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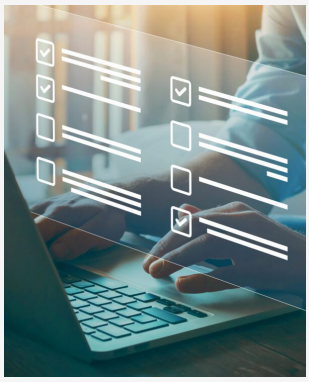
Ontario court 'puts the squeeze' on franchisors and their disclosure documents

MAY 20, 2021 10 MIN READ



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On March 26, 2021, the Ontario Superior Court released its decision in the latest franchise rescission case, *2611707 Ontario Inc., et al v. Freshly Squeezed Franchise Juice Corporation, et al.*, 2021 ONSC 2323 (*Freshly Squeezed)*. This decision provides insight into the nature of material deficiencies, which give rise to the two-year rescission remedy under the *Arthur Wishart Act (Franchise Disclosure), 2000,* SO 2000, c.3 (the AWA), whereby, if successful, a franchise agreement is unraveled and the franchisor is obliged to, among other things, refund all monies received from the franchisee and compensate the franchisee or any losses incurred in acquiring, setting up and operating the franchise.

The Court's decision in *Freshly Squeezed* referred extensively to the Court of Appeal's decision in another rescission case, *Raibex Canada Ltd. v. ASWR Franchising Corp.*, 2018 ONCA 62 ("*Raibex*"). In *Raibex,* the franchisee was provided with a franchise disclosure document and entered into a franchise agreement prior to a site being selected for the franchise. The cost of developing the franchise proved higher than the franchisee expected, and the franchisee purported to rescind the franchise agreement, alleging, among other things, that the lack of a head lease in the franchise disclosure document rendered it materially deficient. The Court of Appeal held that the lack of a head lease in the franchise disclosure document didn't justify rescission under s. 6(2) of the AWA.

The Court of Appeal found that the franchise agreement provided two important safeguards for the franchisee that were a "complete answer" to the franchisee's rescission claim. First, the franchise agreement included a collaborative site selection clause that contemplated the franchisee's active participation in the selection of the head lease. Second, the franchise agreement contained an "opt-out" clause that allowed the franchisee to cancel the agreement and sublease without penalty if the franchisee disagreed with the terms of the head lease once negotiated. As noted in our Osler Update on the case, *Raibex* affirmed the common industry practice of franchisors providing a disclosure document to prospective franchisees, and entering into a franchise agreement, prior to identifying a specific site for the franchise and negotiating the related head lease.

Background

The franchisee in this case entered into a franchise agreement with Freshly Squeezed Franchise Juice Corporation for a franchise located in the RioCan Food Hall of Mount Sinai Hospital. The franchise began operating in March 2018. Just over six months later, in

September 2018, the franchisee delivered a statutory notice of rescission under s. 6 (2) of the AWA.

The franchisee alleged that there were a number of deficiencies in the Disclosure Document, including four "fatal flaws" – material deficiencies, each of which would on their own, entitle the franchisee to rescind the franchise agreement and recover damages. The alleged deficiencies were:

- the franchisor's certificate required under s. 5 of the AWA was missing the requisite number of signatures;
- the financial statements disclosure was inadequate;
- the franchisor didn't disclose that it had not yet entered into a head lease for the franchise location; and
- the disclosure was made in a piecemeal fashion.

The test for determining whether alleged deficiencies in a disclosure document are serious enough to engage the right to rescind is whether the franchisee was deprived of the ability to make an informed investment decision. Following the Court of Appeal's decision in *Raibex,* the Court affirmed that this test remains an objective one, and held that two of the four alleged material deficiencies were each, on their own, sufficient to give rise to the two-year rescission remedy.

Notes referenced in financial statements must be included for complete disclosure

The Court accepted the franchisee's allegation that the financial statements included in the disclosure document were materially deficient because they didn't include the auditor's notes referred to in certain line items. Although the franchisee didn't adduce any evidence regarding whether the notes were required to be included in order for the statements to meet the requisite standard accounting principles, the Court emphasized the fundamental importance of franchisees knowing the complete financial picture of the franchisor's business in order to make an informed investment decision. The fact that the financial notes were referred to in the financial statements included in the disclosure document, but not included themselves, was sufficient to render the franchisor's financial statements disclosure incomplete. The Court held that the failure to disclosure a complete version of the financial statements in the disclosure document is a material deficiency that, on its own, gives rise to rescission under s. 6(2) of the *AWA.*

Court relies on requirements of location-specific disclosure articulated by the Court of Appeal in Raibex

The franchisee alleged that the franchisor's location-related disclosure was materially deficient because the disclosure document didn't disclose the absence of the head lease and the franchisee wasn't provided with the opportunity to back out of the franchise agreement and sublease if the terms of the head lease were unacceptable. The franchisee also argued that the franchisor failed to disclose two material facts:

- the existence of a partly executed agreement to lease between the landlord and franchisor; and
- that the location of the franchise was the first non-mall retail location in the franchise

system.

The Court accepted the franchisee's allegations and held that the franchisor's location-related disclosure was materially deficient. First, the Court found that although a head lease couldn't have been included in the disclosure document because it didn't yet exist, the franchisor was required to disclose the lack of a head lease. Second, the Court found that the franchisor should have disclosed the existence of an agreement to lease that was negotiated and executed by the franchisor prior to the delivery of the disclosure document and contained material terms that ought to have been disclosed to the franchisee.

