Toronto Law Journal

Franchisor "Squeezed" for Rescission Damages Arising from Improper Disclosure

Mariette Niranjanan (BA, MPA, JD), Student at Law, and David Kornhauser (MBA, LLB), Corporate Counsel, Macdonald Sager Manis, LLP

Introduction

In *2611707 Ontario Inc. et al v Freshly Squeezed Franchise Juice Corporation, et al.*, 2021 ONSC 2323 ("***Freshly Squeezed***"), the Court provided further guidance on the level of detail that franchisors are required to include in a disclosure document provided to prospective franchisees pursuant to section 5(1) of the *Arthur Wishart Act (Franchise Disclosure)*, 2000, S.O. 2000, c.3 ("*Act*").[1]

Pursuant to section 6(2) of the *Act*, a franchisee can rescind their franchise agreement within two years, if the franchisor failed to provide the prospective franchisee a disclosure document. As the case law has articulated, the failure to provide includes circumstances in which the disclosure document was so deficient that it was tantamount to there being no disclosure document thereby impairing the franchisee's ability to make an informed investment decision.

Background Facts

2611707 Ontario Inc. (the "**franchisee**") received what was alleged to be a disclosure document on or about December 18, 2017 (the "**Disclosure Document**"). The franchisee and Freshly Squeezed Franchise Juice Corporation (the "**franchisor**") entered into a franchisee agreement on January 8, 2018 (the "**Franchise Agreement**"). The franchisee issued a Notice of Rescission on September 10, 2018 for "non-disclosure" (a revised Notice of Rescission was also subsequently provided). The franchisee claimed statutory compensation in the amount of $370,849 pursuant to section 6(6) of the *Act*.

The Alleged Deficiencies

The franchisee claimed that the Disclosure Document that was provided had four fatal flaws that they deemed "material deficiencies" and validated their rescission, including:

1. The franchisor's certificate, required under section 5 of the *Act*, only had the signature of one of the two officers of the franchisor (the "**Certificate**");

2. The financial statement disclosure report was missing the referenced notes;

[1] This analysis would also likely apply to franchise legislation in other Canadian provinces, as well as arguably in the Province of Quebec.

3. The Disclosure Document did not have information regarding the fact that there had been no head lease, and further, there was no escape clause provided to the franchisee to terminate the agreement if they were not agreeable to the subsequent lease; and

4. Disclosure was made in piecemeal fashion.

As further evidence that the Disclosure Document was deficient, the franchisee also claimed that the following material facts were absent:

1. Failure to disclose a negotiated Agreement to Lease between Landlord and Franchisor, including clauses pertaining to the right of the landlord to terminate the lease early, without compensation; and

2. Failure to advise that the designated location (in the food hall of a hospital) was the first ever non-mall retail location for this franchise business.

The Court was required to determine whether any of these deficiencies, either alone or in combination, constituted material deficiencies that were tantamount to the franchisor having made no disclosure.

The case law developed to date supports that certain deficiencies in a disclosure document will satisfy the section 6(2) test to allow for rescission of a franchise agreement.[2] However, the case law also recognized that even these presumptive "material" deficiencies can be rebutted where the factual circumstances of a case requires it. As such, an analysis of the deficiencies is required in the individual circumstances of each case.

The Certificate

It is a mandatory statutory requirement, under section 5(4)(a) of the *Act*, that when a franchisor has two or more officers and/or directors, a minimum of two officers or directors need to sign the Certificate. In *Freshly Squeezed* the franchisee alleged that based on the Corporation Profile Report the franchisor had two officers, only one of whom had signed the Certificate. However, based on the evidence provided at trial, it was determined that the second director had resigned quite some time before the Disclosure Document was issued. The Court therefore concluded that the Certificate was properly signed and thus rejected the franchisee's assertion in this regard.

[2] An exhaustive list is beyond the scope of this article; however, the courts have held that rescission can be claimed if: (a) the franchisor failed to include a signed and dated certificate in the appropriate form signed by the required number of officers or directors of the franchisor; (b) the franchisor failed to provide financial statements as required or provided stale dated (not current) financial statements; (c) the franchisor failed to provide a statement of material change in circumstances where it was required; (d) the disclosure document was provided in successive stages and not as one document at one time; and (e) the disclosure document did not contain copies of all agreements that the franchisee was required to sign.

