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Net Profit or Gross Profit? – From Concreters Ready Mix v. St. Lawrence Cement to Electrolux v. A.I.M.: The Court of Appeal of Quebec's 40-year Track Record in Quantifying Lost Profit

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Editor's Note

This contribution to the 2018 Journal by Fellow Jasmin Lefebvre and certified public accountant Guy St-Georges, CPA, CA, CFF, CFE, provides a 40-year historical analysis of the quantification, by the Court of Appeal of Quebec, of lost profit in situations of breach of contract.

The authors remind us that under Quebec civil law, the first paragraph of Article 1611 of the *Civil Code of Québec* establishes the purpose of an award for damages to the victim of a fault: "*1611. The damages due to the creditor compensate for the amount of the loss he has sustained and the profit of which he has been deprived*." They identify the 1976 *Concreters Ready Mix v. St-Lawrence Cement Co.* ruling of the Court of Appeal as a major decision which had all of the attributes to become a leading case for quantification of lost profit in unjust termination and loss of contract situations.

More precisely, in *Concreters Ready Mix*, the Court of Appeal paid particular attention to the calculation required to respect the principle of full compensation for the loss sustained due to the unjust termination of a revenue generating contract. In doing so, it stated the following, recognizing the importance of the gross profit amount, and of the contribution of the revenues from a particular contract to the fixed costs, or general expenses, of the victim.

> [TRANSLATION] I am of the view that, for the producer, the profit it makes on a given sale of its product is the difference between the price received and the expenses it specifically incurred to produce the quantity of product sold, which expenses it would not have incurred had it not had to manufacture that quantity of its product, as well as storage and delivery expenses, if these are less than the price received.

> It is with these profits on each commercial transaction that the enterprise will defray its general expenses and obligations. If, despite the fact that the enterprise makes a profit on each of its commercial transactions, the number of those transactions is not sufficient during a financial year for the aggregate profit thereon to defray its general expenses, the enterprise will have an operational deficit. If the contrary is the case, it will have a surplus. The enterprise may thus be in a loss-making position despite the fact that the production operation per se is profitable. Where, as is the case here, the actual production expenses are less than the price of the sold products, it is the volume of sales that will determine whether the enterprise realizes a surplus or deficit in a given year. The loss of some 10% of its sales has made the respondent poorer. Had the contract been performed, its fixed costs would have remained unchanged, and the profit it would have made on the price the appellant was to have paid it would have improved its financial situation. Through the appellant's fault, the respondent has been deprived of those profits. Therefore, in order to place the respondent in the position it would have been in had the appellant respected its obligations, the appellant must indemnify it for this lost profit.

The authors provide both a fundamental explanation of the distinctions between net profit and gross profit and between variable costs and fixed costs, both from a legal and accounting point of view. They continue their analysis with a 40-year review of rulings by the Court of Appeal of Quebec, wherein the approach to the quantification of lost profit, in situations of unjust termination or loss of a contract, is sometimes analogous to the reasoning in *Concreters Ready Mix* but, it would appear, too often different and sometimes even contrary to that approach; particularly in some recent rulings which they review in detail. The Court of Appeal has come to rely on an approach which gives predominance to a quantification based upon the net profit, to the exclusion of a compensation commensurate with the gross profit of the victim, as illustrated notably in the 2016 *American Iron & Metal LP v. Electrolux Canada Corp.* ruling. This article by Jasmin Lefebvre and Guy St-Georges provides a broad and comprehensive analysis of the evolution of the Court of Appeal rulings towards this more recent choice as well as a reasoned invitation for a return to the approach favoured 40 years ago in *Concreters Ready Mix*.

1. INTRODUCTION

In civil law, the rules on quantification of damages are somewhat tenuous. The guiding principle is that the purpose of an award of damages is to place the victim of a fault, to the extent possible, in the financial situation it would have been in but for the fault. The compensation must be such that the plaintiff is made neither richer nor poorer by the award. The guiding principle is meant to be universal, regardless of the context in which the loss occurred or the nature of the loss. The scope of its application is thus very broad.[1]

In this article, we will focus on the issues involved in compensating a victim for lost profit in commercial matters, mainly in cases of breach of contract. The impetus for our focus is a recent judgment of the Court of Appeal from which leave to appeal to the Supreme Court of Canada was denied: *American Iron & Metal, l.p. v. Electrolux Canada Corp.*[2]

Our methodology consists of first explaining our understanding of the rules that should be applied when quantifying damages for lost profit. We will then examine how the Court of Appeal has dealt with matters involving compensation for lost profit, by focussing on the most significant decisions rendered in this regard over the last 40 years.

We have deliberately chosen the date of March 15, 1976 as the starting point for our case law review, which is the day on which the Court of Appeal rendered its decision in *Concreters Ready Mix Ltd. v. St. Lawrence Cement Co.*[3]

2. COMPENSATION OF LOST PROFIT

The first paragraph of Article 1611 of the *Civil Code of Québec* defines the purpose of the damages to which the victim of a fault is entitled:

> *1611. Les dommages-intérêts dus au créancier compensent la perte qu'il subit et le gain dont il est privé.*
>
> 1611. The damages due to the creditor compensate for the amount of the loss he has sustained and the profit of which he has been deprived.

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1 It is worth noting that this scope excludes damages arising from the unilateral termination of an enterprise contract by the client (article 2125 CCQ), as it is established in the case law that such termination does not give rise to a claim for loss of profit.

2 2016 QCCA 1692, leave to appeal refused *American Iron Metal LP v. Electrolux Canada Corp.*, 2017 CarswellQue 1519 (S.C.C.).

3 [1976] C.A. 385 (Que.).

In our view, the expression "the profit of which [the creditor] has been deprived" is intended by the legislature to mean any consequence of a fault that prevents the victim's financial situation from being improved. In addition, it must be assumed that the legislative intent underlying Article 1611 is to respect the principle of full compensation for a loss sustained, as this is one of the cornerstones of the civil law.

We are also of the view that the wording of Article 1611, which is a very general and universally applicable provision, is not derived from accounting terminology. Rather, the science of accounting is to be used to apply the legal rule to the effect that when a profit is lost due to a fault, the financial consequences must be determined as precisely as possible in order that the victim's financial situation may be placed in the state it would have been in had the fault that caused the lost profit never occurred.

The French version of Article 1611 is a general statement couched in everyday language rather than scientific jargon:

> "*Les dommages-intérêts dus au créancier compensent la perte qu'il subit et le gain dont il est privé*."

This is less true of the English version however. The term "profit" has several accepted meanings in the English language – as it does in French as well – one of which corresponds to an accounting concept that is narrower than the meaning of the French word "*gain*".

No doubt because of the significant degree to which accountants appear as experts in litigation involving Article 1611, and also due to the linguistic duality of Quebec and its Civil Code, the French word "*profit*" is frequently used in court proceedings conducted in French concerning lost profit, rather than the French word "*gain*".

This may have contributed to the inconsistencies observed in the case law.

Article 1611 CCQ is a two-fold provision in which all the consequences of a fault for the victim's financial situation are addressed, not just lost profit. "Loss sustained" is the second aspect of Article 1611. While this paper deals only with the quantification of lost profit, in order to illustrate the full scope of Article 1611, we have included the following example depicting the difference between "loss sustained" and "lost profit".

A Corp transfers $20,000 to B Corp as a deposit under a contract to purchase $100,000 worth of merchandise from B Corp. A Corp has

promised to resell the merchandise to C Corp for $250,000. A Corp has made a non-refundable payment of $2,000 to lease space to store the merchandise pending its delivery to C Corp. In the event that its contract is cancelled, C Corp is entitled to compensation of $5,000 from A Corp. For the purposes of our example, the above-mentioned expenses are the only ones A Corp had to incur to perform the contract with C Corp.

B Corp does not honour its contract with A Corp. The latter's claim against B Corp should include the following:

1. $20,000 paid to B Corp (Reimbursement[4]);
2. Non-refundable payment of $2,000 to lease storage space (Loss Incurred[5]);
3. $5,000 penalty payable to C Corp (Loss Incurred);
4. Lost profit of $148,000, calculated as follows:

   $250,000 (resale price) minus:

   a) $100,000 (purchase price of merchandise)

   b) $2,000 (rental cost)

In this example, the "loss sustained" by A Corp would be $27,000,[6] *i.e.* the total amount disbursed by it in connection with the anticipated transaction plus the $148,000 "lost profit" of which it was deprived, for total damages of $175,000.[7] Compensation of $175,000 would place A Corp in exactly the financial position it would have been in had B Corp not cancelled the sale transaction[8], as the following comparative table shows:

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4 *Restitution Interest*.
5 *Reliance Interest*.
6 Total of items 1 to 3, *i.e.*: $20,000 + $2,000 + $5,000 = $27,000.
7 $27,000 + $148,000 = $175,000.
8 Accountants also use the term "But For Scenario".

Table 1

	Current situation	**Anticipated situation but for the fault**
Compensation amount	$175,000	-
Purchases —Initial payment to B Corp	($20,000)	($20,000)
Additional rent	($2,000)	($2,000)
Penalty to C Corp	($5,000)	-
Purchases —Final payment to B Corp[9]	-	($80,000)
Sale to C Corp	-	$250,000
Net cash inflow	**$148,000**	**$148,000**

The costs taken into account in calculating the lost profit of $148,000 are those that would have been incurred in performing the contract. The damages thus calculated allow the claimant to be placed in the financial situation it would have been in had the contract not been cancelled.

The financial harm caused by the conduct of a third party is rarely as simple to calculate as in the above example, particularly where lost profit (item 4) is concerned. The following section provides the essential information that must be taken into consideration when quantifying lost profit.

3. QUANTIFICATION OF LOST PROFIT

Where an enterprise is deprived of revenue due to the fault of a third party, the first step in calculating compensation is to determine the amount of that lost revenue. This step is easier if the amount is provided for in the contract.

The next step is identifying and quantifying the costs that the enterprise would have had to incur in order to generate the revenue it was deprived of. In order to quantify the lost profit, which profit percentage should be applied to the lost revenue: the gross profit percentage or the net profit percentage?[10]

The profit percentage applied to the amount of lost revenue must reflect all the specific costs related to the lost revenue in order to identify the

[9] Total cost of units purchased ($100,000) minus the down-payment ($20,000) yields $80,000, the balance owing.

[10] The percentage of gross profit, or of net profit, represents the amount of profit (gross or net) expressed as a percentage of total revenues.

marginal effect of that lost revenue on the financial results of the enterprise. This exercise consists of determining what contribution the performance of the contract would have made to the financial situation of the victim of the fault. With the financial contributions from its various contracts, an enterprise can pay its fixed costs and potentially make a net profit on its overall business activities.

