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Ontario Court of Appeal Finds for Franchisors: Imperfect Disclosure is Not Equivalent to No Disclosure

On January 25, 2018 the Ontario Court of Appeal released its eagerly-anticipated decision in *Raibex Canada Ltd. v ASWR Franchising Corp*.[1] ("***Raibex Canada***"). Franchisors will be happy – by overturning a lower court ruling (released in late 2016), the *Raibex Canada* appeal decision represents a rare win for franchisors in the context of rescission claims asserted by franchisees under s. 6(2) of the *Arthur Wishart Act (Franchise Disclosure), 2000* (the "*AWA*").

Background

Prior to the lower court decision in *Raibex Canada*, it was a relatively common practice for franchisors to sell a franchise before determining its specific location. Franchisors proceeded in this way largely to avoid committing themselves to a head lease without first securing a franchisee to operate at that location under a sublease. In order to comply with the mandatory disclosure obligation contained in provincial franchise legislation,[2] franchisors in these circumstances typically either:

[1] *Raibex Canada Ltd. v. ASWR Franchising Corp*., 2018 ONCA 62 (CanLII).

[2] For example, see s. 5 of the *AWA*.

1. provided a franchise disclosure document ("**FDD**") containing all the "generic" information mandated by franchise legislation to the prospective franchisee, along with a copy of the franchise agreement (which sets out the process for selecting a location) but indicating that, since a location had not yet been selected, no site-specific information could be provided;

2. provided an initial disclosure document containing all the "generic" information mandated by franchise legislation to the prospective franchisee and, after a site was selected, provided a second disclosure document to the prospective franchisee (now with all site-specific information together with copies of the head lease and sublease included) at least 14 days before the franchise agreement was signed or any payments in connection with the franchise were made; or

3. after providing the initial disclosure document as described in 1 above, issued a statement of material change containing all the site-specific information and documents to the prospective franchisee before the franchise agreement was signed or any payments made (thereby avoiding the restarting of the 14 day cooling off period).

Sending shock waves throughout the franchise bar and franchisor community, the lower court decision in *Raibex Canada* called the common practices described above into serious question.

The Lower Court Decision in *Raibex Canada*

The franchisee, Raibex Canada Ltd. ("**Raibex**"), entered into a franchise agreement (the "**Agreement**") with ASWR Franchising Corp. ("**AllStar**") for the operation of a wings and ribs restaurant in Mississauga before a specific location for the restaurant had been selected. AllStar had provided Raibex with an FDD that:

- did not contain a copy of the head lease (because no site had been identified at that point);

- included a copy of AllStar's standard form sublease, which required Raibex to accept all terms of the head lease as negotiated by AllStar;

- contained a copy of the Agreement which, among other things:

  - indicated the franchise would be located in Mississauga and that the territory "would be reasonably determined" by AllStar;

  - required the parties to use their "reasonable best efforts" to find a suitable location acceptable to AllStar; and

  - provided that if AllStar failed to negotiate a lease for a suitable location within 120 days, Raibex could terminate the Agreement and be refunded all amounts paid, less expenses reasonably incurred by AllStar; and

- contained an estimate of costs to construct a new restaurant from a shell ($800,000 to $1.15 million), but no estimate for converting a pre-existing restaurant into an AllStar franchise. On that subject, the FDD indicated that the cost of converting an existing restaurant is highly site-specific (but in AllStar's experience these costs are less than the cost of building out from a shell), and recommended that Raibex maintain a "significant contingency reserve" for the development costs.

About 11 months after the Agreement was signed, the parties found a mutually acceptable location that was available for lease to be converted into an AllStar restaurant. AllStar's affiliate signed a head lease (which required an initial deposit of $120,000, a fact Raibex was made aware of) and subleased the property to Raibex. A few months later, when the restaurant was almost complete, AllStar notified Raibex that the conversion costs exceeded $1 million and asked Raibex to pay unpaid construction invoices of approximately $110,000, as well as the $120,000 lease deposit.

Raibex refused to pay the amounts and served a notice of rescission (almost 20 months after having signed the Agreement) under s. 6(2)

of the *AWA*.[3] AllStar did not accept the notice of rescission, terminated the Agreement and assumed control of the restaurant. Raibex then sued for, among other things, a declaration that the Agreement was validly rescinded and recovery of approximately $1.3 million. Raibex moved for summary judgment. AllStar brought a cross-motion seeking to have Raibex's action dismissed.

In her decision released on September 7, 2016, Justice Matheson held that AllStar's failure to disclose both the terms of the head lease and a cost estimate for converting an existing restaurant into an AllStar franchise meant that its FDD did not contain "all material facts" as required by section 5 of the *AWA* (that these facts were unknown when the Agreement was signed was of no moment). According to Justice Matheson, until a franchisor has and is prepared to make proper disclosure of all material facts, it "must wait – it does not get excused from its statutory obligations". Justice Matheson went on to conclude that AllStar's failure to include this information amounted to an "egregious" breach of its disclosure obligations, that the FDD contained "stark and material deficiencies", and that the test for rescission under s. 6(2) of the *AWA* had therefore been met.

Justice Matheson's decision was widely criticized by the franchise bar as introducing yet another element of uncertainty for franchisors that makes franchising as a business model much more difficult. The bar, as well as franchisors and franchisees alike, have been anxiously waiting on the results of AllStar's appeal.

