FRANCHISING - CANADA

Franchisors rejoice! Ontario Court of Appeal raises bar for franchise rescission

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Introduction

The Ontario courts have recently endeavoured to clarify the outer limits of the parameters within which a franchisee may exercise its right to rescind a franchise agreement. In *Raibex Canada Ltd v ASWR Franchising Corp*, the Ontario Court of Appeal overturned the lower court's controversial rescission order of a franchise agreement between Raibex Canada Ltd, the franchisee, and ASWR, the franchisor of the AllStar Wings and Ribs (ASWR) franchise. The appeal court held that an imperfect disclosure document does not always provide sufficient grounds for rescinding a franchise agreement. Further, it stressed the importance of taking into account the provisions of a franchise agreement when adjudicating a franchisee's claim for rescission, which the motion judge had failed to do in this case.

The decision comes as welcome reassurance for franchisors that commonly enter into franchise agreements prior to selecting a specific location for the franchised business.

Facts

In September 2012 Mr Bastaros, the sole director and officer of Raibex, approached ASWR to express an interest in obtaining a franchise. While no specific location was contemplated for the franchise at that time, on October 16 2012 Raibex was provided with a franchise disclosure document which set out an estimate of development costs to build a franchise from a shell. The disclosure document also mentioned that the franchisee could convert a pre-existing restaurant location into an ASWR franchise. The franchisor did not otherwise provide an estimate for conversion costs due to the fact that, according to the franchisor, such costs were highly site-specific and "the Franchisor had no reasonable means of estimating or predicting conversion costs with any certainty".**(1)**

The franchise disclosure document also attached certain draft agreements, including a draft sublease which stated that Raibex would accept all of the terms, covenants, conditions and obligations in the principal lease negotiated by ASWR, as tenant, with the landlord. However, no draft principal lease was included in the franchise disclosure document, as no site had been located for the franchise at that time.**(2)**

Two weeks after the franchise disclosure document was delivered, Raibex made a formal application for a franchise, which was submitted along with a preliminary business plan. The franchise agreement was executed on November 21 2012. Similarly to the franchise disclosure document, the agreement did not designate a specific site for Raibex's ASWR franchise. However, it did contain a clause whereby both parties would use their "reasonable best efforts" to search for an acceptable franchise location. The agreement also provided that, in the event that a suitable location was not identified within 120 days of the franchise agreement's signature, the franchisee would be entitled to opt-out of

the agreement and receive a refund and release from the franchisor.(3)

Soon after signing the franchise agreement, the parties located a mutually agreeable restaurant that was available for lease and conversion. An affiliate of the franchisor entered into a lease with the landlord dated September 19 2013 and a sublease with Raibex one month later. The principal lease provided for an initial deposit of five months' rent together with a security deposit for the final month's rent, which – according to the sublease – formed part of the terms, covenants, conditions and obligations of the principal lease that the subtenant (Raibex, the franchisee) had agreed to comply with pursuant to the draft sublease attached to the franchise disclosure document. Although Bastaros did not receive a copy of the head lease at this time, he was informed of, and acquiesced to, the deposit condition prescribed by the principal lease.(4)

The conversion of the leased restaurant began in November 2013 and was substantially completed just before the franchise opened in March 2014. Approximately one month before opening, ASWR sent Raibex a letter notifying it of its contractual requirement to pay the remaining development costs and that the estimated cost for the franchise build-out was over C$1 million. This fell within the cost range in the franchise disclosure document for an initial shell build, despite having been a restaurant conversion.

In July 2014 the franchisor's affiliate holding the lease rights for the franchise's premises invoiced Raibex for the pre-paid rent and security deposit due under the principal lease. When Raibex failed to pay such amounts and the balance of the construction costs, ASWR delivered a notice of default to Raibex. In return, Raibex served a notice of rescission, claiming C$1.28 million from ASWR and its related entities. The franchisor and related parties responded by:

- delivering a notice of termination of the franchise agreement and the sublease; and
- assuming control of the leased premises and franchised business.(5)

Decisions

Ontario Superior Court of Justice

While ASWR had provided Raibex with a disclosure document containing all of the information in its possession at the time, the Ontario Superior Court of Justice found that material information which had been necessary for Raibex to make a properly informed decision with respect to acquiring a franchise had been missing. The court refused to accept ASWR's argument that disclosure could not have been made on the basis that certain material information had simply been unavailable when the disclosure statement was prepared. The court further emphasised that, since franchise disclosure law aims to protect franchisees' interests, to require that franchisors disclose only the information which is known to them at the time of disclosure would essentially enable franchisors to give disclosure at a premature stage when material matters are not yet known, thereby encouraging the signature of franchise agreements by uninformed franchisees and allowing franchisors to avoid statutory disclosure obligations. The court concluded that if it is impossible to make proper disclosure because material facts are not yet known, a franchisor is not yet ready to deliver the statutorily required disclosure document and must await the information.

The court noted that the lease was a material and critical component of the franchise disclosure. It therefore ruled that the lack of a copy of the lease in the franchise disclosure document constituted a violation of ASWR's legal disclosure obligations.