The gross profit percentage normally takes into account the specific costs mentioned above, subject to certain exceptions that we touch on below. To calculate the compensation, this percentage can also be applied to the lost revenue in cases where it represents only a marginal fraction of the total revenues of the enterprise.

In cases where all of the revenues of the enterprise are lost, for example, after the loss of its sole contract or following a devastating fire, the starting point for the calculation of lost profit will instead be based on the enterprise's net profit, as it will no longer carry on activities and therefore cease incurring fixed costs.

Before going into further detail regarding the costs to take into consideration in calculating the marginal contribution, it is worth looking at a few definitions:[11]

Gross profit

Definition: The difference between net sales and cost of goods sold.

Synonyms: Gross margin, gross profit margin

Variable costs

Definition: Costs that vary directly with the volume of production or activity.

Synonym: Variable expenses

The "cost of goods sold" or "cost of sales" are variable costs, and represent either the purchase price of goods or their manufacturing cost, depending on whether the enterprise's business consists of retail or wholesale commerce, or manufacturing. The cost of manufacturing goods includes the cost of materials, labour and other costs specifically incurred in order to manufacture the goods.

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[11] Definitions taken from TERMIUM Plus®, the Government of Canada's terminology and linguistic data bank.

Net profit

Definition: The excess of revenues over expenses for a period . . .

Synonyms: Net income, earnings

Fixed costs

Definition: Indirect costs that remain relatively unchanged in total regardless of the volume of production or activity within a fairly wide range of volume.

Synonym: Fixed expenses

"Total operating expenses" include the cost of sales, selling expenses and administrative expenses ("operating expenses") finance charges and income taxes. Generally, contrary to the components of the cost of sales, operating expenses are fixed costs, meaning that they do not vary with the volume of sales. The terms "overhead" and "indirect costs" are also often used to denote operating expenses.

Depending on an enterprise's business, there may be some exceptions. For example it is possible that variable costs such as sale commissions, calculated as a percentage of sales, may be accounted for in selling expenses.

It should also be noted that certain operating expenses that are fixed in nature may vary if the volume of activities of the enterprise varies sufficiently. Consider, for example, the rental cost of a warehouse for finished products. Such costs normally represent a fixed expense, as the annual amount does not vary depending on the number of stored units. It is possible however that obtaining a new contract will require renting additional storage space. This new rental cost represents a "step variable cost".

Finally, some operating expenses can vary in a way that is not proportional to the level of production activity because they have both a variable portion and a fixed portion.[12]

The takeaway is that the specific costs incurred in order to generate additional revenue are not necessarily all to be taken into account in the gross profit. Some may be accounted for as operating expenses. The margin obtained following a costs analysis and after taking into

[12] Semi-variable costs.

consideration other specific costs accounted for as operating expenses is termed the "contribution margin" or "variable cost margin".

3.1 The Costs to Consider or the Profit Percentage to Apply

The principle of full compensation and the relevant facts of each case should serve as guides for identifying the costs to take into account in calculating compensation. In order to put the plaintiff in the position it would have been in but for the fault committed by the defendant, the costs to consider in calculating the lost profit are the additional costs that the enterprise specifically had to incur in order to generate the anticipated revenue. Theoretically, the victim of the fault could have avoided incurring these expenses directly related to the revenue-generating activity affected by the fault. Hence the importance of deducting them from the lost revenue in order to arrive at the actual lost profit and avoid over-compensation.

As for the enterprise's fixed costs, they must not be deducted when calculating the lost profit because they would have been incurred whether or not the contract was performed. The deduction of fixed costs in calculating the lost profit would have the effect of undervaluing the actual amount of the lost profit, contrary to the spirit of Article 1611 CCQ and the principle of full compensation.

Here is an example illustrating the impact of taking fixed costs into account in calculating lost profit. In 2017, D Corp, which typically sells one million units per year, enters into a contract to sell E Corp 100,000 additional units at $10 per unit. Assuming that the variable costs are $4 per unit, and that sales and administration costs remain the same regardless of the 100,000 additional units, the impact of the contract on the results of D Corp will be a $600,000 increase in profit.

Table 2

D Corp **Earnings statement for the year 2017** (in thousands $)	**Current situation**	**Anticipated situation but for the fault**	**Difference**
Sales (1,000,000 units @ $10)	$10,000	$10,000	
Additional contract (100,000 units @ $10)	-	$1,000	
Total sales	**$10,000**	**$11,000**	**$1,000**
Cost of sales (1,000,000 units @ $4)	($4,000)	($4,000)	
Additional contract (100,000 units @ $4)	-	($400)	
Gross profit	**$6,000**	**$6,600**	**$600**
Selling and administrative expenses (fixed)	($2,500)	($2,500)	-
Net profit before income taxes	**$3,500**	**$4,100**	**$600**

If E Corp reneges on the contract and does not purchase the 100,000 units, D Corp sustains an actual loss of profit of $600,000, such that compensation in that amount would place D Corp in the position it would have been in had E Corp performed the contract.

However, assuming that for each unit sold by D Corp, sales and administration costs are $2.27[13] and that part of those fixed costs is applied to the 100,000 additional units, the compensation would be reduced to $372,727.[14] Thus, taking a portion of the fixed costs into account in calculating the damages would have the effect of awarding compensation that is $227,273 less than the actual lost profit of $600,000. This result would not respect the principle of full compensation for the loss sustained. In the above example, compensation of $372,727 would deprive D Corp of the resources necessary for defraying its fixed costs and negatively affect its financial situation. As production of the 100,000 units pursuant to the contract with E Corp would have had no impact on D Corp's sales and administration charges, it would be unjust for the party at fault to have the damages payable by it reduced by taking those costs into account, as the fault it committed did not allow D Corp to save on those costs.

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[13] $2,500,000 / 1,100,000 units = $2.27 per unit.
[14] $600,000 minus 100,000 units @ $2.27 per unit, i.e. $227,273, for a balance of $372,727.

The foregoing example highlights the importance of taking into consideration the appropriate cost factors when calculating compensation for lost profit. It is thus essential to perform a detailed analysis of operating expenses in order to identify all costs specifically related to the lost revenue. In most cases, this analysis will be done by the enterprise's accounting department.

A further example will illustrate the same concept but in a situation where the rate of earnings shown in the financial statements of the victim is used to determine the compensation that should be paid to it.

F Corp, the successful bidder on a construction contract, is unable to perform the contract because of the fault of the project owner. The lost contract would not have had a disproportionate effect on the overall results of F Corp. Moreover, it would have been able to perform the contract without making any adjustments to its operational infrastructure, and thus without any increase in fixed costs.

F Corp had anticipated making a gross profit of $500,000 by performing the contract. This amount is the difference between its bid price of $5,000,000 and the direct expenses of $4,500,000 it would have had to incur to perform the contract.

Assume the anticipated gross profit of 10%[15] on the contract corresponds exactly to the gross profit rate of 10% shown in F Corp's financial statements, which also show a pre-tax net profit rate of just 1% after all fixed costs are paid.

In such a situation, is F Corp's net profit rate a valid factor for determining its lost profit due to the fault? In our view, not at all. We shall see however that the courts do not always share this view. We will deal with this in detail below.

In our opinion, in the above example the consequence of the fault – the lost profit – is due to the loss of a contract that was going to generate $5,000,000 in revenues versus $4,500,000 in direct expenses. As described in the example, the contract could have been performed without any change to F Corp's basic operational structure, and thus without any additional fixed costs. The only expenses that the fault allowed F Corp to save on were the $4,500,000 in direct expenses that it would have had to incur in order to perform the contract.

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[15] $500,000 / $5,000,000 = 10%.

This example vividly shows the extent to which it would be harmful to the claimant, and contrary to the principle of full compensation of the loss sustained, to award compensation of only $50,000[16] based on the net profit rate of the enterprise applied to the value of the contract.

In order to be able to defray its fixed costs, an enterprise must earn revenue from which it can make a gross profit allowing it to pay those costs.

If the net profit rate is used as the factor for determining the compensation of F Corp the enterprise will be seriously under-compensated, as the gross profit on all its contracts is used to defray the basic operational expenses of the business, its fixed costs. Thus, to place F Corp in the financial situation it would have been in but for the fault, its compensation cannot be limited to the lost net profit.

3.2 Loss-making Enterprises

Can a loss-making enterprise be harmed by a loss of profit? The question seems simple, even simplistic. However, it has the merit of illustrating how inappropriate it is to compensate for lost profit by applying the enterprise's net profit rate to the revenue it would have earned on a contract it was prevented from performing by the other party's fault.

It cannot be seriously contested that an enterprise operating at a loss could still be harmed by being deprived of the opportunity to perform a profitable contract through the fault of another party. In such a situation, the enterprise would not be able to earn revenue that would have contributed to paying its fixed costs. There is a loss in profitability even if the unearned revenue would not have been sufficient to make the enterprise profitable overall. A loss-making enterprise most definitely has the right to judicially claim any profit of which it was deprived that would have improved its financial situation.

In this case, regardless of the reason the enterprise is operating at a loss, using net profit – or in fact the absence thereof – as the determining factor for calculating the extent of the loss it sustained leads inevitably to under-compensating the victim and is fundamentally at odds with the principle of full compensation for the loss sustained.

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[16] 1% x $5,000,000 = $50,000.

3.3 Relative Importance of the Lost Profit

We previously highlighted the question of the extent of the lost revenue and its impact on the calculation of lost profit. This question is important given that the more the lost revenue is significant relative to the activity level of an enterprise, the more costs considered as fixed are likely to vary. In the example shown in Table 2 above, the anticipated increase of 100,000 units in its sales volume represents 10% of the existing activity level of D Corp. Subject to a detailed analysis, it is plausible that such an increase would have no effect on the cost structure of the enterprise and it would thus be correct to take only variable costs into consideration in calculating the lost profit.

It might be otherwise where a lost contract represents 40% to 50% of the enterprise's existing activity level. The impact of the loss of such a contract on the enterprise's cost structure must be analyzed thoroughly in order to identify the additional expenses required for its performance in terms of administrative staff, storage space, equipment maintenance, office space, etc. In such cases, these additional expenses must be taken into account in calculating the lost profit.

In cases where all the revenues of the enterprise are lost, for example after the loss of its sole contract or following a major fire, the lost profit will be based instead on the enterprise's net profit, as by no longer carrying on activities it will cease incurring fixed costs. In such a case, the lost profit may correspond to the value of the enterprise, which would then have to be determined using a recognized business valuation method. Various monetary losses may also result from the cessation of all business activities, and these are to be added to the amount of the financial harm sustained.

Moreover, it may be that the enterprise would not have been able to perform the lost contract due to its magnitude and the residual capacity of the enterprise. In such cases, the legitimacy of the claim for lost profit may be dubious.

