

## Missing Notes to Financial Statements and Other Disclosure Deficiencies

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A recent Ontario case considered the test for determining whether deficiencies in a disclosure document are so material so as to amount to no disclosure at all, thereby permitting rescission within two years under section 6(2) of the *Arthur Wishart Act (Franchise Disclosure), 2000* (Ontario) (Wishart Act).<sup>1</sup> The decision notes that the test, which considers whether the deficiencies impair the ability of a franchisee to make an informed decision, is an objective one, but which must account for the particular facts of each case.

### Summary and Implications

In *2611707 Ontario Inc., et al v. Freshly Squeezed Franchise Juice Corporation, et al*,<sup>2</sup> the Ontario Superior Court of Justice assessed a disclosure document for deficiencies. The Court concluded that the deficiencies, on an objective basis, were sufficient to deprive the franchisee of the ability to make an informed decision with respect to its investment in the franchised business, such that the franchisee was entitled to rescind within the two-year period under section 6(2) of the Wishart Act.

### Background of the Case and Findings

2611707 Ontario Inc. operated a retail outlet selling specialized juice beverages as a franchisee of Freshly Squeezed Franchise Juice Corporation. The franchisee operated the franchised business for slightly less than a year before delivering a Notice of Rescission.

Under the Wishart Act, in the event a franchisor fails to deliver a disclosure document to the franchisee, the franchisee is entitled, within two years of entering into the franchise agreement, to rescind the franchise agreement and be compensated for any net losses it may have incurred.

While the franchisor did provide the franchisee with its disclosure document, the franchisee claimed that the deficiencies were so material that it was tantamount to no disclosure having been provided, thereby justifying rescission within the two years under section 6(2) of the Wishart Act.

The Court reviewed the franchisor's disclosure document to assess whether the claimed deficiencies were sufficiently material that it effectively amounted to no disclosure being provided.

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After reviewing the law with respect to the level of deficiency needed to warrant rescission, the Court stated:

In my view, based on *Raibex* and the appellate jurisprudence to date including *Springdale*, the test for determining whether alleged deficiencies are serious enough such that they impaired the ability of the franchisee to make an informed investment decision is still an objective one. However, the objective standard must take into account the particular facts of each case, including the terms of the (franchise) agreement, in determining whether the alleged deficiencies reasonably impaired the ability of a prospective franchisee from having the opportunity to make an informed investment decision.

The Court then reviewed the disclosure document and the claimed deficiencies to determine whether the franchise agreement had been properly rescinded.

## Certificate

The disclosure document contained a certificate that had been signed by a single officer/director. The franchisee produced a corporate registry search that showed, at the relevant time, another individual was also an officer of the franchisor and, therefore, the certificate should have been signed by 2 officers/directors. The franchisor claimed that the individual had in fact resigned as an officer and director of the franchisor and that the corporate registry documents had not been updated due to an oversight. The franchisor provided some evidence of this and the Court determined that the certificate needed only one signature.

## Financial Statements

While financial statements, prepared on a review engagement basis, were included in the disclosure document, the financial statements were missing the pages that contained the notes to the financial statements. The notes provided additional background on the information found elsewhere in the financial statements.

The Court stated:

Incomplete financial statements do not comply with the Regulation and, in any event, did not provide the Franchisee with the full information to which it was entitled so that it could assess the financial health of the franchise system in which it was about to invest.

The Court described this deficiency as a “material deficiency.”

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## Lease Information

While negotiations of the Head Lease had not been completed by the franchisor and the landlord, the franchisor had signed an Agreement to Lease. At the time of the disclosure, the landlord had not yet signed the Agreement to Lease. A copy of the Agreement to Lease was not included in the disclosure document.

By the terms of the Agreement to Lease, the Head Lease was to include provisions that allowed the landlord to unilaterally terminate the Head Lease without payment of compensation in certain circumstances, including in the event a decision is made by the landlord to demolish, renovate or redevelop the area in which the franchised business was to be located. This information was not included in the disclosure document.

The Court stated:

In the absence of having provided the Franchisee with the contractual comfort of having the option to cancel the Franchise Agreement and sublease upon receipt of the Head Lease, or any other safeguards, I find that this non-disclosure is a material deficiency.

The “contractual comfort” refers to the right of the franchisee to terminate the franchise agreement in the event it is not satisfied with the terms of the Head Lease once the Head Lease has been finalized by the franchisor and the landlord.

## Location of the Franchised Business

The franchised business was located in a hospital, being the first non-mall location within the franchise system. The fact that it was the first non-mall location was not disclosed in the disclosure document. The Court stated:

The fact that this franchise location was the first retail one to be in a non-mall setting was a material fact that should have been explicitly referenced in the Disclosure Document. There was no track record for the success of this franchise business in non-mall settings and that, in and of itself, could be (sic) pose a risk to the financial viability of this particular venture. This was a material fact that was relevant to a franchisee's ability to make an informed investment decision within the meaning of s. 5(4)(a).

The Court found that this was in breach of the requirement that the disclosure document is to include all material facts.

## Conclusions of the Court

In reviewing the various deficiencies, the Court stated:

The Franchisor failed to act in a transparent manner here, and the deficiencies in question reach the threshold for a s. 6(2) rescission. The Disclosure Document failed to provide the Franchisee, on the facts of this case, with the information needed for it to have the opportunity to make an informed investment decision and as required by the Wishart Act. It was thus tantamount to the non-delivery of an effective disclosure document within the meaning of s. 6(2) of the Wishart Act.

## Key Takeaways

This case considered deficiencies in disclosure. In particular, the failure to include all prescribed information, which denies a prospective franchisee the ability to make an informed investment decision with respect to the franchised business, may lead to a rescission. Franchisors should consult with experienced franchise counsel to assist with the disclosure process.

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<sup>1</sup> S.O. 2000, Chapter 3

<sup>2</sup> 2021 ONSC 2323, <https://canlii.ca/t/jf5pl>