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Franchisors Beware of Deficient Disclosure

Franchisors in Ontario have learned to tread carefully in their dealings with franchisees since the coming into force of the *Arthur Wishart (Franchise Disclosure) Act, 2000,* (the "Act"), a statute intended to level the playing field between franchisors and franchisees. The Act is perhaps best known for legislating an implied duty of fair dealing into every franchise agreement, creating a new, broadly worded cause of action that operates as a "catch all" for disgruntled franchisees looking for a way out of their agreement and to recoup their investment.

A separate mechanism through which franchisees can attempt to extricate themselves from their franchise agreement, that continues to be broadened by the courts, is the rescission remedies available under Section 6 of the Act. The Act provides for two possible scenarios under which a franchisee can seek to rescind the franchise agreement: (a) within 60 days of receiving the disclosure document, if the franchisor failed to provide a statement of material change or if the contents of the disclosure document did not meet the requirements of Section 5 of the Act (please see Section 5 of the Act and Ontario Regulation 581/00 for full details) (Section 6(1)); or (b) within two years of entering into the franchise agreement if the franchisor never provided the disclosure document (Section 6(2)).

A straightforward reading of Section 6 suggests that, so long as a franchisor delivers a disclosure document, even if it does not meet the requirements of Section 5, the franchisee must provide notice of rescission within 60 days, creating a tight timeline within which it must serve its notice. This 60-day deadline stands in stark contrast

to the alternate two-year deadline. The shorter deadline appears to provide the franchisor with some certainty going forward that the franchisee cannot lie in the weeds and use a lack of disclosure claim as a mechanism to undo what may become a less desirable investment down the road. These deadlines are particularly important when one considers the serious financial consequences that may fall upon a franchisor if the franchisee successfully claims rescission remedies resulting from a breach of Section 6, including the refunding of all money received from the franchisee; the forced purchasing of its inventory, supplies and equipment; and compensation for any losses it incurred in acquiring, setting up or operating the franchise. In other words, an unhappy franchisee can use its rescission remedies to turn back the clock at the franchisor's expense.

This straightforward reading of Section 6, however, has been broadened by the Courts to such an extent that franchisors must ask themselves an important question: When is a disclosure document so deficient as to constitute no disclosure at all under Section 6(2) of the Act? Several recent cases provide warnings as to the circumstances under which the Ontario courts have proven ready to scrutinize disclosure documents in just such a fashion.

The Court of Appeal in *1490664 Ontario Limited* v. *Dig This Garden Retailers Ltd* . concluded that providing only 70% of the information required to be disclosed in "bits and pieces over time and not in one document delivered at one time" defeats the purpose of disclosure and constitutes no disclosure at all.

In *Sovereignty Investment Holdings Inc.* v. *9127-6907 Quebec Inc.* the Court found four separate deficiencies in a disclosure, each of which, on its own, was sufficiently material that its absence resulted in no disclosure at all. Those deficiencies were: (1) failure to provide financial statements; (2) failure to provide a basis for the earnings projections set out in the disclosure document or a statement of the assumptions underlying the projections; (3) failure to provide a

single disclosure document and to deliver it at one time; and (4) failure to provide a franchisor's certificate.

The Court of Appeal in *6792341 Canada Inc.* v*. Dollar It Ltd*. identified a large list of material deficiencies with a disclosure document, which led it to conclude that there was no disclosure at all. Those deficiencies included: (1) failure to sign and date the franchisor's certificate; (2) failure to make any financial disclosure; (3) failure to provide a copy of the head lease; (4) a lack of information about the advertisement fund; and (5) failure to describe the territory being granted. The Court of Appeal explained that simply calling something a disclosure document does not make it one for the purposes of Section 6(2). In cases such as this, where the deficiencies were "material" and "many," the franchisee did not have sufficient information to make a properly informed decision on the investment and, as a result, the Court granted it two years to exercise its right of rescission. A very similar conclusion was reached by the Court in *Melnychuk* v*. Blitz Ltd*.

To date these cases make up the limited case law authority dealing with this question since the coming into force of the Act, leaving the franchise industry with a modest amount of guidance as to when deficient disclosure becomes no disclosure at all. In fact, Justice H.J. Wilton-Siegel in the *Sovereignty Investment Holdings* case warned that the dividing line between Section 6(1) and Section 6(2) is hard to draw and depends on the facts of each particular case. Franchisors should take precautions at the outset of each new franchise application and ensure that their disclosure documents satisfy Section 5 and the related regulations, and should pay particular attention to the thoroughness of their disclosure as it pertains to what the courts have described as the more material issues.

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a cautionary note

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