

Franchise Disclosure: To be or not to be, that is the question

In what may be a landmark decision, the Ontario Superior Court of Justice has judicially determined in *Sovereignty Investment Holdings Inc. v. 9127-6907 Quebec Inc.*¹ which deficiencies in disclosure may be fatal to a franchisor's compliance with the requirement to deliver a disclosure document.

This issue of the sufficiency of disclosure, and more importantly whether there are any deficiencies of disclosure, is significant since Ontario's franchise legislation, the *Arthur Wishart Act (Franchise Disclosure), 2000*, sets out different limitation periods for franchisees to rescind their agreements depending upon whether or not disclosure was provided as required in the *Act*. If disclosure was delivered by the franchisor, although late or deficient in content, the franchisee would have 60 days in which to rescind the agreement and obtain reimbursement of all amounts paid to the franchisor or otherwise incurred to set up or acquire the franchise. If, however, disclosure was never provided by the franchisor, or if it was *deemed* that disclosure was never provided for fundamental deficiencies, the limitation period of rescission for the franchisee is extended to 2 years.

Considering that there is no defence within Ontario's legislation for "substantial compliance" with the disclosure requirements – as is the case in similar franchise legislation in Alberta and Prince Edward Island – there is a high risk that the disclosure document will contain some deficiency in providing all "material facts", whether of a technical or substantive nature, and that the franchisor will not be in compliance with its disclosure obligations. For this reason, the cases prior to *Sovereignty Investment* dealing with rescission by a franchisee invariably grappled with the issue of whether the disclosure deficiencies were of such a serious nature to conclude that no disclosure document was delivered under the legislation which, in turn, provided the franchisee with a 2-year rescission period. In effect, a franchisee that could make this argument would have a 2-year guarantee of success from the franchisor since it would have the option of rescinding the relationship in the face of a unsuccessful franchise.

In *Sovereignty Investment*, the franchisee sought rescission of a franchise agreement for the operation of a "Houston Steaks & Ribs" restaurant at Vaughan Mills Shopping Centre in Vaughan, Ontario. Prior to signing the franchise agreement, the franchisor delivered to the franchisee a variety of documents *at different times* including a disclosure document, *pro forma* financial projections, and a draft of the franchise agreement. Subsequently, the franchisee also received a *pro forma* opening balance sheet, a sublease for the franchised premises which it eventually signed, a copy of the head lease, and a trade-mark license agreement. When it became apparent that the business was not successful after approximately 16 months of operation, the franchisee sent the franchisor a notice of rescission.

¹ (2008) CanLII 57450 (Ont. S.C.) – Released November 7, 2008.

The central issue for the Court to decide was whether the deficiencies in the “disclosure document” from the franchisor were of such a serious and fundamental nature to disqualify the documentation as a “disclosure document” under the legislation. If so, the franchisee’s rescission notice would have been validly delivered within the 2-year limitation period.

In arriving at his conclusion that the franchisor failed to deliver a “disclosure document” for the purposes of the *Act*, Justice H.J. Wilton-Siegal specifically referred to four deficiencies in the disclosure to Sovereignty, each of which in his view, *on their own*, were fatal to the document being a “disclosure document.” They were:

- The failure of the franchisor to include a copy of its financial statements with disclosure as required by the *Act* and the regulations.²
- The failure of the franchisor to include a statement specifying the basis for the earnings projections and estimates, as well as a statement of assumptions underlying the estimates and a location where information was available for inspection to substantiate such estimates and projections.
- Following the decision of the Ontario Court of Appeal in *1490664 Ontario Ltd. v. Dig This Garden Retailers Ltd.*³, the failure of the franchisor to provide disclosure in a single document and delivered at the same time.
- The failure of the franchisor to include a signed Certificate of Disclosure confirming that disclosure was true and accurate and contained all material facts.⁴

It may also be interesting to note the passing comments of Justice Wilton-Siegal that none of the additional deficiencies cited by the franchisee would on their own disqualify the disclosure for the purposes of the *Act*, and that the cumulative effect of these minor deficiencies could not achieve this result.

The message from the Superior Court in *Sovereignty Investment* has at least clarified some of the “fundamental” elements of disclosure under the *Act*, and a franchisor would be wise to at least review its franchise disclosure document to ensure that it complies. As already noted, failure to comply in this respect may expose the franchisor to unwittingly providing a franchisee with a 2-year guarantee of success. The question that remains is what other requirements under the *Act* and its regulations may also be considered “fundamental” as opposed to just simply deficiencies. Only time and rescinding franchisees and their counsel will tell.

² Although the franchisor in *Sovereignty* failed to include any financial statements with disclosure, it may be presumed that the inclusion of outdated statements or statements not prepared in accordance with generally accepted accounting principles that are at least applicable to review engagement reporting standards would also be fatal to disclosure since they would not comply with the regulations.

³ (2005) CanLII 25181 (Ont. C.A.).

⁴ Also see the recent case of *Hi Hotel Limited Partnership v. Holiday Hospitality Franchising Inc.* (2008) ABCA 276 (CanLII) in which the Alberta Court of Appeal came to a similar conclusion under Alberta’s *Franchises Act*.

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