

# Rescission or bust: statutory requirements trump franchisee's insouciance

February 13 2018 | Contributed by [Lapointe Rosenstein Marchand Melançon LLP](#)

[Introduction](#)  
[Facts](#)  
[Decisions](#)  
[Comment](#)

## Introduction

In several Canadian provinces (including Ontario) franchisors are subject to stringent pre-contractual disclosure obligations, which require them to provide a franchise disclosure document to every proposed franchisee before the sale of a franchise. If the franchisor fails to do so, the franchisee may rescind the agreement within two years of its signing, without penalty. In order to meet its disclosure obligations in Ontario, a franchisor must disclose any material information that might affect the franchisee's decision to acquire a franchise, including information pertaining to the business, operations, capital and control of the franchisor.<sup>(1)</sup>

In *Mendoza v Active Tire & Auto Centre Inc* the Ontario Court of Appeal confirmed that a disclosure document does not comply with statutory requirements if it is "materially deficient". Where a disclosure document is materially deficient, this will be equivalent to no disclosure having been made and the franchise agreement may be rescinded. The court of appeal overturned the lower court's finding that a deficient disclosure document may be forgiven if the franchisor has provided the franchisee with sufficient information to make an informed decision regarding the acquisition of the franchise. It also held that, where disclosure is insufficient, rescission may be granted regardless of whether the franchisee has read the contents of the franchise disclosure.

## Facts

Mr Mendoza began negotiating the purchase of a franchise from Active Tire & Auto Centre Inc in early 2015. During the negotiation process, Mendoza sought independent financial and legal advice regarding the proposed franchise agreement, in addition to obtaining several disclosure and ancillary explanatory documents from the franchisor. After three months of negotiations, the purchase of the franchise was finalised and the agreement signed in June 2015. Mendoza operated the Active Tire franchise at a loss for approximately three months and, by mid-August, notified the franchisor of his intention to terminate the franchise agreement. Active Tire received an official notice of rescission from Mendoza in late August 2015.

In the franchisee's claim for rescission served shortly thereafter, the franchisee contended that Active Tire had not provided the requisite franchise disclosure, given that:

- the franchisor had failed to provide a disclosure document signed by two officers and directors;
- the franchisor had failed to provide audited financial statements from its most recently completed fiscal year;
- the disclosure documents were not all delivered at the same time;
- the irrevocable letter of credit described in the franchise application differed significantly from that which was signed by the franchisee; and

## AUTHORS

[Bruno Floriani](#)



[Marissa Carnevale](#)



- the franchisor had failed to provide the required assumptions and information as part of the financial projections.

## **Decisions**

### ***Ontario Superior Court of Justice***

In assessing the franchisee's right to rescission due to deficient disclosure, the Ontario Superior Court of Justice first analysed the nature and extent of the deficiencies alleged by the franchisee. It recognised that the franchisor's production of disclosure documents was inadequate and deficient. However, the court found that these deficiencies were not "significant or misleading" and ultimately not substantial enough to warrant rescission of the franchise agreement. More importantly, it concluded that the information provided afforded the franchisee the opportunity to make an informed decision as to whether he should invest in the Active Tire franchise.(2)

As a result, although the pre-contractual disclosure did not strictly comply with Ontario franchise legislation, the court denied Mendoza's rescission claim.(3) In reaching its verdict, the court also took into consideration the fact that Mendoza had failed to read the entirety of the disclosure material supplied by the franchisor.(4)

### ***Ontario Court of Appeal***

On appeal by Mendoza, the Ontario Court of Appeal ruled that the deficiencies amounted to a serious breach of the franchisor's statutory disclosure obligations; Mendoza's claim for rescission was accordingly granted.(5)

The court of appeal determined that the lower court had erred in its interpretation of the test for rescission, finding that this should have been whether the franchise disclosure document was materially deficient as opposed to whether the franchisee had made an informed decision in purchasing the franchise.(6)

The court of appeal focused on what it considered to be the principal shortcomings in Active Tire's disclosure – namely, the absence of:

- a second officer or director signature on the disclosure document; and
- recent financial statements.

