Cassels

Fit For Rescission: Two New Ontario Court of Appeal Cases Put the Squeeze on Franchisors Facing Faulty Disclosure Claims

Christopher Horkins

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The Ontario Court of Appeal recently released two decisions that considered deficiencies in disclosure documents and whether those deficiencies were so material so as to amount to no disclosure at all, thereby permitting rescission under section 6(2) of the *Arthur Wishart Act (Franchise Disclosure), 2000* (the Wishart Act).[1] The new decisions appear to rein in the more expansive interpretations of the "informed investment" test outlined in *Raibex* and highlight the ongoing risks to franchisors from faulty disclosure.

Summary and Implications

In *2611707 Ontario Inc. v Freshly Squeezed Franchise Juice Corporation* (*Freshly Squeezed*)[1]and *2483038 Ontario Inc. v 2082100 Ontario Inc.* (*Fit For Life*)[2] the Ontario Court of Appeal upheld two lower court decisions in franchise rescission cases where the lower court found the disclosure documents to be materially deficient. In each case, the Court of Appeal 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 disclosure amounted effectively to no disclosure at all and the franchisee was entitled to rescind their franchise agreement under section 6(2) of the *Arthur Wishart Act (*Wishart Act*)*.

The *Freshly Squeezed* and *Fit For Life* decisions are the latest in a series of decisions examining the impact of the Court of Appeal's seminal decision in *Raibex Canada Ltd. v ASWR Franchising Corp.*[3] (*Raibex*) and the proper application of the "informed investment" standard outlined by the Court in that case. These decisions appear to rein in some of the more expansive interpretations of *Raibex*, clarifying that the rescission test is an objective one that does not look to the franchisee's specific knowledge or conduct and that certain "fatal flaws" such as a defective disclosure certificate will continue to always provide a basis for rescission irrespective of whether the franchisee's ability to make an informed decision was impaired.

Freshly Squeezed

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 2 years of entering into the franchise agreement, to rescind the franchise agreement and be compensated for any 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*.

Test to be Applied For Rescission

The franchisor claimed that the lower court failed to assess whether the disclosure deficiencies genuinely impaired the franchisee's ability to make an informed investment, arguing that the Court of Appeal's prior decision in *Raibex* imposed a "subjective" standard which requires the franchisee to lead evidence establishing that their ability to make an informed investment decision was impaired by the alleged deficiencies in the disclosure document. The Court of Appeal rejected this argument, stating:

The s. 6(2) test focuses on the disclosure itself, not its recipient, because the Act seeks to ensure that the franchisor provides the same disclosure to every potential franchisee.

The Court clarified that the test is an objective one and it does not matter whether the deficient disclosure actually impaired the franchisee's ability to make an informed decision or if the particular franchisee acted or reacted in a specific way to the disclosure provided. As such, it is clear from this decision that the court will not look into the mind of a plaintiff franchisee seeking to rescind or scrutinize their conduct to determine whether *their* ability to make an informed decision was impaired. Rather, the Court will consider, objectively, whether a reasonable franchisee in the plaintiff's circumstances would be impaired as a result of the alleged deficiencies.

Financial Statements

While financial statements, correctly prepared on a review engagement basis, were included in the disclosure document, the financial statements were missing its notes. The notes, prepared by the accountant, help the reader to understand the information presented in the financial statements. The Court of Appeal stated that these "notes were necessary to allow the respondents to assess the financial health of the franchise system" and agreed with the lower court judge that their absence was a "material deficiency."

Lease Information

While negotiations of the Head Lease had not been completed by the franchisor and the landlord, the

franchisor had negotiated and signed an Agreement to Lease for the location where the franchised business would ultimately be established. At the time of the disclosure, the landlord had not 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 of Appeal stated, in assessing this aspect of the lower court's decision:

Nor can we identify an error in the application judge’s finding that the appellants’ failure to disclose a negotiated agreement to lease and the absence of a head lease prevented the respondents from making an informed investment. In particular, the respondents were not advised that the landlord could terminate the head lease without compensation if the decision was made to demolish or redevelop the franchise’s location.

Further, the franchise agreement did not permit the respondents to back out of the lease should its terms be unacceptable. We see no error in the application judge’s finding that the appellants’ failure to disclose their negotiated agreement to lease and the absence of a headlease obscured the respondents’ degree of risk and, therefore, prevented an informed investment.

The ability of the franchisee to back out may be provided by way of an “escape clause” which enables a franchisee to terminate the franchise agreement without penalty 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. No such clause was provided for in this case.

