Mendoza v. Active Tire & Auto Centre Inc. – Ontario Court of Appeal rejects role of an "informed decision" in rescission

JUNE 8, 2017 6 MIN READ

Related Expertise

- Automotive
- Retail and Consumer Products

Authors: Jennifer Dolman, Sarah McLeod

The recent decision by the Ontario Court of Appeal in *Mendoza v. Active Tire & Auto Centre Inc.*, 2017 ONCA 471 rejected a lower court's interpretation of the test for rescission under section 6(2) of the *Arthur Wishart Act (Franchise Disclosure), 2000,* SO 200, c 3 (the *AWA*), and granted summary judgment to the appellants rescinding the franchise agreement. The Ontario Court of Appeal confirmed that the test for rescission under section 6(2) of the *AWA* is whether the disclosure was "materially deficient," and not how a particular franchisee happened to act or react upon receipt of a disclosure document. The Court emphasized that even when franchisees have not studied the contents of the disclosure document, they are entitled to rely on its contents.

As noted in a previous Osler Update, in the lower court decision (2016 ONSC 3009), Justice Dow considered whether the franchisee had made an "informed decision" to enter the franchise relationship, instead of objectively assessing the disclosure to determine if it was "materially deficient." Further, Justice Dow assessed the subjective knowledge of the franchisee as opposed to assessing whether the franchisor's disclosure was objectively, materially deficient in light of the requirements of the *AWA*. While this less strict, more subjective approach to section 6(2) was a welcome development for franchisors, it diverged from previous Ontario decisions, including those from the Ontario Court of Appeal.

Background

In this case, the Mendozas entered into a franchise agreement with Active Tire & Auto Centre (Active Tire) to operate an Active Tire franchise. After operating for about three months at a loss, the franchise was not successful and on August 31, 2015, the Mendozas provided Active Tire with a notice of rescission. The Mendozas sought rescission under section 6(2) of the *AWA* which provides that "[a] franchisee may rescind the franchise agreement, without penalty or obligation, no later than two years after entering into the franchise agreement if the franchisor never provided the disclosure document."

Seeking to rescind the franchise agreement on the basis of this provision, the Mendozas alleged the following disclosure deficiencies:

(1) Only one officer/director of Active Tire signed the disclosure certificate;

(2) The financial statements were not entirely prepared on an "audited" or "review engagement" basis;

(3) Active Tire failed to deliver all the requisite documents at one time as part of one document;

(4) An irrevocable letter of credit described in the Application for Dealership varied significantly from what was actually signed; and

(5) Active Tire failed to disclose the underlying assumptions and information as part of the financial projections.

Justice Dow recognized that there were deficiencies in the disclosure document, particularly because it only contained one signature and because of the insufficient and non-compliant financial disclosure. However, Justice Dow concluded that although Active Tire had not complied with the requirements of the *AWA*, the documents it did provide were sufficient for the Mendozas to make an informed decision about whether or not to enter into the franchise agreement, and that the deficiencies were neither significant nor misleading.

Court of Appeal decision

The Court of Appeal reiterated the conclusion of Justice MacFarland in *6792341 Canada Inc. v. Dollar It Ltd.,* 2009 ONCA 385 *Dollar It*), that where there are a number of material deficiencies, the purported disclosure document is not a disclosure document within the meaning of the *AWA*, and rescission under section 6(2) is available.

In this case, Justice Dow acknowledged that there were deficiencies: the absence of signatures of two directors or officers on the disclosure certificate, and the failure to provide financial statements in compliance with the *AWA*. The Court of Appeal agreed with Justice Dow that these deficiencies were the principal ones. However, unlike Justice Dow, the Court of Appeal held that they represented material deficiencies that were fatal to the disclosure document.

First, the Court of Appeal emphasized the requirement for two officers' or directors' signatures on the certificate is tied to section 7(1)(e) of the *AWA*, which provides that those who sign the disclosure document are personally liable in damages to the franchisee for any such misrepresentation. In addressing this issue, Justice Dow discounted the failure to provide two signatures because the Mendozas had met most of the directors and had information about their backgrounds in Part II of the disclosure documents.

According to the Court of Appeal, the approach by Justice Dow misses the point of section 7(1)(e) of the *AWA*, which is to give franchisees substantive rights in damages against the directors and officers who sign the disclosure document, and by doing so, impress upon signatories the importance of ensuring the disclosure document is complete and accurate. The Court found that the failure to provide two signatures on the certificate was a material deficiency in disclosure:

[...] This is not a meaningless requirement. Those who sign are personally responsible for the accuracy and sufficiency of the contents of the disclosure document, and that responsibility is backed up by personal liability to the franchisee. This is an important right for franchisees which the motion judge failed to consider. It is clearly material to any franchise agreement.

Secondly, the Court of Appeal did not agree with Justice Dow that Active Tire's failure to provide the most recent financial information of the franchisor in the form and within the time prescribed by the *AWA* was insignificant. Regulation 581/00 to the *AWA* requires that a franchisor provide the prospective franchisee with audited financial statements for its most recently completed fiscal year, but provides a 180-day grace period for franchisors who do not yet have the financial statements for their most recent fiscal year prepared.

In this case, Active Tire did not produce its 2014 financial statements as required. It only

produced its 2013 statements, beyond the 180-day grace period. According to the Court of Appeal, to accept that the deficiency was not material because the former year's financial statements were only delivered two weeks after the statutory grace period, would mean that franchisors would be free to ignore the statutory requirements regarding the obligation to produce current financial statements, and franchisees would be unable to rely on the protections contained in the *AWA*.

The Court of Appeal also found it was an error for Justice Dow to take into account the argument of Active Tire that because Mr. Mendoza had not personally read the entire disclosure document, he could not take the position that the contents were of importance to him. According to the Court of Appeal:

[26] The Act imposes significant disclosure obligations on franchisors for the benefit of franchisees. It does not make the rescission remedy conditional on the approach taken by a particular franchisee to the disclosed material. This is consonant with the intent of the Act, which is to ensure that franchisors who wish to enter into franchise agreements with franchisees must consistently provide the required documentation to every proposed franchisee. Their obligations do not change depending on the actions or reactions of a particular franchisee. Nor are those obligations diminished when a franchisee does not study the contents of the disclosure document. Franchisees are entitled to rely on its contents and the ability to later verify what they believed and understood when they decided to proceed with the franchise.

While Justice Dow's less strict approach, which focused on the franchisee's "informed decision," was a welcome development for franchisors and would have afforded them new fodder for defending rescission claims, the Court of Appeal maintained that the test for proper disclosure is strictly objective. This result is not surprising, and is consistent with prior decisions in Ontario, including: *Dollar It*, *2240802 Ontario Inc. v. Springdale Pizza Depot Ltd.*, 2012 ONCA 2360, and *Sovereignty Investment Holdings Inc. v. 9127-6907 Quebec Inc.*, [2008] OJ No 4450, 171 ACWS (3d) 597.