3.4 Income Tax

Income tax is not to be taken into account when quantifying lost profit because the monetary compensation awarded to the plaintiff is subject to the same taxation rules as income earned by it in the normal course of business.

3.5 Summary

From our study, the takeaway is that in cases where the lost revenue is only a marginal fraction of the enterprise's total revenues, the profit percentage to be applied to the lost revenue in order to determine the lost profit thereon must take into account all of the costs specifically related to the lost revenue in order to identify the marginal effect of the lost revenue. The gross profit percentage normally takes into account these specific costs, subject to certain other variable costs sometimes included in operating expenses which also must be taken into account as the case may be. The gross profit minus these other variable costs, if any, represents the contribution margin, a ratio reflecting all costs that must be taken into consideration. All of the enterprise's costs must be closely analyzed in order to identify and take into account all of the costs, but only the costs that are relevant to the calculation to be performed.

While the solution proposed here for determining appropriate compensation appears to be self-evident, there is a tendency in the case law for courts to determine lost profit by taking into account, unjustifiably in our view, the enterprise's fixed costs or, in many cases where it is equally inappropriate, the enterprise's net profit rate.[17] And as we shall see, the Court of Appeal is not immune to this tendency.

This case law is open to criticism because it often ignores basic accounting principles and facts that would allow the judiciary to better achieve the ideal of full compensation for loss sustained. Given the technical nature of the calculation of lost profit, jurists in our opinion should apply accounting rules, and as often as necessary retain the services of expert accountants, in order to determine appropriate compensation.

4. THE DIFFICULTIES INHERENT IN THE JUDICIAL TASK OF QUANTIFYING DAMAGES, PARTICULARLY ON APPEAL

In the course of the judicial exercise of quantifying the loss sustained by the claimant, it is often necessary to apply accounting rules and principles. These must however be applied judiciously or the compensation awarded may be markedly inappropriate.

In our view, while the principles that should govern compensation of victims are legal in nature, those applicable to the quantification of damages are first and foremost accounting principles, to which jurists

[17] Which amounts to the same thing.

should show more deference. Our study of the case law on the compensation of loss in the form of lost profit shows that the courts are ill-equipped to readily understand and process the evidence on damages that is before them. These difficulties are often heightened by insufficiencies in the evidence adduced by the parties and their lawyers, who tend to make greater efforts at proving fault than the actual harm suffered by the claimant. Lawyers whose mission is to present evidence to the court are frequently at a loss when it comes to proving damages. They often defer to their clients, or to their expert, if they are fortunate enough to have one.

In addition, it should be noted that the adversarial spirit that prevails in the courtroom discourages the Cartesian search for truth that the science of accounting requires for the quantification of damages. The parties' conflicting interests often lead to bias in the minds of witnesses and experts, which can greatly detract from the usefulness of their contributions to constituting the evidence required for quantifying the loss sustained.

All these factors that tend to compromise the determination of appropriate compensation at first instance often create cases where the Court of Appeal must rule on damages on the basis of acutely deficient evidence.

In addition, it must of course be emphasized that the Court of Appeal views the first-instance file exclusively through the prism of the trial judgment. And the Court of Appeal will only intervene if it is shown that the trial judge committed an error of law or a palpable and overriding error in assessing the evidence. Otherwise it will not substitute its opinion for that of the trial judge. Now, the fact that the trial judge may have rejected the opinion of an accounting expert does not necessarily constitute a palpable and overriding error. However, the tendency of the courts to defer to the point of view of the trial judge – the jurist – rather than that of the accounting expert is not without risks. For an error involving accounting principles committed at trial may well not be corrected on appeal, as the court might not consider it a "palpable and overriding" error. In such cases, given the authority accorded precedents – and particularly those decided by the Court of Appeal – there is a risk that such errors will contaminate the positive law.

5. HIGHLIGHTS OF THE CASES ON QUANTIFICATION OF DAMAGES FOR LOST PROFIT DECIDED BY THE COURT OF APPEAL OF QUEBEC SINCE 1976

5.1 *Concreters Ready Mix v. St-Lawrence Cement Co.*: A Keystone Judgment Consigned to Oblivion

Our review of the cases decided by the Court of Appeal during the last 40 years involving the quantification of damages for lost profit begins with the decision in *Concreters Ready Mix Ltd. v. St. Lawrence Cement Co.*[18] It is in our opinion, a major decision that had all the attributes for being a leading case in damages law, but astonishingly it has fallen into virtual oblivion. According to our research, the judgments of the various levels of courts in Quebec in which it is cited can literally be counted on the fingers of one hand.[19]

In its decision the Court of Appeal paid particular attention to the calculation required to respect the principle of full compensation for loss sustained due to the unjust termination of a revenue generating contract.

The contract in that matter had a five-year term and was for the exclusive supply of concrete by the respondent to the appellant. The contract was terminated by the appellant after a year. The dispute centred on the quantification of damages for the loss of the sale of 866,205 loads of cement.[20]

The appellant maintained that the damages for lost profit on the terminated contract should be calculated on the basis of the difference between the sale price for barrels of cement and the average of the respondent's fixed and variable costs to produce such barrels, for each year of the contract. The result was to be multiplied by the number of barrels that the appellant was to have purchased annually. This effectively meant that if the respondent lost money during a given financial year, the damages would be zero. In fact the respondent had experienced a financial loss in three of the four years remaining on the terminated contract.

The respondent argued on the contrary that the calculation of the damages should be based on the difference between the per-barrel sale

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18 *Supra*, note 3.

19 See in particular: *Entreprises de construction Panzini inc. c. Agence métropolitaine de transport*, 2005 CarswellQue 8291 (C.S.); *6592031 Canada inc. c. Pontiac (Municipalité)*, 2013 QCCQ 13282.

20 This was a marginal production volume representing only 10% of the overall production of St. Lawrence Cement.

price and the respondent's variable expenses, *i.e.* those specifically incurred for the manufacture and delivery of the cement contemplated by the contract. This argument found favour with the trial judge, whose decision was upheld by the Court of Appeal. It is worth reproducing an excerpt from Justice Bernier's decision which well illustrates his train of thought:

> [TRANSLATION] I am of the view that, for the producer, the profit it makes on a given sale of its product is the difference between the price received and the expenses it specifically incurred to produce the quantity of product sold, which expenses it would not have incurred had it not had to manufacture that quantity of its product, as well as storage and delivery expenses, if these are less than the price received.
>
> It is with these profits on each commercial transaction that the enterprise will defray its general expenses and obligations. If, despite the fact that the enterprise makes a profit on each of its commercial transactions, the number of those transactions is not sufficient during a financial year for the aggregate profit thereon to defray its general expenses, the enterprise will have an operational deficit. If the contrary is the case, it will have a surplus. The enterprise may thus be in a loss-making position despite the fact that the production operation per se is profitable. Where, as is the case here, the actual production expenses are less than the price of the sold products, it is the volume of sales that will determine whether the enterprise realizes a surplus or deficit in a given year. The loss of some 10% of its sales has made the respondent poorer. Had the contract been performed, its fixed costs would have remained unchanged, and the profit it would have made on the price the appellant was to have paid it would have improved its financial situation. Through the appellant's fault, the respondent has been deprived of those profits. Therefore, in order to place the respondent in the position it would have been in had the appellant respected its obligations, the appellant must indemnify it for this lost profit.[21]

This decision highlights the importance of isolating the operation affected by the breach from the other operations of the enterprise and the fixed costs incurred, when quantifying the loss on the affected

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[21] *Supra*, note 3, pp. 5 and 6.

operation. It is inconceivable that an enterprise, because it happened to be losing money, would not be entitled to compensation for the benefit it would have received from a profitable transaction aborted by the commission of a fault. Otherwise, compensation would depend on the richness of the victim and could only be quantified at the end of its financial year, in light of its results. The fact that an enterprise is losing money[22] does not necessarily entail that it is losing money on all its operations. For the purpose of quantifying damages, it is thus essential to concentrate solely on the specific operation of the enterprise affected by the fault and to disregard the enterprise's fixed costs.

The *Concreters Ready Mix* decision provides a clear explanation of the principles to be applied for compensating lost profit in commercial matters. Unfortunately, for unknown reasons, the clear and practical guidelines that it contains have rarely been followed by the Court of Appeal in the 40 years since it was rendered.

And yet we have not found in the case law any subsequent decision in which the Court of Appeal dwelled at such length as it did in *Concreters Ready Mix* on the issue of quantification of lost profit. In our opinion the court could and should bring back to the fore this crucial decision on the nature of the costs to be taken into account when calculating compensation for lost profit.

We shall see that in this area of the law, it is hard to discern a common thread in the cases decided by the Court of Appeal.

5.2 Decisions of the Court of Appeal Awarding Compensation for Lost Profit Based on Gross Profit

Over the last 40 years, the Court of Appeal has on several occasions approached the exercise of quantifying damages for lost profit from the perspective of the gross profit lost by the victim.

For example, in *Trans-Quebec Helicopters Ltd. v. Lee Estate,*[23] while there was some debate as to whether the gross profit margin per hour of flying time was 40% or 75%, it was on the basis of this gross margin that the appellant's compensation was calculated following the loss of its aircraft, which took the life of David Lee. Rightly, in our view, for the purposes of its calculation the court did not take into account the overall profitability of Trans-Québec Helicopters.

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[22] For example, because its fixed costs are too high relative to its revenues.
[23] [1980] C.A. 596 (Que.).

In 1988, in *Bahler c. Pfeuti*,[24] the Court of Appeal upheld the decision at trial,[25] in which the judge awarded the promissor-purchasers the loss in gross profit margin due to the promissor-seller's refusal to transfer ownership of the promised farm.

Similarly, that same year, in another agricultural matter, *Bernard Proulx Inc. c. Proulx*,[26] while its reasons are not very explicit, the Court of Appeal appears to have awarded the loss of gross profit that the respondent would have made from its seasonal corn harvest on a field where cultivation proved impossible due to faulty drainage work performed by the appellant the previous season.

Four years later, in *E. & S. Salsberg Inc. c. Dylex Ltd.*,[27] the Court of Appeal again based itself on anticipated gross profit in calculating the compensation payable to the victim of the unjust termination of a services contract. The victim was entitled to three months' prior notice of termination, and the court awarded it its anticipated profit based on the gross profit margin from its business dealing with the respondent, which exceeded its overall gross profit margin.

In *Salsberg*, it is both interesting and relevant to note the concrete application of the principle to the effect that, to the extent that adequate evidence is led, the damages are to be calculated on the basis of the factual situation and the financial particulars specific to the breached business relationship, rather than on the basis of the overall general information in the victim's financial statements.

Again in 1992, in *Gatehouse Lasalle inc. c. Trans-Canada Freezers ltd.*,[28] the appellant had been prevented for a time from carrying on its business of selling food products, and had consequently suffered a loss in revenues. While the Court of Appeal justices disagreed on the sample period to be used for estimating the loss sustained, they did agree that compensation was to be calculated on the basis of the loss in gross profit during the business interruption period.

