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Springdale Pizza: More than 2 for 1…

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Should franchisees be able to get something for nothing? One would think not but in the recent decision in *2189205 Ontario Inc. et al. v. Springdale Pizza Depot Ltd. et al.*, 2013 ONSC 1232, 2013 CarswellOnt 2630 (*Springdale Pizza*), the Ontario Superior Court of Justice may well have set a precedent for precisely this result.

The unique aspect of this case is that unlike the majority of rescission cases, the rescinding franchisee earned a net profit during the period of operation before rescission. The issue before the court was whether any net profits could be set off against the losses for which the franchisee was to be compensated pursuant to section 6(6) of the *Arthur Wishart Act (Franchise Disclosure) 2000*, S.O. 2000, c. 3 (the "*Wishart Act*"). *Springdale Pizza* is among the first, if not the first, rescission case to consider the issue of a franchisor's obligation to compensate a franchisee for any losses suffered during the course of the franchise relationship when the franchisee earned a profit.

It is readily acknowledged that the *Wishart Act* is remedial legislation. Nowhere, however, is the *Wishart Act* said to be penal towards franchisors. When a franchisee recovers all expenditures outlaid in the operation of the business without any offset for the profits generated from those expenditures one might say that the *Wishart Act* is operating to penalize the franchisor.

The saga of *Springdale Pizza* begs the question whether the *Wishart Act* is being interpreted to provide a windfall in addition to the remedial aspects of its provisions?

To these admittedly franchisor-friendly authors, the refusal of the court to net out profits against section 6(6) damages as determined in *Springdale Pizza* results in the Wishart Act penalizing franchisors, a result well beyond its otherwise remedial purposes.

Background

In this latest decision in the long-running and procedurally-complex *Springdale Pizza* saga, the court was asked to reconsider a June 2012 decision of Master Muir assessing the damages owed to the rescinding franchisee under section 6(6) of the *Wishart Act*. This followed a declaration that the franchise agreement between the parties was validly rescinded. In determining the amount to be paid by the franchisor under section 6(6)(d), the Master found that because the franchisee earned a net profit of $8,314,48, no compensation was owed under that sub-section.

Although the net profit earned was of a modest amount, it raises the novel question of what a court should do in such a situation. Should the net profit be set-off against any amounts awarded under sections 6(6)(a) to (c) (which is the thrust of this article); or should it simply result in no compensation under section

6(6)(d) (as later upheld by the court in *Springdale Pizza*) (a result which to these authors is a windfall to franchisees)?

Section 6 of the *Wishart Act* allows a franchisee to rescind a franchise agreement in one of two situations. First, where the franchisor failed to make timely disclosure, under section 6(1), the franchisee may rescind the franchise agreement within 60 days after receiving the disclosure document. Second, in situations where no disclosure document was received, or where the disclosure document was so deficient as to amount to no disclosure, pursuant to section 6(2), the franchisee may rescind the franchise agreement no later than two years after its execution.

On rescission, the franchisor's obligations are set out under section 6(6) of the *Wishart Act*, which states:

> **Franchisor's obligations on rescission**
>
> (6) The franchisor, or franchisor's associate, as the case may be, shall, within 60 days of the effective date of the rescission,
>
> > (a) refund to the franchisee any money received from or on behalf of the franchisee, other than money for inventory, supplies or equipment *[i.e. royalties, ad fees and other upfront fees]*;
> >
> > (b) purchase from the franchisee any inventory that the franchisee had purchased pursuant to the franchise agreement and remaining at the effective date of rescission, at a price equal to the purchase price paid by the franchisee *[i.e. inventory on-hand at the time of rescission]*;
> >
> > (c) purchase from the franchisee any supplies and equipment that the franchisee had purchased pursuant to the franchise agreement, at a price equal to the purchase price paid by the franchisee *[i.e. supplies and equipment, uniform costs without accounting for any depreciation that may have been taken against these items]*; and
> >
> > (d) compensate the franchisee for any losses that the franchisee incurred in acquiring, setting up and operating the franchise, less the amounts set out in clauses (a) to (c). *[but what if the franchise operated at a profit?]*

A Franchisee's Profits Should be Offset Against Losses Under Section 6(6) of the *Wishart Act*

In practice, section 6(6) establishes the framework under which franchisors are to compensate franchisees for any losses incurred in establishing and operating the franchise where a proper notice of rescission is delivered. Section 6(6) appears to assume that the franchisee suffered losses during the period leading up to rescission of the franchise agreement. It is not immediately clear, however, how section 6(6) should operate where a franchise was profitable for the franchisee. It is no wonder that section 6(6) is unclear in cases where a franchisee has been profitable, since in some cases it would be counter-intuitive for a profitable franchisee to seek statutory rescission in the first place.