Location of the Franchised Business

The particular franchised business was to be located in a hospital, make it the first “non-mall” location within the franchise system. The fact that the plaintiff would be the first Freshly Squeezed location outside of a shopping mall was not disclosed in the disclosure document. The Court found that this deficiency rendered the disclosure document “essentially worthless,” stating:

The appellants were duty-bound to inform the respondents that they were essentially test-driving the franchise in a non-mall setting. Their failure to do so caused the respondents to unknowingly invest in a business model with no track record of success.

Notably, the Court of Appeal acknowledged that the plaintiff could have determined from the information

included in the disclosure document that there were no other locations in the Freshly Squeezed system located outside of a shopping mall. However, the Court held that a greater onus was required for the franchisor to bring this fact and its implications for the franchised business to the plaintiff's attention in the disclosure document.

Conclusion of the Court of Appeal

In reviewing the decision of the lower court, the Court of Appeal in finding that rescission was the appropriate remedy stated:

Even in light of the high threshold for rescission under s. 6(2) of the Act, the application judge made the necessary findings of fact, applied the correct test, and reached a determination amply available on this record.

Fit For Life

This case was concerned with a disclosure document that did not include the required certificate signed by appropriate officers/directors of the franchisor. The lower court reviewed the jurisprudence and found that the absence of a signed and dated certificate in the disclosure documents is considered to be a "fatal flaw" which will always render a disclosure document the equivalent of no disclosure at all.

On appeal the franchisor attempted to argue that the "informed investment" test, as outlined in *Raibex*, required the lower court to engage in a deeper analysis as to whether the lack of a signed and dated certificate impaired the franchisee's ability to make an informed investment decision and further argued that a defective certificate must be accompanied by other substantive deficiencies in order to ground a valid rescission claim.

The Court of Appeal rejected these arguments stating:

I also agree with the conclusion of the trial judge that the absence of the certificate is a fatal flaw in the disclosure. Therefore, the franchisees had a right to rescind the franchise agreement without penalty under s. 6(2) of the Wishart Act and did so lawfully.

The Court clarified that *Raibex* (which did not involve an unsigned certificate) does not displace prior and subsequent case law where a defective certificate was found to be a "fatal flaw" and noted that *Raibex* did not "import" the informed investment test into the analysis of a defective certificate.

Key Takeaways

The *Freshly Squeezed* and *Fit For Life* cases provide franchisors with some important takeaways with respect to disclosure:

1. The test with regard to a deficient disclosure document is an objective one. It is irrelevant that the deficient disclosure document did not actually impair the franchisee's ability to make an informed investment decision with respect to the franchised business or if the franchisee fails to lead evidence that their ability to make an informed decision was actually impaired. The analysis focuses instead on the impugned disclosure document itself and whether it would impair a reasonable franchisee in the circumstances of the plaintiff from making an informed decision.
2. A defective disclosure certificate (i.e. where the certificate is missing or not signed by the required directors or officers of the franchisor) will always be a "fatal flaw." The analysis in defective certificate cases does not require an examination of whether the franchisee was prevented from making an informed investment decision.
3. The failure to include important parts of the financial statements, such as the notes, will be fatal where the missing information is necessary to enable a potential franchisee to assess the financial health of the franchise system.
4. The disclosure document should include cautions on any risks associated with anything that is unique or different about the specific franchise being granted including any information the franchisor may have about the particular circumstance and associated risks. This may include potential risks associated with a new franchise format or different location where the franchise system may be seen as "untested." Franchisors should consider carefully whether any such circumstances exist and work with their legal counsel to determine whether and how to disclose such information to the prospective franchisee. A general caution regarding potential unique circumstances for the franchise being granted and associated risks is also recommended.
5. In circumstances where the franchise location is to be subleased by the franchisor or its affiliate, and the location is not determined at the time the franchise agreement is entered into, the franchisor should ensure that any "offer to lease" or other documents reflecting the negotiated lease terms is disclosed. This applies even where such documents are not fully executed at the time disclosure is made. The franchise agreement should also include an escape clause allowing the franchisee to terminate the franchise agreement in those instances where the franchisee may not be satisfied with the final terms of the head lease for the proposed location.

Ultimately, notwithstanding the helpful precedent established by the Court of Appeal in *Raibex*, the *Freshly Squeezed* and *Fit For Life* decisions underscore that the court will still apply a strict standard when deciding franchise rescission matters. The best defence to such claims remains ensuring that your disclosure document is accurate, compliant, up-to-date, and complete in consultation with specialized franchise legal counsel.

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[1] S.O. 2000, Chapter 3, https://canlii.ca/t/54qkm

[2] 2022 ONCA 437, https://canlii.ca/t/jpl1v

[3] 2022 ONCA 453, https://canlii.ca/t/jprf9

[4] 2018 ONCA 62, https://canlii.ca/t/hpzxv
