Cassels

An *AllStar* Decision for Franchisors: Court of Appeal Restores Clarity and Commercial Sense to Disclosure Obligations in Long Awaited *Raibex* Appeal Decision

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Cassels Brock Succeeds For Franchisor in Important Appeal

On January 25, 2018, the Ontario Court of Appeal released the closely followed decision in *Raibex Canada Ltd. v ASWR Franchising Corp.* providing much needed clarity on the pre-contractual disclosure obligations imposed on franchisors under the *Arthur Wishart Act (Franchise Disclosure), 2000* (the Wishart Act).

The Court of Appeal's decision is a welcome development for franchisors who have had to grapple with the uncertainty arising from the lower court decision, released in late 2016. The lower court had granted the franchisee's rescission claim concluding that it would be "premature" for a franchisor to provide disclosure and enter into a franchise agreement if potentially material facts about the franchise, such as the location, had yet to be determined. This uncertainly was particularly evident in dealing with executing franchise agreements when there was no lease entered into yet for a franchise location.

The Court of Appeal's decision granting the franchisor's appeal and thus setting aside the rescission of the franchise agreement clarifies that the disclosure obligations under the Wishart Act must be interpreted practically and with reference to the commercial realities of the circumstances surrounding the grant of the franchise and the terms of the franchise agreement. The post-agreement location selection process employed by the franchisor, which is common in the industry, was not found to be offside of the Act's disclosure regime. As such, the Court of Appeal clarified that franchise parties can, in certain circumstances, enter into a franchise agreement without having entered into a lease beforehand.

Background to the Case

In 2012, the plaintiff franchisee, Raibex Canada Ltd. (Raibex), entered into a franchise agreement with ASWR Franchising Corp. (AllStar) for the operation of a new "AllStar Wings & Ribs" franchise in Mississauga. Prior to entering into the agreement, Raibex received a comprehensive 190+ page franchise disclosure document (FDD) as required by section 5 of the Wishart Act. The franchise agreement allowed for the location of the franchise to be determined after the franchise agreement was signed, at which point the franchisor would sublease the chosen location to the franchisee.

If a suitable location was not found within 120 days, the franchise agreement provided an “opt-out” clause allowing the franchisee to terminate the franchise agreement and receive a refund of its initial fee. After touring several locations with the franchisor’s real estate agent, Raibex decided to pursue a location formerly home to another restaurant which it would convert into an AllStar franchise. At the time this location was selected, the opt-out clause was available to Raibex but not exercised.

After completing construction and a few months of operating the franchise, the franchisee served a notice of rescission in response to the impending termination of its franchise agreement due to non-payment of over $200,000 owing for rent and amounts owed to contractors. AllStar and its related entities and principals, named as co-defendants, moved to dismiss the entire action, including the franchisee’s claims under sections 3 and 7 of the Wishart Act, and for judgment on its own breach of contract claim arising from the termination of the franchise agreement. Aside from the quantification of damages, the motion judge resolved the entire action on summary judgment, granting the rescission claim and dismissing the plaintiffs’ claims under sections 3 and 7.

Decision on Summary Judgment

On the summary judgment motion, the lower court granted the franchisee’s claim for rescission asserting that the franchisor ought to have ‘waited’ until a copy of the head lease for the location was available. That court did so despite the fact that the location would not be selected by the franchisor and franchisee until some six months after the franchise agreement was signed.

The motion judge also found that AllStar failed to disclose estimates of development costs sufficiently tailored to that location. The estimates provided were in relation to a “shell” and not a conversion of an existing restaurant. In doing so, the motion judge suggested that a franchisor in such a situation is "not yet ready" to disclose and "must wait” until all “material matters” are known before delivering a disclosure document. This decision caused confusion for franchisors in Ontario, many of whom followed the longstanding and common practice of selecting a location after the franchise agreement is signed using a location selection process set out in the franchise agreement.

Decision on Appeal

In granting AllStar’s appeal and dismissing Raibex’s cross-appeal, the Court of Appeal has restored clarity and commercial sense to the interpretation of the disclosure requirements and rescission remedies set out in the Wishart Act. It is anticipated that this clarity will assist franchisors, franchisees and franchise law practitioners alike in understanding what properly needs to be included in a disclosure document and how decisions to rescind or not ought to be made.