In contrast with the lower court, the court of appeal found not only that these deficiencies were of material importance, but also that they were "fatal to the ability of the purported disclosure document to be a disclosure document" within the meaning of Ontario's franchise disclosure legislation.(7)

The court of appeal found that the lower court had misinterpreted the significance of the two-signature requirement. While the motion judge had dismissed this deficiency based on the fact that Mendoza had physically met some of Active Tire's directors and officers, the court of appeal explained that the purpose of this obligation is to impose personal liability on officers and directors of the franchise in the event that the information contained in the franchise disclosure document is incomplete or inaccurate. Therefore, this requirement was found to be necessary for adequate disclosure and could not be replaced by a potential franchisee having met the officers and directors of the franchise.(8)

In addition, the court of appeal was of the view that Active Tire's failure to remit updated financial statements to Mendoza was equally significant. Active Tire had provided Mendoza with its statements for a prior fiscal year, but not its most recent financial statements. The court noted that franchisees often base their decision to purchase a franchise on the financial information provided by the franchisor; given that a franchisor's financial statements provide an indication of the viability of the franchise as a potential business, the financial statements submitted to the franchisee must be accurate and up to date. If a franchisor cannot provide a prospective franchisee with, among other things, its financial statements within the allotted period, then it should refrain from entering into a franchise agreement with the franchisee.(9)

The court of appeal also found that the other disclosure deficiencies cited by the franchisee and the

fact that disclosure had been made in a "piecemeal" manner were important enough to constitute failings pursuant to the statutory disclosure requirements. It further found that the lower court had erred in taking into account the fact that Mendoza had not read the contents of the franchise disclosure package. The court of appeal stressed that the test in establishing whether rescission should be granted in cases of deficient disclosure is strictly objective; subjective factors, such as the actions or reactions of a franchisee, are irrelevant to the analysis.(10)

Moreover, the franchisor had argued that Mendoza should not be entitled to the statutory rescission remedy given that his initial motives for rescinding the agreement related to the failure of his Active Tire franchise operations. The court of appeal rejected this submission – a franchisee's right to rely on the accuracy of the contents of a franchise disclosure document is not dependent on the conduct of the franchisee (including failure to review the disclosure document) or on the franchisee's motives for seeking rescission.(11)

## **Comment**

While the Ontario Superior Court of Justice's proposed informed decision test was more favourable to franchisors, the court of appeal's reversal of the lower court's ruling confirms that little leniency will be afforded to franchisors in cases of deficient franchise disclosure documents. The court of appeal has provided a strong and clear reminder that franchisees have an absolute right to rescission in cases of materially deficient disclosure, which is consistent with the protective purposes of franchise disclosure legislation. In evaluating whether a franchise disclosure document complies with law, franchisors will be held to a strict and objective standard of compliance with the statutory requirements, without any consideration for the franchisee's behaviour or reaction to the franchise disclosure document, or to the motives for seeking rescission. Perhaps surprisingly, the fact that a franchisee has not read the contents of the franchise disclosure document has no bearing on the analysis.

It would therefore seem that many other factual or even equitable defences of a franchisor could meet a similar fate, although not directly addressed in this decision. While franchisors may still put forth the position that a franchisee's informed decision to invest in a franchise should be determinative in certain cases, any such determination should be made by courts on a case-by-case basis going forward.

Franchisors are strongly advised to err on the side of caution when preparing franchise disclosure documents and to seek guidance from specialised counsel – particularly given that a failure to do so could result in serious consequences, including rescission of the franchise agreement and potentially a requirement to refund the money invested by the franchisee.(12)

*For further information on this topic please contact [Bruno Floriani](mailto:bruno.floriani@lrmm.com) or [Marissa Carnevale](mailto:marissa.carnevale@lrmm.com) at Lapointe Rosenstein Marchand Melançon LLP by telephone (+1 514 925 6300) or email ([bruno.floriani@lrmm.com](mailto:bruno.floriani@lrmm.com) or [marissa.carnevale@lrmm.com](mailto:marissa.carnevale@lrmm.com)). The Lapointe Rosenstein Marchand Melançon LLP website can be accessed at [www.lrmm.com](http://www.lrmm.com).*

## **Endnotes**

(1) Arthur Wishart Act (Franchise Disclosure), 2000, SO 2000, Chapter 3, Sections 1 and 5(4).

(2) *Mendoza v Active Tire & Auto Centre Inc*, 2016 ONSC 3009, Paragraphs 12-25.

(3) *Ibid*, Paragraph 24.

(4) *Ibid*, Paragraph 16.

(5) *Mendoza v Active Tire & Auto Inc*, 2017 ONCA 471, Paragraph 39.

(6) *Ibid*, Paragraph 19.

(7) *Ibid*, Paragraphs 20-21.

(8) *Ibid*, Paragraphs 22-27.

(9) *Ibid*, Paragraphs 28-34.

(10) *Ibid*, Paragraphs 25-26 and 36.

(11) *Ibid*, Paragraph 38.

(12) Arthur Wishart Act (Franchise Disclosure), 2000, SO 2000, Chapter 3, Section 6(6).

---

The materials contained on this website are for general information purposes only and are subject to the [disclaimer](#).