Under section 6(6)(d) the franchisor is to compensate the franchisee for losses not captured by sections 6(6)(a) to (c). By including the language "less the amounts set out in clauses (a) to (c)" in section 6(6)(d), it is clear that the legislature is seeking to avoid double recovery for the rescinding franchisee. It follows that where, for instance, accounting write-downs have been made to reflect the depreciation of equipment or loss of inventory (through spoilage or redundancy), this should be clawed back under section 6(6)(d) where the rescinding franchisee has been compensated for the full value of the acquisition cost of the items written down or depreciated under section 6(6)(b) or (c).

This reasoning should also extend to circumstances where the franchisee has earned a profit under section 6(6)(d). The franchisor in *Springdale Pizza* argued that because the franchisee earned a profit, this should be reflected in section 6(6)(d) and be set off against any losses under sections 6(6)(a) to (c). This interpretation was rejected by Justice Lederman, who concluded that section 6(6) is clear and "does not say that a franchisor is allowed to offset any revenue or gain under subsection (d) from amounts awarded under subsections (a) – (c)." Justice Lederman went on to say that:

> if it were otherwise, subsections (a) – (c) of the Act would not be necessary. A single section providing compensation for losses would suffice if the intention of the Act was simply to put the franchisee back into its former position. For example, *The Alberta Franchises Act,* R.S.A. 2000, c. F. -23 at ss. 13-14 simply grants a rescinding franchisee compensation for its net losses rather than the itemized array incorporated into Ontario law.

Perhaps the Alberta franchise legislation is not an apt comparison. Closer to home, the Ontario Court of Appeal (in *1490664 Ontario Ltd. v. Dig This Garden Retailers Ltd.*, 201 O.A.C. 95, 2005 CarswellOnt 3097 at para. 31 (Ont. C.A.) (*Dig This Garden*)) has indicated that the purpose of the section 6(6) is precisely what Justice Lederman said it was not. That is: "to put the franchisee back in its pre-franchise position".

Contrary to the court's view in *Springdale Pizza*, the itemized array in section 6(6)(a) through (c) is not inconsistent with a set-off for profits earned in section 6(6)(d). Rather, the itemized array assists in specifying which losses are to be reimbursed on rescission. For instance, a loss such as a loss of opportunity does not necessarily fall within the scope of section 6(6).

The purpose of section 6(6) is to provide compensation for losses. If there are no losses on operation, (i.e. the franchisee was profitable) the franchisor should receive the net benefit of that profit in the section 6(6) calculation. This is consistent with the purpose of the provision as expressed in the Hansard during the Committee Debate on the *Wishart Act* on March 6, 2000. In that debate, Joseph Hoffman, director of policy and agency relations at the Ministry of Consumer and Commercial Relations, stated:

> If the franchisee decides that there has not been disclosure of the material facts or about a material change and elects to exercise the rescission right within 60 days of receiving notice of rescission from the franchisee, the franchisor must refund any money received from or on behalf of the franchisee other than money for inventory supplies and equipment; **buy back at the purchase price any inventory remaining at the date of rescission which has been sold in accordance with the agreement**; buy back at the purchase price any supplies and equipment that has been sold to the franchisee in accordance with the agreement; and **compensate the franchisee for any losses that the franchisee incurred in acquiring, setting up and operating the business**. The burden of proof under the statute is on the franchisor to go to court and demonstrate that disclosure has been carried out in accordance with the act, otherwise these obligations are in effect. [Emphasis added.]

This passage implicitly recognizes that there would be a windfall for inventory that is no longer on the shelf. To the extent that a profit was made on any inventory sold pursuant to the franchise agreement, why should the franchisor not get credit for that?

Moreover, on April 19, 2000, Mr, Hoffman stated that the obligation of the franchisor on rescission extends to the repayment of monies:

> A franchisee does not need to go to a court to exercise that right of rescission. The legislation as drafted right now allows the franchisee to exercise that option. Once they exercise the rescission requirements in accordance with the statute, that triggers certain obligations on behalf of the franchisor in terms of the repayment of monies, etc.