In 1994, in *Alain c. Télébec ltée*,[29] the business loss suffered by the respondent denturist due to an error in a telephone directory was established through a discretionary choice by the trial judge – endorsed by the Court of Appeal – between the parties' two contradictory

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[24] C.A. no 500-09-001163, December 10, 1987.
[25] *Bahler c. Pfeuti*, S.C. no 450-05-000976-825, June 3, 1983.
[26] [1988] R.J.Q. 2664 (C.A.).
[27] 1992 CarswellQue 2199 (C.A.).
[28] 1992 CarswellQue 757 (C.A.).
[29] 1994 CarswellQue 796 (C.A.).

positions as to what the respondent's gross profit margin was on his professional activities.

In 1996, in *Consortium M.R. Canada Ltée c. J.C.O. Malenfant Inc.*,[30] the trial judgment was upheld by the Court of Appeal. In that case a bidder, J.C.O., was suing the general contractor, M.R., for not having awarded it a contract it should have obtained pursuant to the rules set out in the bidding code of the *Bureau des soumissions déposées du Québec*.

In his judgment, the Superior Court trial judge awarded the respondent the amount it had anticipated earning when preparing its bid ($50,867) after having deducted a small amount representing overhead and surety costs ($2,598.48).[31] The respondent had succeeded in convincing the judge to accept its evidence pertaining to the specific contract on which it bid, and to reject the appellant's argument that the lost profit should instead be determined based on the average profit shown in the respondent's financial statements for the previous three years. The Court of Appeal noted the extent to which the respondent's evidence rendered its profit estimate credible, which led it to side with the trial judge's conclusion. In addition, the court stressed that the anticipated 17.6% profit on the lost contract was corroborated by the respondent's financial results over the previous three years.[32]

In *Consortium M.R.*, on the basis of credible evidence regarding the profit that would have been earned on the lost contract, the Court of Appeal refused to apply the quantification method used in the *Acier Mutual Inc. c. Fertek Inc.*[33] decision rendered a month earlier. In that matter, because of deficient evidence on the damages being claimed, the compensation was determined on the basis of the plaintiff's net profit rate. The *Acier Mutual* decision significantly influenced the subsequent case law. We deal with it in more detail below.

Foisy c. Garage Raymond Ouellet inc.,[34] decided in 2000, is another matter where, insofar as damages were concerned, the trial judgment was upheld by the Court of Appeal. In that case the respondent sought

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30 1996 CarswellQue 302 (C.A.).

31 According to the trial judgment (*J.C.O. Malenfant Inc. c. Consortium M.R. Canada Ltée*, 1991 CarswellQue 1168 (C.S.), Judge Georges Savoie), these costs did not have to be incurred, as the plaintiff was not awarded the contract.

32 While the nature of the profits referred to in the decision is not specified, our understanding is that the appellant argued that compensation should be determined based on the respondent's average net profit over three years, whereas the respondent succeeded in establishing that its anticipated profit estimate was valid by comparing it to the gross profit rate shown in its financial statements for the last several years. The trial judgment is unfortunately not more explicit in this regard.

33 1996 CarswellQue 194 (C.A.).

34 2000 CarswellQue 1719 (C.A.).

compensation for the unjustified suspension of its exclusive contract with the municipality for roadside repair and towing services. The suspension was prompted by a dispute with the municipal police chief.

The trial judge had calculated the damages based on the gross profit lost by the respondent (revenues less operating costs) on its towing, storage and repair activities due to the suspension of its exclusivity deal with the municipality. The lost monthly gross profit of $1,380 was multiplied by 32, the number of months the suspension had lasted.

Three years later, in its 2003 decision in *Ahsan v. Second Cup Ltd.*,[35] the Court of Appeal endorsed the respondent's decision to terminate the appellant's franchise contract due to various breaches thereof by the appellant franchisee. The amount of damages awarded the franchisor at trial was however substantially reduced on appeal: it was scaled back to three months of the royalties normally paid by the franchisee to the franchisor, which was the period deemed sufficient by the court for finding a replacement franchisee.

Obviously the royalties payable to The Second Cup constituted lost income for the franchisor. But the costs it had to incur to perform its obligations as franchisor are nowhere discussed in the judgment.[36] In any event, if the costs inherent in acting as a franchisor were saved following the termination of the franchisee's contract, calculating the franchisor's compensation on the basis of gross revenues (the amount of which being necessarily larger than gross profit) would likely have the result of overcompensating the respondent.

In 2004, in *J.M.O. Climatisation inc. c. Construction Abtech (1996) inc.*,[37] the Court of Appeal allowed the appeal and determined that the appellant's compensation for being unjustly deprived of a contract was to be "15% of the cost price". Was that the gross profit margin? It is impossible to say: neither the trial nor the appeal decision contains any details that would allow the question to be answered definitively. This case well illustrates that in the judgments of our courts, the exercise of quantifying damages for lost profit often takes the form of a fairly summary discretionary decision based on limited facts or information.

Somewhat clearer is the decision in *Metal Laurentide inc. c. Stellaire Construction inc.*[38] rendered a few weeks later, disposing of a similar

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35 2003 CarswellQue 508 (C.A.).
36 Perhaps they were negligible, or non-existent.
37 2004 CarswellQue 1511 (C.A.).
38 2004 CarswellQue 2638 (C.A.).

dispute involving calls for tenders in the construction industry. The Court of Appeal sided with the appellant and awarded it compensation for lost profit on a contract it should have obtained. The court calculated the compensation based on the difference between the contract price and the appellant's estimate of the costs it would have had to incur to perform it. In its reasons, however, the court stated that the anticipated amount of profit on the contract corresponded to the gross profit rate shown in the appellant's financial statements for the relevant financial years.

While it does not expressly refer to *Concreters Ready Mix*, the decision in *Métal Laurentide* is based on the same premise, *i.e.* that in order to perform a construction contract, the contractor potentially does not have to incur any additional overhead. The gross profit derived from the additional contract can be used by the enterprise to defray its overhead, and perhaps increase its profit. Calculating compensation for lost profit due to the loss of a contract by subtracting overhead from gross profit leads directly to under-compensation of the victim, because it prevents the enterprise from having the resources needed to defray its overhead. Overhead is theoretically in no way influenced by the loss of a contract that leads to litigation. If a claimant does not receive an amount corresponding to its gross profit on the lost contract, it will be appreciably and unjustly made poorer, contrary to the principle of full compensation for loss sustained. A defendant has no valid ground for asking that a percentage of overhead, which remains unchanged, be deducted from the amount of compensation payable to the victim.

The authors Cimon and Gosselin aptly explain this concept as follows:[39]

> [TRANSLATION] Overhead consists of expenses related to the enterprise's head office activities such as accounting, purchasing and general administration, that are required for the contractor to be able to perform the work. These are necessary and useful expenditures for the operation of the enterprise. This implies in turn that all revenues generated by its various projects must contribute to defraying those expenses, even though it may be difficult, if not impossible,

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[39] Ian Gosselin and Pierre Cimon, "*La responsabilité du propriétaire*", in Olivier F. Kott and Claudine Roy (ed.), *La Construction au Québec: perspective juridique*, Montréal, Wilson & Lafleur, 1998, pp. 403 and 404. Of note, in *Dawcolectric inc. c. Hydro-Québec*, 2014 QCCA 948, pp. 28-30, the Court relied on this same opinion of authors Gosselin and Cimon to grant the claimant a 13.76% increase of its duly proven impact costs, a percentage corresponding to the "historical" average of its "overhead" and "profit". This increase represented the equivalent of the gross profit that Dawcolectric generally derived from the performance of its contracts.

> to make a direct correlation between them and any particular project.
>
> It must therefore be concluded that the contractor's bid price always includes an amount to cover part of the total head office expenses for the projected duration of the work. This amount is generally expressed as a percentage of the estimated costs. (references omitted.)

In its 2007 decision in *Magasins libre services Pitt inc. c. Nazaraly*,[40] the Court of Appeal awarded compensation to the appellant calculated on the basis of the gross profit it expected to make on the sale of shoes ordered from the respondent that proved to be defective. Based on the number of shoes ordered, the lost profit was determined by the court by deducting from the sale price of the shoes, their purchase price plus the amount of excise taxes applicable thereto. Thus, the appellant's other sales costs and its overhead were not – and rightly so in our view – taken into account in determining what the respondent owed the appellant due to the poor quality of the delivered product.

In this case, as in *Métal Laurentide*, it is highly unlikely that having an additional consignment of product in its inventory would cause the appellant's overhead to increase. The gross profit expected from the lost sales was therefore no doubt the proper basis for determining compensation.

Agences Jacques Parent inc. c. Meubles Concordia ltée,[41] decided in 2011, is a good illustration of a *sui generis* case involving corporations with only one employee. In this matter, the appellant's agency contract was terminated by the respondent on insufficient notice. The trial judge's finding that notice should have been given a year in advance was upheld on appeal, but the same was not true of the judge's quantification of the appellant's lost profit during that period.

The trial judge calculated the compensation by multiplying the appellant's after-tax net profit by 31%, which was the percentage of the appellant's total revenues represented by the price of the terminated contract.

Basing itself on a line of cases decided by the Superior Court, the Court of Appeal instead applied the 31% factor to the sum of the corporation's pre-tax net profits plus the salary and benefits paid annually by the

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[40] 2007 QCCA 454.
[41] 2011 QCCA 1694.

plaintiff. The court thereby awarded compensation corresponding to the gross profit the corporation would have derived from the terminated contract.

Finally, in *Vidéotron s.e.n.c. c. Bell ExpressVu, l.p.*,[42] decided in 2015, the appellant claimed compensation for lost revenues from its cable broadcasting service due to the respondent's negligent failure to prevent the piracy of its own television signals broadcast to its subscribers. In a copiously reasoned judgment in which the Court of Appeal dwelled at length on its power to intervene on the quantification of damages, the compensation is calculated on the basis of the cash flow that would have come from the lost subscribers minus the cost of acquiring subscribers. As thus calculated, the amount of the compensation corresponded to the appellant's lost gross profit due to the respondent's fault.

The subsequent sections of this article indicate that the Court of Appeal approaches the exercise of compensating lost profit in a highly variable manner, according to the circumstances.

5.3 Decisions of the Court of Appeal Awarding Compensation for Lost Profit Based on Net Profit

An examination of the case law from the Court of Appeal reveals an increasingly regular tendency on its part to quantify lost profit based on the anticipated net profit that was not realized. The "principle" that appears to emerge from these cases is that lost profit consists of the net profit that could not be earned because of the fault. This tendency is perhaps motivated in part by fear of overcompensating the victim.