The Court distinguished the circumstances of this case from *Raibex* where, although the head lease was also not disclosed because it didn't yet exist, the franchise agreement contained collaborative site selection clauses and, importantly, a franchisee-friendly "opt-out" right of termination if an acceptable head lease couldn't be negotiated. The Court emphasized that these clauses were given significant weight by the Court of Appeal in *Raibex*. The Court held that, in the absence of a clause that would give the franchisee "the contractual comfort of having the option to cancel" the franchise agreement and sublease, or any other safeguards, the franchisor's lack of disclosure was a material deficiency.

In sum, both failing to disclose the lack of head lease and failing to disclose the partly executed agreement to lease are each, on their own, material deficiencies which give rise to the two-year rescission remedy. However, both of these "fatal flaws" could be cured by including in the franchise agreement an "opt-out" clause, as was done in *Raibex,* or some other contractual protection.

The Court also held that the fact that the franchisor failed to disclose that this franchise would be the first "non-mall" location in the franchise system was a material fact that ought to have been disclosed in the Disclosure Document. The Court found that the fact there was no "track record for the success of this franchise business in a non-mall setting…could pose a risk to the financial viability of this particular venture." Although this fact was relevant to the Franchisee's ability to make an informed investment decision, the Court held that failure to disclose this material fact on its own wasn't sufficient to give the Franchisee the right to rescind. Only in combination with the material deficiencies noted above did the Franchisee have such a right.

Retroactive amendments may cure deficiencies with the franchisor's certificate

The Court rejected the franchisee's allegation that the franchisor's certificate didn't contain the requisite number of signatures. It's a mandatory requirement, under the regulations to the AWA, that the franchisor's certificate be signed by a minimum of two officers and/or directors of the franchise where a franchisor is incorporated and has more than one officer or director.

The Court found that the second director had resigned in September 2014, but his name had been inadvertently left on the franchisor's corporate profile register. The Court accepted as evidence the Notice of Change dated September 11, 2020 that rectified the error retroactive to September 3, 2014. The Court held that the certificate was therefore properly signed by the sole director and officer of the franchisor.

No piecemeal disclosure

In *1490664 Ontario Ltd. v. Dig this Garden Retailers Ltd.*, 2005 CanLII 25181 (ON CA) ("*Dig This*

Garden"), one of the first rescission cases, the Court of Appeal for Ontario noted that piecemeal disclosure (i.e., not providing disclosure in one document at one time) is a material deficiency that gives rise to the two-year rescission remedy under s. 6(2) of the AWA. This is because piecemeal disclosure does not meet the requirement under the AWA for comprehensive disclosure by way of one single document. Notwithstanding *Dig This Garden*, the Court rejected the franchisee's allegation that disclosure was made in a piecemeal fashion. The Court held that, because the franchisor had stipulated it was only relying on the Disclosure Document as the sole source of disclosure required under the AWA, there was no piecemeal disclosure. As the decision doesn't provide any factual details regarding the manner in which the franchisor provided disclosure to the franchisee, or the nature of the piecemeal disclosure alleged by the franchisee, it is difficult to reconcile this decision with *Dig This Garden*. The lack of details may be a result of an agreement between the parties in order to allow the matter to proceed by way of application, whereby the franchisee would only rely upon the evidence of the franchisor and its own evidence when not in conflict with the evidence of the franchisor.

Conclusion

The Court's decision demonstrates that lack of complete financial statements and location-related disclosure continue to be treated as fatal deficiencies which give rise to the two-year rescission remedy.

In addition, it's clear, based on this case, and the Court of Appeal's reasons in *Raibex,* that whether or not a head lease has been signed is a material fact that must be included in the Disclosure Document. However, the Court's reasons emphasize that even where location-related disclosure is materially deficient, it can be saved by providing franchisees with an "opt-out" clause or some other form of contractual protection in the event they disagree with the ultimate terms of the head lease.

This decision is troubling for franchisors as it's a signal that Ontario courts may have unwittingly expanded the pre-contract disclosure obligation under the AWA to 'require a form of negative disclosure, particularly as it relates to site specific information (i.e., "there's no head lease" or "we have never granted a franchise outside of a mall location" or "we haven't yet finalized our lease negotiations"). Arguably, by the franchisor simply not including a copy of the head lease as well as a description of the site selection process, the franchisee candidate should already have sufficient information upon which to make its informed investment decision. While franchisors can update their disclosure documents to include this type of express negative disclosure about the non-existence of a head lease, it's difficult to predict how the Court's rationale in *Freshly Squeezed* could be interpreted by future courts with respect to other information about the system or franchise.

Equally troubling is the Court's suggestion that this otherwise material deficiency would have been cured if the franchise agreement contained a *Raibex*-style termination right in favour of the franchisee. Not only does this reasoning go beyond the scope of assessing whether "all material facts, including material facts as prescribed" have been disclosed, but it treads dangerously into an assessment of whether the commercial bargain struck between the parties (or offered by the franchisor) meets a minimum standard of franchisee contractual protection. As the franchisor has appealed the Court's decision to the Court of Appeal for Ontario, there will hopefully be an opportunity for these important disclosure issues to be clarified.