Court of Appeal Decision in *Raibex Canada*

The Court of Appeal granted AllStar's appeal, set aside the rescission finding and ordered Raibex to pay AllStar the $230,000, less any financial benefits AllStar derived from operating the restaurant for the duration of the lease.

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[3] Section 6(2) of the *AWA* provides that a franchisee may rescind a franchise agreement, up to two years after entering into it, if the franchisor never provided the disclosure document required by s. 5 of the *AWA*. By contrast, s. 6(1) of the *AWA* provides that a franchisee may rescind a franchise agreement, up to 60 days after receiving a disclosure document, if the disclosure document was not provided within the time required by, or if its contents do not meet the requirements of, s. 5 of the *AWA*.

The Court began by noting that s. 6 of the *AWA* provides franchisees with the "extraordinary remedy" of rescission if franchisors fail to provide a FDD in compliance with s. 5 – but that two different limitation periods apply, depending on when and whether the franchisor provides a disclosure document. First, a franchisee may rescind a franchise agreement under s. 6(1) of the *AWA* within 60 days after receiving a FDD if the FDD is not provided within the time required by, or if its contents do not meet the requirements of, s. 5. Second, under s. 6(2) of the *AWA*, a franchisee may rescind a franchise agreement within two years of entering it if the franchisor never provided the FDD.

The Court then summarized two guiding principles from the case law under s. 6(2) of the *AWA*: first, a franchisee who receives imperfect disclosure is not necessarily in the same position as a franchisee who never receives a FDD at all; and second, a disclosure document may be so deficient that it does not amount to disclosure at all, and simply calling a document a 'disclosure document' does not necessarily make it one.[4] The Court held that whether deficiencies in a FDD are so serious as to amount to no disclosure at all under s. 6(2) must be determined on the facts of each case with a view to all relevant circumstances (including the franchise agreement itself), and that the enquiry must focus on whether the franchisee has been effectively deprived of the opportunity to make an informed investment decision.[5] On the facts of *Raibex Canada*, the Court held that the alleged deficiencies of the FDD were not so serious as to amount to a complete lack of disclosure necessary to entitle Raibex to rescind the Agreement under s. 6(2) of the *AWA*.[6]

With respect to AllStar's failure to disclose the head lease, the Court found that all parties knew at the time of disclosure that no location had been selected and that they had agreed that they would work collaboratively to select a site. The Agreement required the parties to exercise reasonable best efforts in selecting a location and gave

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[4] *Raibex Canada*, para 45 – 47.

[5] *Raibex Canada*, para 48 and 49.

[6] *Raibex Canada*, para 41.

Raibex the right to reject a location, terminate the Agreement and obtain a refund. The Court held that these safeguards were a "complete answer" to the inquiry as to whether AllStar's failure to disclose the head lease in its FDD deprived Raibex of the ability to make an informed investment decision.[7]

Regarding the alleged failure to disclose conversion cost estimates, the Court held that the FDD put Raibex on notice as to the potential financial risks of conversion. The FDD included cost estimates for developing a franchise from a shell, a clear warning that cost estimates for conversions vary greatly from location to location, and a caution to maintain a significant contingency reserve for such costs. Although conversion did offer potential costs savings, the shell estimates clearly disclosed a useful reference point to measure the costs of development of the franchise, which were in fact on par with the actual costs incurred in this case.[8]

The Court concluded that, even if the above-noted omissions amounted to a breach of s. 5, they did not amount to "no disclosure at all" and that the motion judge's failure to give effect to the legislative distinction found in s. 6(1) and 6(2) of the *AWA* amounted to an error of law. To obtain the extraordinary remedy of rescission under s. 6(2) of the *AWA*, a franchisee must not only demonstrate that the FDD is deficient, but also show that it was so deficient that the franchisor effectively never provided a disclosure document.[9]

Key Take Aways

There are several key take aways from this important Court of Appeal decision, including the following:

1. It clarifies that the disclosure obligations imposed by s. 5 of the *AWA* must be interpreted practically and in light of the facts and commercial circumstances surrounding the grant of the franchise. It clearly stands for the proposition that franchisors can, in

[7] *Raibex Canada*, para 54.

[8] *Raibex Canada*, para 56.

[9] *Raibex Canada*, para 40.

certain circumstances, furnish a compliant FDD and enter into a franchise agreement before a location has been selected (or a lease has been entered into with respect to the location).

2. It impliedly means that the scope of required disclosure does not extend to material facts that are not known or that do not exist at the time the FDD is issued.

3. The test for determining a rescission claim under s. 6(2) of the *AWA* is more narrow than before. Under prior case law, the test was whether the FDD was "materially deficient" or "fundamentally inadequate" or "seriously non-complaint" with the requirements of s. 5 – in essence, it was a strict liability test. Now, the test more squarely focuses on whether the franchisee has been deprived of the opportunity to make an informed investment decision.

4. When determining whether rescission is available under s. 6(2), the court must consider all relevant circumstances (including the language contained in the franchise agreement) that bear upon whether a franchisee could make a properly informed investment decision.

5. Appropriately worded disclaimers and express warnings in a FDD can minimize a franchisor's exposure to liability.

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a cautionary note