In certain circumstances, particularly where the fault committed affects the enterprise as a whole and causes it to go out of business, anticipated net profit is undeniably a good starting point[43] for evaluating the loss sustained, since as explained above, by ceasing operations the enterprise also ceases to incur fixed costs.

However, we respectfully submit that in cases where only one revenue-generating operation is affected, compensating the victim on the basis of lost net profit leads directly to under-compensation.

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[42] 2015 QCCA 422, leave to appeal refused, *Vidéotron s.e.n.c. c. Bell ExpressVu, l.p.*, 2015 CarswellQue 9607 (S.C.C.).

[43] In such cases, the loss could correspond to the value of the enterprise, which would then have to be determined using a recognized business evaluation method.

We will now review the major judgments rendered by the Court of Appeal over the last 40 years where compensation was determined on the basis of lost net profit. Three distinct types of cases are dealt with successively.

a) ***Situations where the fault affects all of the enterprise's activities and leads to the cessation of its operations***

First of all, we should say that we are of the view that using the enterprise's net profit rate as the determining factor may be appropriate where the task is to reconstitute the financial situation of an enterprise whose entire operation has been affected by the fault and caused it to go out of business. In such a case, net profit is a useful tool, because it is a reflection of the overall business performance of the enterprise and thus constitutes an appropriate starting point for determining the extent of the loss due to its demise.

Thus, in *Banque de Hongkong du Canada c. Bert Friedman Enterprises Ltd.*,[44] rendered in 1996, it appears to be justified that the damages were calculated on the basis of anticipated net profit. The dispute arose because the appellant had abruptly and intemperately terminated its business relationship with the respondent, an importer and distributor of fruits and vegetables. Because of the termination, the respondent was forced to make a bulk sale of its assets. Consequently, it is quite possible that its need to incur fixed costs was eliminated. It is therefore probably justifiable that its compensation was determined to be simply the net profit lost during the year impacted by the bulk sale.[45]

Similarly, in *Subaru Auto Canada Ltée c. Caravane & Auto du Cap Inc.*,[46] also decided in 1996, the Court of Appeal confirmed the trial judge's evaluation of damages due to the early termination of a franchise contract, in the course of which the judge had quantified the lost profit by deducting the operating costs incurred to run the business from the anticipated gross profit. This yielded the net loss sustained which, under the circumstances, was probably the appropriate compensation.[47]

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[44] 1996 CarswellQue 781 (C.A.).

[45] The facts of the case do not allow it to be determined whether the compensation corresponded or should have corresponded to the value of the enterprise after taking into account net proceeds from the disposition of its assets.

[46] 1996 CarswellQue 228 (C.A.).

[47] The facts of the case do not allow it to be determined whether the compensation corresponded or should have corresponded to the value of the enterprise.

The 1998 case of *Crédit Bombardier Ltée c. Meloche* [48] involved a claim for damages by the respondent and two corporations it operated in the area of the sale and repair of motor boats. Following an abrupt and ill-advised taking-in-possession by the appellant, the two businesses were forced to close. In awarding compensation, the lost profit of the two corporations was determined for the period necessary to resume operations, which was deemed to be three to four years. The amount of compensation was calculated on the basis of the corporations' pre-tax annual net profit multiplied by 3.5 years. Under the circumstances, using net lost profit as the guideline was an appropriate choice.

The 2003 decision in *Aéroports de Montréal c. Hôtel de l'Aéroport de Mirabel inc.*[49] is another example of a case where the Court of Appeal was justified in calculating compensation on the basis of anticipated net profit. In this matter the respondent corporation was seeking compensation for the progressive loss of its earning capacity due to the closing of Mirabel airport to passenger flights. It was thus normal under that situation that compensation was determined on the basis of the net profit that the corporation had expected to earn from its hotel.

In the matter of *Yaskawa Motoman Canada Ltd. c. Bercar Electronics Ltd.,*[50] decided in 2006, a distribution contract with a seven-year term had been terminated before its expiration date of December 31, 2002. Subsequently, in early 2003 the plaintiff-appellant had been obliged to cease doing business. It sought compensation for the losses it sustained due to the unjust early termination of the contract. During the previous year it had sustained a loss, such that the defendant maintained that the termination of the distribution contract had not caused it any harm.

The trial judge allowed the action, however, based on the plaintiff's results for the previous financial years, in a context where the termination of the distribution contract had of course negatively impacted the results for 2002.

While the Court of Appeal subscribed to the logic that the results of the preceding year should not be the basis for quantifying the loss sustained, it nevertheless revised the trial judgment by calculating compensation on the basis of seven months' anticipated net profit rather than seven months' anticipated gross profit. In doing so, it relied on its judgment in *Construction Gesmonde ltée c. 2908557 Canada inc.*,[51] which it

[48] 1998 CarswellQue 779 (C.A.).
[49] 2003 CarswellQue 1768 (C.A.).
[50] 2006 QCCA 1575.
[51] 2005 QCCA 537.

maintained stood for the "usual rule" that damages are determined on the basis of a corporation's net profit rather than gross profit.

We will canvass the *Gesmonde* decision in a subsequent section, where we will show that what is characterized in *Yaskawa* as the "usual rule" appears in fact to be an expedient resorted to by the Court of Appeal in cases where there is insufficient evidence of lost profit from one contract in particular.

b) *Situations where the value of the enterprise is affected by the fault but does not cause it to cease operating*

Where the fault committed does not lead to the winding up of the enterprise's operations but nevertheless adversely affects its profitability and value, using net profit as the determining factor can probably allow the variation in the victim's financial situation due to the fault to be quantified. Our research of the last 40 years of case law has identified two decisions having a fact pattern of this nature.

In *Provigo Distribution Inc. c. Supermarché A.R.G. Inc.*,[52] decided in 1997, the dispute was over whether the respondents, who owned four supermarkets in the Granby area whose sales, prices paid for inventory, and certain operating costs had been adversely impacted by unfair competitive practices on the part of the appellant, were entitled to compensation. The appellant's conduct had not adversely impacted any of the respondent's activities in particular, but had had an overall negative effect on the profitability and value of their supermarkets. It would therefore be logical to assume that their collective financial results showing a reduction in the net profits they had expected to derive from the supermarkets would have been used to determine the amount of the compensation payable by the appellant.

The 2017 decision in *Sainte-Marthe-sur-le-Lac (Ville) c. Expert-conseils RB inc.*,[53] is another example of a similar case where it appears that the lost profit was rightly determined on the basis of the lost anticipated net profit.

In that matter the respondent engineering corporation's compensation for the negative financial consequences of defamatory statements made about it by representatives of the appellant municipality had to be determined. To do so, the court saw fit to determine the impact of the

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[52] 1997 CarswellQue 1250 (C.A.).
[53] 2017 QCCA 381.

municipality's fault on the respondent's net profit throughout the period during which the defamatory statements had caused it harm.

Certain specific contracts had been proven at trial, but as the respondent's overall business had evidently been adversely affected by the defamation, it was deemed justified to quantify the damages based on the reduction in the respondent's net profits during the relevant period.

c) *Situations where the fault affects only one activity of the enterprise*

Our research has shown that during the reference period for this article, in several of its judgments the Court of Appeal used a calculation method for lost profit based on the net profit rate of the victim of the fault. This method was used despite the fact that the revenue of which the plaintiff was deprived was marginal compared to the rest of its activities. This manner of proceeding, which is contrary to the guidelines set out in the landmark judgment in *Concreters Ready Mix*, in our view appears to disregard the fact that there is only a remote connection between an enterprise's net profit and the profit it anticipated earning from a single commercial transaction or contract.

It is moreover troubling that certain judgments of the court refer to this practice as a ''rule'', which in no small way influenced the judgments of the courts below in similar matters. Even more troubling is the fact that, in our view, in many cases this ''rule'' is at odds with that of full compensation for the loss sustained, which is the cardinal rule.

We shall see moreover that the ''rule'' consisting of calculating compensation for a lost contract on the basis of the claimant's net profit margin is nothing more than a palliative for a lack of evidence before the court, and has led judges to reduce the compensation awarded because the demonstration of the lost gross profit being claimed did not appear convincing to them. It is important to highlight this situation because it has the potential to prompt the impugning of the above-described ''rule''.

Our review of the case law in this regard begins with the decision in *Benoit & Kersen Ltd. c. Magil Construction Ltd*[54] rendered in 1978.

In its decision, following extremely brief reasons for judgment, the Court of Appeal determined the compensation payable to the bidder on a contract that it should have been awarded by deducting part of the

[54] [1978] C.A. 301 (Que.).

bidder's overhead included in the amount claimed. This apparently amounts to the compensation awarded being limited to an amount corresponding to the net profit rate applied to the price of the lost contract.

Subsequently, in 1980, in *Landry c. Econ Oil Co.*,[55] the court upheld the trial judge's decision to dismiss a claim for lost gross profit and to award damages based on his discretion on lost net profit. In this case the appellant had unjustly terminated a heating-oil supply contract. The respondent had established that its gross margin per gallon of fuel was $0.09 and that its cost of transporting the fuel to the appellant's building was $0.01 per gallon. In order to arrive at the respondent's net profit, the trial judge had reduced the claim by approximately 25% to take into account overhead and "other expenses" regarding which, however, no evidence had been adduced.

In light of the fact that the contract for supplying the appellant's building was but one of the respondent's many such contracts, it is unlikely that its performance occasioned any increase in the respondent's overhead. Consequently, the judgment probably resulted in under-compensation of the victim of the fault.

The use of a method for calculating compensation based on net profits seems in our view even more inappropriate in *Acier Mutual Inc. c. Fertek Inc.*,[56] decided in 1996. This turned out to be a very important judgment, given the extent to which it influenced the subsequent case law on determining compensation for a fault committed in connection with a call for tenders.

In its reasons, the court lamentably seems to consider gross profit and net profit as interchangeable factors to be applied at the discretion of the judge calculating compensation for a lost contract. Moreover, the court seems to be suggesting that an estimate of lost net profit is critical, and should be used as a guideline by courts when calculating damages for lost profit. However, the fact pattern underlying this decision is so unique that it should have been considered a *sui generis* case rather than a precedent of general application.[57]

In this matter Fertek claimed damages for the loss of a subcontract for the supply of reinforcing steel that it should have been awarded. Its

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[55] [1980] C.A. 166 (Que.).
[56] 1996 CarswellQue 194 (C.A.).
[57] In this regard it must be said that in Gesmonde the pendulum appears to be swinging the other way. We will return to this later.

witness testified that the anticipated gross profit on the contract was 20% or $136,000. That evidence was vigorously contested by the appellant on the basis of Fertek's financial statements, which showed that its annual net profit rate was less than 3%. In addition, the court was faced with a deficiency in Fertek's evidence, as its witness maintained that the average price of a ton of reinforcing steel was $350, whereas other witnesses put it at between $370 and $400. According to the court, this discrepancy alone represented an amount of $36,750 whereby Fertek's damages had been overestimated. And it appears that this perceived exaggeration by Fertek's witness tainted his entire testimony.

