currency of the franchise agreement.

In reviewing the Chambers Judge's handling of future profits, the Court of Appeal held that taking into account future profits is beyond what is contemplated by the *Franchises Act* and, particularly, net losses are

to be assessed during the period in which the franchisee was acquiring, setting up and operating the franchised business, in other words, during the currency of the franchise agreement.

In assessing the reasonableness of the expenses, the Court stated:

We agree that a franchisee's claim for net losses may be subjected to an assessment for reasonableness when such losses are disputed. As was stated by the chambers judge "a franchisee [in the absence of such an assessment] would be able to incur any number of expenses that do not fall within the scope of the mischief at which section 14(2) is aimed". On the other hand, the assessment of the reasonableness of expenses incurred by a franchisee in good faith ought not to be a hindsight-aided assessment of the prudence of each and every expense incurred, keeping in mind that an inexperienced, new franchisee may incur costs which, in hindsight, might appear to be less than prudent. Such scrutiny must be undertaken with a degree of deference to the business decisions of the inexperienced, unsophisticated new franchisee. Here the principals of the franchisee were not unsophisticated and at the end of the day, the court's role is to ensure that any amount awarded for net losses does justice to both parties.

On this basis, the Court of Appeal agreed with the Chambers Judge's handling of the management, accounting and advertising expenses and that those expenses should be reduced to the market equivalent for similar services.

Key Takeaways

This case provides some general guidance on calculating net losses for the purposes of rescission under the Alberta *Franchises Act*. In particular, in assessing net losses, the Court can review the expenses to ensure they are reasonable. In this regard, when faced with a rescission it is important to review the claimed expenses to ensure they properly relate to the franchised business and, where amounts were paid to individuals or entities related to the franchisee, the expenses should be assessed for their reasonableness. Expert evidence can help in this regard.

While the Court of Appeal of Alberta determined that future profits cannot be taken into account, it may be open for the Court to look at the value the former franchisee received from the franchise arrangement. Obviously, in assessing net losses upon rescission, the value of any equipment needs to be taken into account, whether that equipment is to be retained by the former franchisee for use in a business or sold. Similarly, if the franchisee is able to make use of intangibles, such as general training and knowledge, then that should be taken into account as well.

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[1] 2021 ABCA 9, https://canlii.ca/t/jclmw

[2] RSA 2000, c F-23

[3] 2019 ABQB 259, https://canlii.ca/t/j001k

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