Incomplete Financial Statements

The franchisee also claimed that the financial statements contained in the Disclosure Document were materially deficient because they did not include as attachments the referenced notes to certain lines on the financial statement. For example, the financial statements reference "Note 3" for the line item that relates to the accounts receivables owed to the franchisor from third parties, which represented about 73% of the franchisor's assets. However, nothing was included in Note 3.

The failure to comply with the requirement to include financial statements has been characterized by the courts as a "foundational part of disclosure", which "by itself constitutes a material deficiency" and rises to the level of non-delivery of a meaningful disclosure statement normally allowing for a rescission. The Court thus concluded that the missing notes resulted in incomplete information that prevented the franchisee from knowing the complete financial picture, which prevented it from making an informed investment decision. This failure constituted a material deficiency.

Failure to Disclose the Absence of a Head Lease

In respect of the lease issues, the franchisee submitted the following were deficiencies:

1. the failure to disclose that a head lease had not been secured;

2. that there was no protection for the franchisee to back out of the Franchise Agreement should the terms of the head lease ultimately be unacceptable to them;

3. that the Disclosure Document was missing the Agreement to Lease, which had been negotiated by the franchisor and the landlord. The franchisee was particularly concerned by two clauses in the Agreement to Lease, one being that the Landlord would not guarantee that the subject unit would be built and that the Landlord reserved the right to terminate the 10-year lease early without compensation, if the hospital decided to demolish, redevelop or renovate the food hall space.

The evidence did demonstrate that the franchisee was made aware of the approximate monthly cost for rent; that a designated unit for their franchisee did currently exist; that a head lease had not been entered into before signing the Franchise Agreement; and that a draft lease was provided to the franchisee.

Ultimately, the Court decided that in the circumstances of the case, the failure to disclose the negotiated (partly executed) Agreement to Lease in the Disclosure Document or at least the material terms of the lease was a material fact that ought to have been disclosed. The Court relied on *Raibex Canada Ltd. V. ASWR Franchising Corp.*, 2018 ONCA 62, 419 D.L.R. (4th) 53, to emphasize that since the franchisee was also not provided any safeguards or options to cancel

the Franchise Agreement and sublease upon receipt of the Head Lease these elements added to the non-disclosures being material deficiencies.

The First "Non-Mall" Location

Finally, the franchise submitted that, although it was aware their franchise would be located in a hospital, the franchisor should have disclosed that this was the first and only franchise location to be opened in a non-mall setting. Of relevance is the fact that the Disclosure Document did list all addresses of all current and terminated franchises, so arguably the information was there from which the Franchisee could have extrapolated that this was a first "non-mall" location.

However, the Court stipulated that the reason for the strict disclosure requirements of the *Act* was to ensure uniform documentary disclosure, so that all of the material facts are contained in a single disclosure document. Based on this, it was determined that the fact that this location was the first non-mall setting was a material fact that should have been specifically referenced in the Disclosure Document.

The Final Decision

After going through the analysis of each claimed deficiency the final determination made was that the Disclosure Document failed to provide the franchisee with the information needed to make an informed investment decision and this was tantamount to "non-delivery" within the meaning of section 6(2). As a result the franchisee's rescission was valid.

The key factor in this case was that the franchisor withheld information that was within their power to disclose, in particular, the Agreement to Lease (or contractual safeguards for termination), the notes to the financial statements, and information that this franchise location would be the first one to be operated in a non-mall retail environment. The disclosure requirements are meant to protect parties and it was determined that the franchisor failed to act in a transparent manner.

Practice Takeaways

In *Freshly Squeezed* the Court stipulated that the *Act* was enacted to "ensure fair, frank and uniform disclosure" by franchisors, yet the takeaway from the case is that there is no exact template as what disclosure will ensure that a franchisor has complied with the "fair" and "frank" requirement. Even those requirements directly stipulated within the *Act* or presumptively determined in case law are not as clear as they may appear. The reality is that the disclosure requirements are enacted to protect franchisees and allow them to make informed decisions; however, the franchisor's disclosure requirements have to be determined based on the circumstances and facts of each individual case.