The court then proceeded to compare Fertek's average net profit to the adjusted gross profit on the lost contract, which would have been 15% following the correction of the steel price. The court was astounded by the assertion by Fertek's witness that its financial performance on the lost contract would have increased its net profits for the year in question by 35%, despite representing just 8.5% of its total sales.[58] In the court's view, there was no explanation for this exceptional profitability.

The court went on to reach the following conclusion:

> [TRANSLATION] In my opinion, in light of these contradictions and obvious exaggerations, and absent any other indicia, I consider that the soundest method for evaluating the loss, i.e. the net profit that the work would have generated had it been performed, consists of applying to the value of the bid the same profit realized on the aggregate of the enterprise's activities in 1981 and 1982, i.e. 3.75%. As at April 30, 1982, the net profit before taxes was $286,056 on sales of $7,984,000, or 3.5%, and as at April 30, 1981, it was $290,331 on sales of $7,160,202, or 4%, for an average of 3.75%. And if I round off the result that yields, I get the amount of $26,000, to which I would apply interest and the additional statutory indemnity.[59]

This decision had far-reaching implications for the years to come, as it helped make *Acier Mutual* a leading case for the principle that compensation for lost profit should as a general rule be determined on the basis of the net profit as shown in the claimant's financial statements, and not on the basis of its gross profit.

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[58] In fact this was entirely possible.
[59] *Supra*, note 56, p. 11.

In our view the court's comments regarding Fertek's evidence show that its judgment was strongly influenced by what it perceived to be insufficient – if not false – evidence. This no doubt led the court to make the inappropriate correlation between Fertek's annual net profit and the anticipated profit on the lost contract. This was essentially speculative, as the expenditures applied to the gross profit to arrive at the net profit were not known. In addition, an explanation of the degree of profitability of the lost contract versus that of the other performed contracts would have been more useful than comparing the claimant's anticipated profit on a particular contract to its pre-tax net profit. In this regard, it must be borne in mind that there is no reason in theory why a loss-making enterprise cannot make a profit on one operation in particular.

In our view, this illustration in and of itself shows the extent to which the statement of "principle" drawn from *Acier Mutual* should be viewed with a great deal of circumspection and that decision distinguished on its facts in the majority of cases. For as the calculation of net profit necessarily involves subtracting fixed costs from the gross profit realized on each revenue-generating operation, it cannot be supposed that a claimant will be placed in the financial situation it would have been in but for the fault by awarding it an amount corresponding solely to its net profit rate applied to the price of the lost contract. In our opinion, and with all due respect, this results in patent under-compensation.

In the 2001 decision in *Laboratoires Bio-Recherches ltée c. Technilab inc.*,[60] the respondent's compensation had to be determined for lost profit due to a delay in its ability to bring a drug to market. The delay had been caused by the appellant, whom the respondent had retained to have the drug approved by the regulator. The drug in question was but one of many marketed by the respondent, such that its business was not dedicated exclusively to the marketing of this particular drug. Thus, the fact that its fixed costs of every nature were taken into account in calculating the respondent's compensation, by deducting them from its gross profits in order to arrive at its net profit, directly resulted in under-compensation for its loss.

In 2002, in *Entrepreneurs électriciens Comtel inc. c. Compagnie Loomex électrique ltée*,[61] the respondent's compensation had to be determined for lost profit due to the loss of a contract because of a fault committed by

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[60] 2001 CarswellQue 208 (C.A.), leave to appeal refused 2001 CarswellQue 2205 (S.C.C.).
[61] C.A. no 500-09-002843-969, May 27, 2002.

the appellant in connection with the submission of a bid pursuant to a call for tenders. The trial judge determined that the compensation should represent 11.245% of the price of the lost contract, which represented an amount between the gross profit and the net profit generally made by the respondent. Finding that the evidence in no way justified that percentage, the Court of Appeal determined that the percentage which should have been used to calculate the compensation was 5.6%, which represented the respondent's average net profit rate for the two previous years and the following year. In the court's reasons, it is important to note that it incorrectly characterizes this percentage as the "average gross profit". A close reading of the trial judgment, where the evidence is set out in detail, indicates that the term that should have been used is "average net profit" and that "average gross profit" appears to be the result of a typographical error.[62]

In 2013, in *Canada (Procureur général) c. Construction Bé-Con inc.*,[63] the court reproduced an excerpt from its decision in *Construction Gesmonde*[64] – which we deal with at length in the next section. It relied on that judgment to reject the appellant's argument that the damages the respondent was entitled to were limited to the profit disclosed in its bid. In the court's view, as stated in *Gesmonde*, the profit that can be claimed is not that which the contractor "hoped" to earn, but that which it "de facto" would have earned.

The court nevertheless did not uphold the trial judgment wherein the judge rejected the contractor's evidence that the contract in question would have yielded a profit (gross?) of $245,000. The court instead relied on a table prepared by the contractor showing its net profit rate for the relevant years, stating that it was justified in doing so because of the "uncertainties inherent in construction contracts".[65]

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62 See *Cie Loomex Électrique Ltée c. Constructions Sicor Inc.*, 1996 CarswellQue 2249 (C.S.).

63 2013 QCCA 665.

64 *Construction Gesmonde ltée c. 2908557 Canada inc.*, 2005 QCCA 537.

65 In this case, the net profit rate applied to the contract price resulted in compensation of $190,660, an amount that suggests an overly high net profit rate, as the contractor maintained that its gross profit was $245,000. The question thus arises whether the net profits shown in the table were truly "net". It should be noted that the claimant corporation's financial statements were not entered into evidence.

5.4 Decisions of the Court of Appeal Awarding Compensation for Lost Profit on the Basis of a Composite Value Midway Between Gross and Net Profit

The case law showing a tendency of the courts in general and the Court of Appeal in particular to compensate lost profit based on an evaluation of the lost net profit is interspersed with decisions that take a more nuanced view of quantification of the loss sustained. In those cases, the starting point for the calculation is the amount estimated on the basis of the net profit rate, but the court then increases the amount from the first calculation in order to take into account general or indirect costs.[66] This results in a composite award of compensation, midway between gross profit and net profit.

In our view it should be noted that this approach runs counter to the principle of full compensation for the loss sustained. Nevertheless, the judgments in this category are important constituents of the positive law in this regard, in that they depart from a dogmatic approach to compensation that considers quantification based on the net profit rate to be a quasi-legal rule. But as we have seen, in order to ensure that the principle of full compensation is respected, this "legal rule" must yield to accounting principles judiciously applied to the facts of each case. We will once again provide several examples of this approach – which seems random and remains imperfect – as it is encountered in decisions of the Court of Appeal.

In *Metroliquid Carriers Ltd. c. Gasbec Inc.*,[67] an exclusive multi-year transportation contract guaranteed the plaintiff haulage company a minimum of $240,000 per year for the term of the contract. In its action for lost profit, the plaintiff claimed its lost gross profit, which it maintained was 15% of its revenues. The evidence showed that the net profit rate for all the plaintiff's operations was 5%. For the purposes of the litigation, Michaud J. – who went on to become the Chief Justice of the Court of Appeal – determined that the plaintiff's annual revenues were $240,000. He awarded 10% of that amount as compensation for lost net profit for each year remaining on the contract. In doing so, he took into account that the lost contract was the most profitable of all the plaintiff's operations. The plaintiff's profit rate on this contract was greater than its general net profit rate.

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[66] Or the inverse: determining the "gross profit" and then subtracting an amount corresponding to the contract's contribution to overhead.

[67] [1987] R.R.A. 267 (C.S. Que.).

> [TRANSLATION] According to accountant Tremblay, the annual lost profit due to the loss of the contract with the defendant is 5% of $240,000, taking overhead into account. If overhead is not taken into account it would be 15% of that amount. The contract would not have been performed without any overhead expenses. However, the plaintiff's overall overhead should not be equated with the overhead expenses specifically incurred for managing the contract with the defendant. As the uncontested evidence shows, that particular contract was far more profitable for the plaintiff than its other contracts.[68]

Metroliquid Carriers – which was upheld by the Court of Appeal in 1991[69] – is in line with the tendency in the case law that compensation is to be determined on the basis of lost net profit, but it evinces a certain hesitancy, in that it allocates only a representative portion of overhead to the terminated contract. The compensation thereby approaches the result of the plaintiff's calculation of the gross profit it hoped to make on the contract, but according to our analysis does not correspond to the loss actually sustained.

Several years later, in its 2005 decision in *Construction Gesmonde ltée c. 2908557 Canada inc.*,[70] the Court of Appeal rendered an important judgment, as it considerably revised the guidelines it previously established for quantifying damages for lost profit. It is much more nuanced than the court's decision in *Acier Mutual*, which was rendered on a very specific set of facts that did not lend itself to the establishment of a general rule. That decision is canvassed above.

In *Gesmonde*, the appeal concerned the quantification of the lost profit sustained by the respondent, who should have received a subcontract for electrical work from Gesmonde. The trial judge awarded compensation corresponding to the gross profit the respondent generally made on its contracts. The gross profit rate – 22.6% – had been reduced[71] to take into account various overhead expenses of the firm.

The quantum of damages was considerably reduced by the court. In its view, the trial judge made a palpable error, as the testimony of the respondent's president revealed that the firm had used the cost price of

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68 *Ibid.*, para. 20.
69 *ICG gaz liquide ltée c. Metro Liquid Carriers Ltd.*, 1991 CarswellQue 522 (C.A.).
70 *Supra*, note 64. Please also consult the Superior Court decision in *Construction Gesmonde ltée c. 2908557 Canada inc.*, 2004 CarswellQue 95 (C.S.).
71 By 20%.

labour in its bid and only anticipated making a profit thanks to a discount it hoped to receive on the equipment to be installed as part of the project. The court awarded the respondent 15% of the profit it had expected to make on the equipment: $46,625.70. That amount was further reduced however, on account of certain overhead costs, because the evidence showed that those expenses increased in tandem with increased business revenues, which indicates that variable expenses had somehow entered into the equation. On the basis of the respondent's financial statements, the court determined that the profit it could have made on the contract was 5.2% of the bid price.

According to the court, the appropriateness of the profit rate applicable to the contract was demonstrated by the fact that the respondent's pre-tax net profit was 3.7%. But as this rate took into account depreciation on equipment and other property, the net profit rate should in our view not have been used to calculate the compensation. The court explained that depreciation yields deductions for tax purposes, but does not represent actual costs currently incurred. By taking depreciation into account, the court felt more comfortable about its decision to award damages based on a profit rate of 5.2% on the lost contract, a rate that exceeded the respondent's net profit rate.