In its reasons on appeal, the Court clarified the crucial distinction between rescission for “deficient disclosure” under section 6(1) of the Wishart Act, which must be exercised within 60 days of receiving a

disclosure document, and rescission under section 6(2), which is available within two years of signing a franchise agreement and where the franchisor “never” provided a disclosure document. Much of the jurisprudence on the rescission remedy has focused on whether and to what extent a deficient disclosure document can be sufficiently non-compliant as to render it tantamount to no disclosure at all and ground a claim for rescission under section 6(2). The much needed clarity that this decision brings is that, in order for a disclosure document to amount to no disclosure at all, the franchisee must effectively be deprived of the opportunity to make an informed investment decision to acquire the franchise. The Court of Appeal added that this determination must be made with reference to the terms of the franchise agreement and all relevant surrounding circumstances of the grant of the franchise.

With respect to the motion judge’s findings regarding the non-disclosure of the head lease, the Court found that the motion judge’s failure to consider the terms of the franchise agreement, and in particular the location selection and opt-out clauses within that agreement, was an error of law. The Court noted that all parties involved knew that the proposed franchise location had not yet been selected at the time the agreement was signed and that the franchisor and franchisee would work collaboratively to find a site, as set out in the agreement. The franchisor’s contractual obligation to use “reasonable best efforts” in selecting a location acted as a constraint on the franchisor’s ability to enter into a lease without considering the franchisee’s legitimate interests. Had the franchisee found the terms of the lease to be objectionable, it had the ability to reject the location or opt out and receive its money back. The presence of these contractual safeguards were found to be a complete answer to the franchisee’s claim that the non-disclosure of the head lease was a material disclosure failure entitling rescission under section 6(2). It distinguishes *Raibex* from prior case law that considered non-disclosure of leases for locations that existed and were known at the time the franchise was granted.

With respect to the disclosure of development costs, the Court of Appeal found that the detailed “shell” cost estimates provided in the FDD were sufficient to put Raibex on notice of the costs and risks associated with a “conversion” opportunity. The Court highlighted the strong warning in the FDD that conversion costs may vary greatly depending on the location and that franchisees should maintain a significant contingency reserve. Given the variance in costs for prior conversions of AllStar franchises, the Court very practically held that disclosing a separate estimate based on those costs, as the franchisee suggested ought to have been done, would not have improved the franchisee’s ability to make an informed investment decision. The shell estimate which was disclosed, on the other hand, did provide a useful reference point and an accurate reflection of the franchisee’s actual costs.

Importantly, the Court of Appeal’s decision clarifies that the Wishart Act does not impose a requirement on *when* a franchisor may provide disclosure (other than the requirement that it be provided at least 14 days before the execution of a franchise agreement or payment of consideration by the prospective franchisee), rather, it defines *what* must be disclosed. From the Court’s reasoning, it can be inferred that the scope of that disclosure does not extend to material facts that are not known or do not exist at the time the franchise agreement is signed.

Where the selection of a location is left to be decided after the execution of a franchise agreement, it is sufficient to disclose, as AllStar did, the details of the location selection process along with an estimate of the likely leasing and development costs associated with establishing the franchise. Such an interpretation accords with common sense and commercial realities, and does not interfere with common arrangements employed by franchisors in Ontario.

The cross-appeal by Raibex, seeking to reverse the dismissal of the section 3 and 7 claims, and the unsuccessful grounds for rescission regarding the certificate in the disclosure document, was also dismissed by the Court of Appeal who found no error in the motion judge's decision on those issues. The Court did find, however, that AllStar's damages for unpaid rent should be reduced to reflect the benefits that may have been received from its post-termination operation of the location, and remitted this issue to be quantified by the lower court.

Key Take-Aways

This case provides franchisors and franchisees with the knowledge that, so long as an otherwise compliant disclosure document provides a prospective franchisee with material facts sufficient to make an informed investment decision, the disclosure document will not support a claim for rescission by the franchisee under section 6(2) of the Wishart Act. This moves the decision as to what will or will not constitute a claim for rescission away from dogmatic adherence to earlier authorities and towards the commercial and practical reality of what was important to the parties viewed on a case by case basis and having regard to the terms of the franchise agreement and all of the surrounding circumstances of the grant of the franchise.

AllStar and the other defendants were represented by Geoffrey B Shaw and Christopher Horkins of the Cassels Franchise Law Group's litigation team.

A copy of the Court of Appeal's decision can be found here.
