ONTARIO COURT OF APPEAL TO FRANCHISORS: "COMPLY WITH YOUR DISCLOSURE REQUIREMENTS, OR ELSE..."

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The Ontario Court of Appeal recently confirmed that the test for rescission under s. 6(2) of the *Arthur Wishart Act (Franchise Disclosure), 2000*, S.O. 2000, c. 3 (the "AWA") (which permits a franchisee to rescind a franchise agreement for up to two years after entering it if the franchisor "never provided the disclosure document")[1] is whether the purported disclosure document is materially deficient. The Court of appeal also confirmed that this is so regardless of whether a franchisee even reads the disclosure document, or otherwise has sufficient information to make an informed decision about investing in the franchise.

In *Mendoza v. Active Tire & Auto Inc.*,[2] the Ontario Court of Appeal overturned a lower court's ruling[3] that a franchisor's non-compliance with its disclosure obligations could be forgiven if the franchisee nonetheless made an informed decision to enter into the franchise agreement. While the lower court's ruling was applauded by franchisors, it stood in stark contrast to several prior decisions on the point. This bulletin explains the significance of the Court of Appeal's decision in *Mendoza*.

The Lower Court Decision in *Mendoza* – An "Informed Decision" trumps Deficient Disclosure

Following six months of negotiations and after receiving numerous documents and information related to the franchise from the franchisor (Active Tire & Auto Inc.), the franchisee (Mendoza) signed a franchise agreement. Before doing so, the franchisee met with the franchisor's CEO, Director of Franchise Development and Operations Manager, retained an accounting firm who compiled financial plans that projected a positive forecast over the first three years of operations and obtained independent legal advice.

A short three months later, however, and after unsuccessfully operating the franchise at a loss, the franchisee sought rescission under s. 6(2) of the AWA claiming that the disclosure document was deficient and moved for summary judgment. In particular, the franchisee complained that:

1. only one officer and director signed the disclosure certificate, contrary to subsection 7(2)(c) of Regulation 581/00;
2. the financial statements included in the disclosure were not on an "audited or "review engagement" basis, contrary to subsection 3(1) of Regulation 581/00;

3. all of the requisite disclosure documents were not delivered at one time, contrary to subsection 5(3) of the AWA;
4. the irrevocable letter of credit described in the application varied significantly from what the franchisee actually signed; and
5. the franchisor did not disclose the required assumptions and information underlying financial projections, contrary to subsection 6(3) of Regulation 581/00.

The motion judge acknowledged that there were deficiencies in the disclosure document, but went on to find that the franchisee was nevertheless able to make an "informed decision" about entering into the franchise agreement and dismissed the rescission claim. The motion judge held that the extensive documents and information provided by the franchisor were sufficient to permit the franchisee to make an informed decision, and the deficiencies with the disclosure document were neither significant nor misleading. The motion judge also accepted the franchisor's argument that, because the franchisee acknowledged he had not read the entire disclosure document (and refused to answer questions about what parts of the disclosure document were deficient or misleading), the franchisee could not take the position that its contents were important.

The motion judge's approach focussed on the subjective knowledge of the franchisee (and whether he or she could and did make an "informed decision" about buying into the franchise), rather than assessing whether the franchisor provided a disclosure document that complies with the AWA requirements. This approach diverged from prior cases holding that where there are "material deficiencies" in a disclosure document, the document is not a disclosure document within the meaning of the AWA (making rescission under s. 6(2) an available remedy). [4]

The Court of Appeal Decision in *Mendoza* – Materially Deficient Disclosure Warrants Rescission

In reversing the lower court's decision, the Court of Appeal underscored that the purpose of the AWA is to protect franchisees and rejected the motion judge's subjective, "informed decision", approach.

The Court of Appeal focused on two deficiencies that, in its view, were material: (1) the disclosure certificate was only signed by one, instead of two, officers of the franchisor; and (2) the disclosure failed to include financial statements in the manner prescribed by the AWA. The Court of Appeal referred to other deficiencies, including that the disclosure was not provided in one document at one time, but did not analyze whether these also amounted to material deficiencies.[5]

Importance of the Requirement For Two Officers' or Directors' Signatures on the Certificate

The Court of Appeal emphasized that the requirement for two officers' or directors' signatures on the disclosure certificate is not merely technical, but instead facilitates an important right granted to franchisees.

By signing the disclosure document, officers and directors become personally responsible for the accuracy and sufficiency of its contents, and personally liable for damages resulting from any misrepresentations contained therein.

