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Is there a new "AllStar" standard for franchise disclosure?

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Ontario's already onerous franchise disclosure requirements may have just been further complicated, based on a recent decision of the Ontario Superior Court[1]. In the September 7, 2016 decision, the court granted a two-year rescission remedy to the franchisees primarily because the franchise disclosure document (FDD) did not contain a copy of the head lease (and associated cost information), despite the fact that no site had been identified, and therefore no head lease existed, at the time of disclosure or when the franchise agreement was executed. *AllStar Wings* (AllStar) is troubling for any franchisor whose site selection process takes place after the execution of the franchise agreement, a practice that the court even acknowledges is not uncommon in the franchise industry. The court said that a franchisor must delay delivering an FDD until all material facts (not just facts about the head lease) are known. Given the non-exhaustive and broad definition of a "material fact," this pronouncement may lead to significant uncertainty for franchisors in determining when they are ready to disclose and when they can enter into the franchise agreement.

The case also contains important developments surrounding the use of disclaimers in FDDs, the proper execution of the franchisor's certificate in an FDD, and the definition of a "franchisor's associate."

Background and the decision

The plaintiffs received an FDD in December 2012, and entered into a franchise agreement in February 2013. The FDD included an estimate that it would cost between $805,500 and $1,153,286 to build a franchise restaurant from a shell building. There was no estimate for converting an existing building, despite all of AllStar's existing locations being conversions, but the FDD did contain the following disclaimer about the costs of converting existing locations: "...while Conversions may be available and offer certain savings to the Prospective Franchisee in development costs, the Franchisor has no reasonable means of estimating or predicting those costs with any certainty."

In May or June of 2013, a site for the restaurant was identified. It was an existing restaurant that would have to be converted to the AllStar format. The plaintiffs participated "to some degree" in the negotiation of the head lease. Ultimately, the lease contained a requirement for an initial tenant payment of approximately $120,000 in security deposits and prepaid rent. The plaintiffs learned about the payment in the course of the negotiation. The sublease was signed in October 2013, however, the plaintiffs did not receive an executed copy of the head lease until after the sublease was signed.

The site was completed around March 2014. The franchisor advised the plaintiffs that the cost of the franchise was more than $1 million. In July 2014, the franchisor invoiced the franchisee for the security deposits and prepaid rent (including the $120,000 security deposit and prepaid rent), which the franchisee refused to pay. On July 21, 2014 the franchisor issued

a notice of default, and the plaintiffs responded with a notice of rescission four days later. The franchisor issued a notice of termination on August 1, 2014, and in December 2014, the plaintiffs commenced the action. The plaintiff franchisees brought a summary judgment motion in an action for rescission and misrepresentation (though the plaintiffs did not pursue the misrepresentation claim in the summary judgment motion).

Providing an FDD without a head lease

The defendants asserted that signing a franchise agreement prior to a site being identified is not an unusual practice in franchising. And in such cases, the defendants argued: how can a franchisor disclose a head lease that does not yet exist?

The court was not persuaded. It emphasized the remedial nature of the *Arthur Wishart Act* (Franchise Disclosure), 2000 and the importance of rigorous disclosure requirements in protecting the interests of franchisees. The court commented that unscrupulous franchisors may deliberately disclose prematurely, when material matters are not yet known, in order to evade its disclosure obligations. The only solution, the court said, is to wait, and delay disclosure until all material facts are known.

The court's position on the timing of disclosure, which indirectly affects when the parties can enter into the franchise agreement, has the potential to impose significant challenges on franchisors who are franchising in Ontario. By holding that the disclosure documents must be specific to the franchisee receiving them, existing jurisprudence in Ontario has effectively expanded the scope of disclosure beyond the prescribed disclosure items in the disclosure regulation. However, it is possible that the *AllStar Wings* decision will have an even greater impact on franchising in the province; specifically whether franchisors and franchisees can even continue the fairly common practice of selecting a site after the franchise agreement has been signed. Surely this decision does not mean that a franchisor must enter into each head lease and assume the associated liability without any certainty that the franchisee will ultimately sign the franchise agreement.