The court then stated the following regarding the *Acier Mutual* decision:

> [6] [TRANSLATION] In theory, these profits must be evaluated based on the contract the respondent was deprived of. In other words, we must evaluate the profit that the respondent would have made had it performed the contract. The decision in *Acier Mutual Inc. c. Fertek inc.*, J.E. 96-602 (C.A.) does not stand for the proposition that lost profit is in all cases to be determined by applying the enterprise's average profit rate to the price of the lost contract, but rather, absent sufficiently convincing evidence of the profit it would have made on the contract, quantification of the loss sustained can be determined using the contractor's general profit margin as shown in its financial statements.
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> [7] In addition, it is not the amount that the party hoped to earn when it submitted its bid that is to be awarded, but the amount it would have actually earned from performing the contract had it been awarded it. In other words, the judge must make a projection of what would have transpired.[72]

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[72] *Supra*, note 64, p. 2.

We find it revealing that in this excerpt the Court of Appeal does not qualify the "profit" it refers to as net or gross. This dictum is also interesting in that it suggests that the loss should be evaluated on a concrete basis rather than by applying a readymade formula taken from the case law and whose application may be wholly inadequate depending on the specific context of each case.

In our view, in its decision in *Gesmonde* the Court of Appeal was possibly seeking to rectify the approach taken in the *Acier Mutual* judgment it rendered 10 years earlier. This however does not elevate the *Gesmonde* decision to the status of a precedent equal in importance to *Concreters Ready Mix* which, deplorably, continued to dwell in oblivion.

A year later, in 2006, in *MYG Informatique inc. c. René-Lévesque (Commission scolaire)*,[73] the Court of Appeal again had the occasion to deal with the quantification of lost profit. In that case, a computer equipment supplier's bid had been unjustly rejected by the respondent school board following two calls for tenders. Because the appellant's action had been dismissed at trial, there was scant evidence before the court for the purposes of quantifying the damages.

It is evident from the decision that the appellant's claim represented 15% of the price of the equipment that it believed it could sell the school board. This margin – a gross margin – was due to a discount available from its supplier, provided its sales reached a certain threshold. However, the evidence needed to establish the amount of the discounts was not in the court record. Moreover, it had been established on cross-examination that the "profit margin" – we understand from the judgment that this actually means "net profit" – of the appellant was 6.45%, 0.42% and 4.8% respectively for the three years relevant to the evaluation. On this basis, the Court of Appeal rejected the claim based on a profit rate of 15%.

In light of evidence establishing that the appellant's contracts with public bodies were more profitable than its average contract, the court awarded damages of 8% of the selling price of the equipment that the appellant would have been able to sell the school board following the tendering process, but for the latter's fault.

In *MYG Informatique*, despite insufficiencies in the evidence, the Court of Appeal determined the compensation by taking into account the anticipated profitability of the specific sales that did not materialize due

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[73] 2006 QCCA 1248.

to the respondent's fault. This matter well illustrates the lesson to be drawn from *Gesmonde* and the court's re-reading of *Acier Mutual* in its decision: only in the absence of sufficient evidence should an enterprise's net profit margin be used to determine the amount of the financial harm sustained from a lost contract. In this regard, Morissette J. stated the following:

> [TRANSLATION] This Court recently reiterated, in its decision in Construction Gesmonde, a rule taken from the *Acier Mutual inc. c. Fertek inc* decision, which can be expressed as follows: in the absence of sufficiently convincing evidence of the profit that would have been made on a contract awarded to a third party, quantification of the loss sustained can be achieved on the basis of the margin generally realized by the contractor, as shown in its most recent financial statements. The examples of such proof based on financial statements in similar instances are fairly frequent in recent case law.[74]

That being said, we repeat that we dispute the idea that quantification of lost profit resulting from the loss of a contract can be validly achieved by applying the victim's net profit rate to the lost revenue, even after adjustments such as those made in the decisions canvassed in this section. As we have seen, this leads to significant under-compensation of the victim because the method – described as a palliative for a lack of evidence – does not allow the victim to be placed in the financial situation it would have been in but for the fault. This method inevitably undervalues the financial loss sustained.

5.5 *Electrolux v. AIM*: The Full Compensation for Loss Rule Shredded Like Scrap Metal?

The *Electrolux* decision, rendered in the autumn of 2016, and which was the inspiration for this article, deals with the quantification of damages resulting from unjust termination of a contract for the supply of scrap metal. This recent judgment is an interesting case study for the purposes of examining and taking stock of the attitude of the Court of Appeal of Quebec when dealing with issues associated with the quantification of lost profit in commercial matters.

It is true that this matter raises questions pertaining to the sufficiency of the evidence adduced, and not only questions specific to the

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[74] *Ibid.*, p. 25.

quantification of damages. It nonetheless remains that, in our view and with all due respect, the Court of Appeal seems to have significantly erred in *Electrolux* in the way it dealt with the concept of lost profit.

In our analysis of the decision, we have endeavoured to gloss over the evidence-related issues and dwell solely on the theme that has provoked our comments, which is the methodology used by the court to quantify lost profit.

a) *The trial judgment*

The *Electrolux* decision was issued pursuant to the appeal of the decision at first instance rendered by the Honourable Stéphane Sansfaçon of the Superior Court[75] in which Electrolux Canada Corp. ("Electrolux") was ordered to pay damages of $1,679,549.43 to the plaintiff American Iron & Metal LP ("AIM"). The lawsuit followed the termination of a contract whereunder Electrolux undertook to sell to AIM, for a defined term, all of the various types of scrap metal generated by its appliance manufacturing plant in the municipality of L'Assomption. The purchase price of the scrap metal was determined using a grid containing the prevailing market prices for the various categories of scrap metal generated by Electrolux.

AIM sold the scrap metal to the Ivaco foundry, pursuant to a long-term supply contract whereunder AIM undertook to satisfy all Ivaco's scrap metal needs. The contract price was based on a per-ton rate for each category of scrap metal delivered to the foundry from AIM's storage facility.

The trial judgment indicates that the scrap metal acquired by AIM from Electrolux represented only a small fraction of AIM's acquisitions of scrap metal from other suppliers: while AIM typically took delivery of one container per day of scrap metal from the Electrolux plant, some 100 to 500 containers per day were delivered to it from other sources. The trial judgment also indicates that all of the scrap metal acquired by AIM from Electrolux was destined for Ivaco, of which AIM was the sole supplier and whose demand for scrap metal was insatiable.

It appears from the factual narrative in the trial judgment[76] that Electrolux decided to illegally terminate its contract with AIM because it had found another purchaser willing to pay more for its scrap metal.

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[75] *American Iron Metal, l.p. c. Electrolux Canada Corp.*, 2015 QCCS 245.
[76] Which was in this regard not called into question on appeal.

Electrolux's liability for thus terminating the contract was not in issue on appeal: only the quantum of damages and certain evidentiary issues were in dispute.

The compensation awarded by the trial judge was determined on the basis of the difference in the price paid by AIM to Electrolux and that paid by Ivaco to AIM for each category of scrap metal sold. The judge's calculations were based on the actual quantities of the various categories of scrap metal that were delivered to the party that replaced AIM as purchaser thereof after Electrolux's illegal termination of the contract.

The judge sought to determine the benefit that had accrued to AIM from the performance of its contract with Electrolux, based on the difference between AIM's purchase price and its resale price to Ivaco. In doing so, he based himself on evidence that he acknowledged was deficient in certain respects, and in arriving at what he considered was the amount of the lost profit, he indicated that he had taken those lacunae into consideration.

To determine the benefit that had accrued to AIM from the contract, the judge took into account the evidence led before him in determining the operating costs associated with the purchase and resale of the materials acquired from Electrolux and resold to Ivaco. These were essentially transportation and handling costs, and the transportation costs were admitted.

With respect to the costs of handling and processing the materials, the judge analyzed the evidence led regarding the expenses incurred specifically on account of the acquisition of scrap metal from Electrolux. These were deemed to be a proportion of the wages of the handlers of the scrap metal and the cost of leasing a crane equipped with an electromagnet.

AIM had estimated the cost per ton for both the magnet crane and the handlers' wages at $4.64 per ton. However, given the evidentiary shortcomings in proving these expenses, the judge saw fit to establish the handling and crane costs at $10 per ton which, added to the transportation costs, led him to the conclusion that that the operating costs applicable to the purchase and resale of the materials acquired by AIM from Electrolux amounted to $34 per ton.

Thus, the trial judge reduced the gross profit on the scrap metal by $34 per ton, despite acknowledging that AIM's loss of its contract with Electrolux likely had virtually no effect on its operational labour requirements, given that the volume of scrap metal sourced from

Electrolux represented a negligible fraction of the scrap metal it acquired on a daily basis from all its suppliers: between 0.2% and 1%, *i.e.* one container load out of the 100 to 500 loads of scrap metal it received each day.

That being said, the trial judge rejected the testimony of Electrolux's expert concerning all of the expenses to be taken into account in order to determine AIM's lost profit due to the loss of its contract with Electrolux. The expert maintained that the operating costs of all of AIM's business activities should be taken into account in determining the harm it suffered from the loss of the contract. Thus, the judge clearly rejected the theory that quantum is to be determined on the basis of the net profit rate applied to the revenue from the terminated contract. His approach consisted rather of determining the gross profit lost by AIM on account of the contract's termination.

The trial judge also rejected the defendant's theory, propounded by its expert, that no harm whatsoever had been sustained by AIM, because Electrolux's breach of contract never caused it to run out of stock for delivery to Ivaco. For despite Electrolux's breach of the contract, thanks to AIM's multiple sources of scrap metal from other suppliers, it was never in a position where it could not sell Ivaco the volume of metal the latter had agreed to purchase from it. By the same token, AIM did not have to purchase material at a higher price than that under the contract with Electrolux in order to supply Ivaco at the agreed upon rate. In Electrolux's view, this meant that the termination of the contract had caused AIM no harm.

However, on the basis of the evidence led by AIM establishing that, sooner or later, the material acquired from Electrolux would have been sold to Ivaco, the trial judge rejected this theory and confirmed that a loss had indeed been sustained by AIM. The fact that the contract with Ivaco was for a lengthy term and the material to be sold to it was by nature imperishable also contributed to his conclusion that the damage was indeed real.

The trial judge thus accepted the plaintiff's evidence establishing that additional supplies of material from Electrolux would be added to the revolving inventory of AIM, which had always sold Ivaco all of the materials acquired by it from its various sources of supply. Thus, sooner or later the material that was to have been sourced from Electrolux would have been sold, at a profit, to Ivaco.

b) ***Judgment of the Court of Appeal***

The Court of Appeal completely rejected the approach taken by the trial judge regarding the quantification of the damages sustained by AIM. In large part, this rejection was based on a purported palpable and overriding error in dealing with the evidence regarding damages. The trial judge is said to have awarded damages despite a shortage, if not absence, of evidence. According to the court, the trial judge could not palliate this lack of evidence by determining in his discretion the amount of compensation to be awarded. By doing so, he committed a palpable and overriding error.