Finally, and similarly, the explanatory note accompanying the *Wishart Act* explains that franchisees are to be compensated for losses:

> 5. A franchisee is entitled to damages for loss if the disclosure document or statement of material change contained a misrepresentation or if the franchisor failed to comply in any way with the requirements respecting the disclosure document or statement of material change.

There is nothing to suggest that in drafting section 6(6), the legislature contemplated that a rescinding franchisee could obtain a windfall gain under that section. Rather, the concept of reimbursement permeates the legislative debate on the *Wishart Act*, then Bill 33. This is inconsistent with an interpretation of section 6(6)(d) that would provide a franchisee with a windfall upon rescission. This concept is also reflected in jurisprudence from the Ontario Court of Appeal.

In *Beer v. Personal Service Coffee Corp.* (2005), 200 O.A.C. 282, the Ontario Court of Appeal recognized the remedial nature of section 6(6) and stated "... once rescinded, the franchisor must fulfil the ***reimbursement*** obligations set out in s. 6(6)." (Emphasis added)
Similarly, in *Dig This Garden* the Court of Appeal stated:

> The Act is designed to put the franchisee back in its ***pre-franchise position*** where there has been non-disclosure, provided notice is served within the prescribed time. (Emphasis added)

How can a franchisee be put back in its pre-contractual position if there is no off-set of profits made during operation? If he keeps the profits with no off-set and also receives section 6(6)(a) to (c) damages not only has he been put in his pre-franchise position, he also has the profits from post-contractual operations. The notion that a franchisee could end up with a windfall upon calculation of rescission damages under section 6(6) is, inconsistent with the purpose of the section, which is to "***reimburse***" a franchisee for losses and to put the franchisee back in its pre-franchise position.

The idea also offends the entrepreneurial nature of owning a business, which involves the outlay of capital and effort in return for an opportunity to earn a profit. After calculation of the amounts under sections 6(6)(a) to (c), there is virtually no outlay for which the franchisee has not been compensated if a net profit has been determined. Yet, when net profit is not offset, the franchisee would reap the benefit of the capital outlay even though that outlay has been returned.

In *Springdale Pizza*, the profit was minor in amount. However, under the common law the principle would apply to all situations. Taken to its logical extreme, it could create a commercial absurdity should a franchisee be ultra profitable and decide to rescind the franchise agreement perhaps to operate independently of the franchisor (absent a continuing restrictive covenant).

Consider the following example, which illustrates the puzzling result created by this decision:

Section (6)(6) Heads of Damage	**Amount**
6(6)(a) – Royalties, ad fees, up-front fees	$50,000
6(6)(b) – Inventory on-hand at time of rescission	$50,000

6(6)(c) – Supplies and equipment, uniform costs $100,000

6(6)(d) – Net profits $200,000

In this rather extreme example, based on the decision in *Springdale Pizza*, a rescinding franchisee would be entitled to compensation totalling $200,000 despite net profits of $200,000. In the authors' view, this result is penal in nature and inconsistent with the purpose of the *Wishart Act*. The better alternative would be to recognize that the franchisee has suffered no losses, since the net profit was equal to the amounts calculated under sections 6(6)(a) to (c).

The interpretation advanced by the franchisor in *Springdale Pizza* is consistent with commercial reasonableness. By analogy, courts will interpret an ambiguous contractual provision in a manner so as to accord with sound commercial principles and good business sense thus avoiding a commercial absurdity (see *Salah v. Timothy's Coffees of the World Inc.*, 2010 ONCA 673, 268 O.A.C. 279 at para. 16). It is suggested that the court's interpretation of section 6(6)(d) in *Springdale Pizza* risks giving rise to a commercial absurdity in that a profitable rescinding franchisee will have been able to enjoy the fruits of the franchised business and yet nevertheless be compensated for all outlays and expenses incurred in establishing and operating that business upon rescission. Effectively, the franchisee receives something for nothing.

Ultimately, it remains to be seen how *Springdale Pizza* will be applied going forward; however, it should serve as a reminder that certain aspects of the *Wishart Act* remain unclear and that care should be taken to ensure that its application remains remedial in nature, not penal.