Further, and perhaps more troubling, could this case be used by unscrupulous franchisees to claim rescission if a "material fact"— which is entirely unknown to the franchisor at the time of disclosure— arises *after* the franchise agreement has been signed?

There may be some small comfort, in that the court seems to focus on the fact that the head lease included a particular provision – the $120,000 up-front payment for security deposits and prepaid rent – that the court described as "very substantial additional up-front cost." It is an open issue whether the court would have found that disclosure was premature if there had been no such up-front cost or if an estimate of such cost had been included in the franchisor's estimate of the costs of establishing the franchise.

The court also leaves the door open for the "possibility that proper disclosure could be made [where the site is not known at the time of disclosure]." Accordingly, it may be possible for a franchisor to meet its disclosure burden without waiting for the head lease to be signed, provided that the head lease does not ultimately impose any new substantial costs and that the disclosed form of sublease accurately predicts the material terms of the head lease. A franchisor who chooses to accept this risk, however, should carefully consider an alternative plan in the event that the terms of the head lease do *not* reflect what was disclosed.

Requirement to provide site specific costs estimates

The court also found that the FDD's estimate of the costs of establishing the franchise was

deficient. The FDD provided an estimate for building a restaurant from a "shell," and suggested that converting an existing building could result in "significant" cost savings compared to building from a shell. However, in reality, the plaintiffs' conversion costs were almost as much as the high end of the estimated cost of constructing from a shell. Justice Matheson noted repeatedly that the franchisor did not have experience with building from a shell as all of its locations were conversions.

The court was looking for an estimate of costs that would reflect the plaintiffs' actual format (i.e., a conversion), and this was not provided. Franchisors should take care to ensure that their estimate of costs of establishing a franchise takes into consideration any different formats that will be available to the franchisee.

Disclaimers do not equal disclosure

Where a franchisor does not have information to satisfy a disclosure requirement, providing a disclaimer to that effect will not suffice. As noted above, in *AllStar Wings*, the franchisor did not include estimated costs of converting an existing restaurant, and instead included a statement that it had no reasonable means of predicting conversion costs, which could vary dramatically from one site to the next. Justice Matheson found this approach very problematic, and equated the disclaimer with an *admission* that the franchisor could not meet its disclosure obligations. The court states unequivocally that a "...broad disclaimer is also no answer to the mandatory statutory disclosure obligations."

This is perhaps an unsurprising development: franchisors cannot evade their disclosure obligations simply by stating that they don't know the answer, that it is burdensome to prepare the information, or because the information provided would be uncertain. Note, however, that while this particular example focused on the disclosure of costs of establishment, Justice Matheson's statements about disclaimers are likely to be relied on by franchisees in respect of a franchisor's use of disclaimers in the FDD more generally.

An equally ineffective defence to deficient disclosure was the defendants' position that one of the plaintiffs was sophisticated and had some legal experience. The court reinforced the point that the sophistication of the franchisee does not reduce the disclosure obligations of the franchisor.

Implications and Practical Considerations

AllStar Wings is one of the most important decisions on disclosure in the past decade. It may have created heightened standards for disclosure, particularly in respect of the timing of the disclosure document, as well as impacting when commercial parties can enter into the franchise agreement and related leasing arrangements. It also remains to be seen how this decision may affect commercial practices in the franchise industry, specifically whether franchisors can provide adequate disclosure prior to a site for the franchised business being located, whether this will put franchisors and franchisees at a competitive disadvantage in Ontario's highly competitive real-estate market against non-franchised tenants, or whether the decision will have a chilling effect on a franchisor's willingness to assist franchisees in site selection and leasing arrangements.

The defendants have 30 days to appeal. Watch for further Osler Updates for developments on this important case. Visit CanLII for a copy of the decision.

[1] Raibex Canada Ltd. v. ASWR Franchising Corp. 2016 ONSC 5575