The Court of Appeal also admonished the trial judge for having taken the plaintiff's evidence on damages into consideration despite the fact that it was unsupported by expert opinion.

In addition, the court indicated that it would have subscribed to the opinion of the defendant's expert that determining the profit lost by AIM could only be accomplished by taking into account the operating costs for its entire operation. As this evidence was not led and AIM's financial statements were not produced, the plaintiff's evidence on damages did not meet the minimal conditions for validity that the plaintiff was required to satisfy.

Having concluded that the claim for damages had not been validly proven, the court dismissed the claim as presented by AIM.

However, as the amount of the increased price obtained by Electrolux from the purchaser that replaced AIM had been proved, the court saw fit to replace the initial award Electrolux had been ordered to pay ($1,679,549.43) with an amount equal to the additional profit made by Electrolux from the sale of its scrap metal after the termination of the contract ($110,795).

Four paragraphs of the decision eloquently attest to the profound divergence in views of the Court of Appeal and the trial judge. Those paragraphs are in our view at the very heart of the Court of Appeal's judgment.

> [13] Respondent could have sought to recoup its loss by proving an increased cost in sources of supply, alternate to Appelant. Instead, as was its right, Respondent sought the "profit of which it was deprived" because of Appellant's breach. At paragraph 59 of the judgment, the judge erroneously described such profit as ". . . la différence entre

> le prix payé et le prix vendu, moins les coûts d'exploitation de l'entreprise pour cette activité". In other words, he equates lost profit to revenue minus certain direct costs, as stated above.
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> [16] Appelant's expert testified clearly and without contradiction, that loss of profit cannot be calculated without operating costs. The expert stated that there was no indication of sales' commission if any, overall salaries (i.e. not merely labour costs connected directly with the performance of this contract), costs of maintenance of machinery, depreciation and electricity. I would add to this enumeration, rent and fixed costs for mortgage, real estate tax, bank interest, utilities generally, insurance and administration.
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> [17] Respondent's attorney pleaded that overhead is a constant so that the proof of these cost items is unnecessary to show the loss of profit from this contract. The position is specious since, if it were true, then the contract in question would necessarily be treated for present purposes as supporting less operating expense and thus generating a higher profit margin than the rest of the Respondent's activities.
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> [18] I consider the absence of the proof of Respondent's overall costs enumerated above to be fatal to the proof of loss of profit. Respondent had the burden of proof of such loss. The judge's error in this regard is palpable and overriding and, given the absence of evidence, we cannot substitute our judgment for that of the trial judge by calculating a gross margin and applying it to the anticipated lost revenue as calculated by the judge to arrive at a figure of lost profit.[77]

c) *Analysis*

If the primary motivation for the *Electrolux* decision had merely been the court's finding that there was insufficient evidence, it would be a relatively banal judgment scarcely worthy of comment. Well-founded or not, the judgment would have been *sui generis*, distinguishable on its facts, and relatively inconsequential. That being said, we would be remiss not to point out the extent to which the criterion of thorough proof of damages is elevated to such a high degree in *Electrolux* compared to the degree found acceptable in many other judgments,

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[77] *Supra*, note 2, pp. 2-3.

including some of the Court of Appeal, where it is stated that although the task of quantifying the damages may be difficult, judges must nevertheless proceed to do so, even though they may be obliged to use their own discretion to determine the amount of compensation. There are many examples of this stance in the case law.[78]

It is evident however that the Court of Appeal's judgment was motivated not only by its finding of evidentiary weaknesses. It is rather based first and foremost on the court's rejection of the trial judge's concept of the burden of proof that the plaintiff had to discharge to prove its lost profit resulting from termination of the contract.

It is this divergence of views that in our opinion justifies close attention being paid to the *Electrolux* decision. This divergence makes *Electrolux* a decision of considerable importance. Despite being taken from a judgment dismissing a victim's claim based on its own loss, the four paragraphs in question contain crucial yet troubling guidelines.

In light of the evidence led regarding the virtually unlimited capacity of AIM to sell its scrap metal to Ivaco, the fact that AIM was no longer able to obtain scrap from Electrolux represented a loss in its capacity to sell the material covered by the terminated contract. In our view this loss in selling capacity clearly caused it harm corresponding to the difference between the per-ton purchase and resale prices, minus the expenses directly related to the operations involved in purchasing and reselling the materials that Electrolux had decided to sell to someone else.

For the Court of Appeal, however, the evidence allowing this calculation to be made was not valid proof of the profit that AIM had lost. According to the decision, proving that profit required taking into account all of the expenses associated with the operation of the plaintiff's business. There would accordingly be no loss on the terminated contract unless the entirety of the plaintiff's operations were profitable, and the loss would be limited to the net profit rate applied to the amount of the terminated contract.

It is evident however that the gross margin realized on the contract with Electrolux was such that it allowed AIM to partially cover its overhead

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[78] See in particular *Procureure générale du Québec c. Inter-Cité Construction ltée*, 2017 QCCA 1525; *Banque de Montréal c. TMI-Éducaction.com inc. (Syndic de)*, 2014 QCCA 1431; *Brizard c. McNicoll*, 2013 QCCA 2192; *Sunrise Tradex Corp. c. Tri-Caddi International Inc.*, 2011 QCCA 2064, leave to appeal refused 2012 CarswellQue 4403 (S.C.C.); *Société de gestion des activités communautaires de l'Île Notre-Dame c. Renaud*, 2004 CarswellQue 583 (C.A.); *Provigo inc. c. 9007-7876 Québec inc.*, 2004 CarswellQue 10072 (C.A.); *Beaver Foundations Ltd./Fondations Beaver ltée c. R.N.R Transport*, [1993] R.L. 391 (C.A. Que.).

and, eventually, to generate a profit. Alternatively, in the event that AIM was losing money, there is no doubt, given the evidence led before the trial judge, that the Electrolux contract would have allowed it to reduce its losses.

In *Electrolux*, the Court of Appeal went further than it has ever gone in asserting that there is a rule to the effect that damages for lost profit are to be quantified based on the victim's net profit rate. In that regard the judgment contradicts previous judgments of the court in which it used the gross margin to quantify lost profit. And, moreover, this decision is diametrically opposed to that in *Concreters Ready Mix*.

In our view the discrepancy between the approach taken by the trial judge and the very different one taken by the Court of Appeal is perhaps partially due to the use of imprecise French terminology ("*le profit*" instead of "*le gain*") no doubt aggravated by the linguistic duality of Quebec and its *Civil Code*, a subject canvassed above. However, over and above terminological issues, we believe that the result in *Electrolux* is fundamentally due to hapless confusion in the application of accounting concepts.

Given the Court of Appeal's position in Quebec's judicial hierarchy, the dicta referenced above, taken from a recent decision rendered by a unanimous bench, have the potential to set a dangerous precedent. They are far from banal, as they consecrate the notion that damages for lost profit are to be determined on the basis of the victim's net profit rate. With all due respect, such a notion, expressed as if it were a general rule, is contrary to the principles of forensic accounting, as we have seen.

Incidentally, *Electrolux* is a very rare example of a case where the compensation awarded a victim of financial loss was determined on the basis of the profit that the defendant's fault allowed it to realize. From that perspective, given the plaintiff's failure to establish the quantum of the damages it suffered, it was effectively given a consolation prize funded by taking away from the defendant the profit that its fault generated. This concept of compensation transforms it into a penalty and strays far from the principle of full compensation for the loss sustained. This approach in no way restores the victim to the financial situation it would have been in but for the fault. While this judgment is not the first of its kind rendered by the Court of Appeal,[79] it nevertheless

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[79] See *Uni-Sélect inc. c. Acktion Corp.*, 2002 CarswellQue 1896, REJB 2002-33889 (C.A.), (leave to appeal refused 2003 CarswellQue 1188 (S.C.C.)) where this approach was also taken. The case of *France Animation c. Robinson*, 2011 QCCA 1361, reversed in part 2013 CarswellQue 12345

raises serious questions, as this method of determining compensation in civil matters does not in any way appear to have been contemplated by the legislature.

In our view, as abundantly expounded above, taking into account all of the operational expenses of an enterprise in order to determine the extent of a loss sustained in connection with a single discreet operation is not justified in either legal or accounting terms. Moreover it potentially constitutes a very serious departure from the principle of full compensation for loss sustained.

In order to rectify the positive law on the evaluation of a loss consisting of lost profit, a return to the basic principles applicable to the quantification of damages, together with forensic accounting assistance to demystify certain concepts, is clearly called for.

To that end, the obvious solution in our view would be for the Court of Appeal to bring the *Concreters Ready Mix* decision back from its shocking and deplorable exile. There can be no doubt that it constitutes a reliable guide for the purpose of properly evaluating lost profit due to a breach of contract. Conceptually, it and the *Electrolux* decision could not be further apart.

6. CONCLUSION

Our review of the last 40 years of case law on the quantification of lost profit in commercial matters shows that the Court of Appeal has followed a tortuous path during that time. It is hard to discern a common thread in its decisions. Some of the judgments are clearly contradictory.

There is also an evident tendency in the case law to limit the amount of compensation for lost profit by applying what appears to be a "quasi-legal rule" whereby, if the evidence on file is not sufficiently convincing that the lost profit amount is higher, the damages are to be limited to a percentage of the net profit margin applied to the revenues that were not earned because of the fault. This "quasi-rule", which seems to rest on the erroneous premise that net profit and gross profit are interchangeable when it comes to quantifying the lost profit, is a departure of the positive law from accepted accounting principles.

(S.C.C.) can be distinguished from the general civil law, as it deals with compensating the victim of copyright infringement.

Finally, there is also an evident drift in the case law. Forty years ago, in *Concreters Ready Mix*, the court rendered a clear and straightforward judgment explaining how and why the loss due to a lost or terminated contract is to be compensated, by identifying the gross profit margin the contract would have yielded. This judgment has unfortunately been completely forgotten. And just one year ago, in four paragraphs, the Court of Appeal stated exactly the contrary. Never, before its decision in *Electrolux*, had the court in our view gone so far as to effectively declare, in a statement of principle, that compensation for lost profit in commercial matters is to be limited to the net profit rate times the amount of the lost or unjustly terminated contract.

With all due respect, in doing so the court failed to abide by the principles of forensic accounting applicable to the quantification of economic loss, and disregarded the rule of full compensation for the loss sustained.

It remains to be seen what impact the *Electrolux* decision will have on the positive law. We can only hope it will be minimal.