The Court of Appeal found two errors in the motion judge's reasoning that missed the point of the right afforded by two signatures on the disclosure document. First, the motion judge improperly discounted the failure to provide two signatures because the franchisee had become familiar with most of the officers and directors during the negotiation process. Second, the motion judge erroneously accepted the argument that since the franchisee had not read the disclosure document he could not take the position that its contents were important. The Court of Appeal noted that the rescission right is not conditional on the approach taken by a particular franchisee to the disclosed material.

By failing to have two officers or directors sign the disclosure certificate, the Court concluded that the franchisee was deprived of an important right that is clearly material to any franchise agreement.

Importance of the Requirement to Provide the Most Recent Financial Information

The Court of Appeal also highlighted the importance of providing the most recent financial information in the form and within the times prescribed by the AWA.

Under the General Regulation to the AWA, disclosure documents must include either an audited financial statement for the franchisor's most recently completed fiscal year or a financial statement for the most recently completed fiscal year. If 180 days have not yet passed since the end of the most recent fiscal year and a financial statement has not been prepared for that year, the disclosure document must instead include a financial statement for the previous fiscal year. If the franchisor has not operated for a full year or 180 days have not yet passed since the end of the first fiscal year and a financial statement has not been prepared, then the disclosure document must instead include the opening balance sheet.

In *Mendoza*, the franchisor did not deliver its most recent financial statement, as required, or its previous year financial statement. It instead produced a financial statement for the period ending 18 months earlier, two weeks beyond the 180 day grace period for doing so.

The Court of Appeal disagreed with the motion judge that this non-compliance with the AWA was insignificant. It noted that the AWA and regulations prescribe what financial statements must be provided and the time parameters for doing so, and that the effect of these requirements is that franchisors must be in a position to provide the prescribed information within the prescribed time. If a franchisor cannot do so, then it cannot proceed to engage with prospective franchisees. The Court of Appeal noted that if it accepted that the deficiency was not material because the former year's financial statements were only delivered a couple of

weeks after the statutory grace period, "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".

Franchisee's Reason for Rescission Not Relevant

The Court of Appeal also rejected the franchisor's argument that, because the franchisee did not read the entire disclosure document, he could not make the argument that its contents were important. The franchisor argued that the real reason the franchisee sought to rescind the franchise agreement was not because of deficient disclosure, but because the franchise did not perform well and the franchisee regretted his decision. In rejecting this argument, the Court of Appeal noted that one cannot know whether the failure of the business was connected to deficiencies in disclosure. More importantly, the Court of Appeal noted that "the remedy in s. 6(2) turns only on the failure of the franchisor to deliver a disclosure document" and that the rescission remedy is not dependant on later conduct of the franchisee.

Key Takeaways

The Court of Appeal sends a very clear message to franchisors with its *Mendoza* decision: strictly comply with your disclosure obligations, or risk rescission. If the disclosure document contains material deficiencies it will not constitute a disclosure document at all and franchisees will be permitted to rescind their agreements under s. 6(2) of the AWA for up to two years after entering into a franchise agreement.

The Court of Appeal confirmed that the failure to: (1) have at least two officers/directors sign the certificate attesting to the truth of information contained in the disclosure document; or (2) strictly comply with the financial statement requirements are fatal – they each constitute a material deficiency entitling a franchisee to rescind up to two years after entering into a franchise agreement.

But perhaps the most important lesson learned from *Mendoza* is that where the disclosure document is deficient, the conduct and subjective knowledge of the franchisee does not matter. The franchisor is on the hook even if the franchisee did not read or rely on the disclosure document or if its reasons for seeking rescission do not relate to the disclosure provided.

Franchisors should review their disclosure practices and the contents of their disclosure documents to ensure compliance with applicable franchise legislation. *Mendoza* serves as a reminder that courts are unlikely to relax enforcement of the AWA's technical requirements even where the facts and circumstances of the case seem to call for it.

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[1] Subsection 6(1) of the AWA permits a franchisee to rescind a franchise agreement within 60 days after receiving the disclosure document if its contents do not meet the requirements of s. 5 of the AWA.
[2] 2017 ONCA 471 (decision release on June 8, 2017).
[3] 2016 ONSC 3009.
[4] See, for example, *6792341 Canada Inc. v Dollar It Ltd.*, 2009 ONCA 385, *Caffe Demetre Franchising Corp. v. 2249027 Ontario Inc.*, 2015 ONCA 258 and *4287975 Canada Inc. v. Imvescor Restaurants Inc.*, 2009 ONCA 308.
[5] Though we note that previous case law has found that a franchisor's failure to deliver disclosure in a single document at one time constitutes a material deficiency. See, for example, *1490664 Ontario Ltd. v. Dig this Garden Retailers Ltd.*, [2005] O.J. No. 3040.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.