Further, the court found that ASWR had failed to provide adequate financial disclosure in the franchise disclosure document given to Raibex, particularly given that:

- the substantial additional deposit under the lease was not yet known; and
- the cost estimate for building out the franchised premises had been based solely on a shell (and not a conversion), when all but one of the franchises as of then had been conversions.

Moreover, in the court's opinion, ASWR's disclaimer in the franchise disclosure document that ASWR had had "no reasonable means of estimating or predicting those costs with any certainty" was tantamount to an admission that ASWR had not fulfilled its disclosure obligations with respect to franchise costs. The court concluded that the failure to adequately disclose costs suggested that the

franchise disclosure document had simply been delivered prematurely, before ASWR had been in a position to properly estimate costs.

The court therefore held that Raibex had properly exercised its right of rescission under Section 6 of the Arthur Wishart Act and referred the assessment of damages to an Ontario Superior Court of Justice master.**(6)**

Ontario Court of Appeal

The Ontario Court of Appeal allowed ASWR's appeal and ruled that the lower court had erred in its interpretation of Section 6 of the Arthur Wishart Act, confirming that the right of rescission is an extraordinary remedy that cannot be applied except in limited circumstances.

The appeal court began its analysis by differentiating between the two scenarios that may give rise to the statutory rescission rights pursuant to the Arthur Wishart Act. First, Section 6(1) of the act states that a franchisee may rescind its franchise agreement within 60 days of its receipt of a franchise disclosure document if it:

- was not delivered within the period prescribed by the act; or
- did not include all of the required materials.

Alternatively, under Section 6(2), a franchisee may rescind a franchise agreement within two years of its signing if a franchise disclosure document was never actually supplied by the franchisor. As was the case here, after the 60-day period prescribed by Section 6(1) has elapsed, if a franchisee wishes to obtain rescission, it may do so only by demonstrating that the franchisor never provided it with a disclosure document.**(7)**

It had previously been established that, in certain circumstances, a franchise disclosure document may be so egregiously deficient so as to "effectively amount to a complete lack of disclosure" and thereby justify the rescission of a franchise agreement pursuant to Section 6(2) of the Arthur Wishart Act. In order to determine whether sufficient disclosure has been provided, the courts must inquire, on a case-by-case basis, as to whether the disclosure materials provided by the franchisor afforded the franchisee the opportunity to make an informed investment decision in purchasing a franchise. **(8)**

The appeal court discussed two governing principles that can be extrapolated from the numerous judicial interpretations given to Section 6(2) of the Arthur Wishart Act. First, an insufficient disclosure document will not always warrant rescission. In particular, the court pointed out that where a franchisee receives an incomplete disclosure document, it is not in the same position as a franchisee that has received no disclosure at all.

When applying these principles to the case at hand, the appeal court found that the issues raised by Raibex did not justify rescinding its franchise agreement with ASWR. More particularly, the appeal court faulted the motion judge for not considering the actual terms of the franchise agreement in its analysis, which the appellate court qualified as "an extricable error of law, justifying appellate intervention".**(9)**

First, with regard to there being no specific location contemplated by the franchise agreement for Raibex's franchise (or any related head lease), the appeal court noted that by signing said agreement, Raibex had acknowledged the fact that the franchise location would be determined only at a later date through the parties' collective efforts. In addition, the reasonable efforts clause included in the franchise agreement had prevented ASWR from entering into a principal lease without first consulting Raibex.

The appeal court also recalled that the franchise agreement had included a termination clause for the benefit of the franchisee, whereby the latter had had the right to opt out of the agreement if the franchisor could not find a satisfactory location for the franchise within 120 days of its signature. If Raibex had been unhappy with ASWR's proposed location, or if it found that the lease requirements were too onerous, it could have availed itself of its right to terminate the agreement or, at a minimum, suggested an alternate location for the franchise premises.**(10)**

Further, with respect to the allegedly undisclosed conversion costs, Raibex was found to have been made aware of the risks associated with pursuing the conversion route as opposed to building an ASWR restaurant from a shell. The appeal court agreed with ASWR that there had been no reasonable method of estimating conversion costs so early on in the franchise negotiation process considering that such costs necessarily vary from site to site. Accordingly, and in contrast with the lower court's position, the appeal court found that ASWR's experience with previous conversions was irrelevant. The appeal court also mentioned that not only had the final construction costs fallen within the estimate provided by the franchisor for constructing from a shell, but also that the franchisee should have used the shell estimates as a reference point for measuring the "upper range of possible costs associated with a conversion".**(11)**

In light of the above, the appeal court concluded that the conditions for obtaining rescission pursuant to Section 6(2) of the Arthur Wishart Act had not been satisfied. Each of Raibex's complaints had been answered by the terms of its franchise agreement with ASWR. Further, the reasonable efforts and opt-out clauses had served as safeguards that had allowed Raibex to make an informed decision in acquiring an ASWR franchise once the franchise location and its lease terms were known to the franchisee.

In addition, the appeal court awarded part of the damages claimed by ASWR for Raibex's unpaid construction fees and head lease deposit.**(12)**

Comment

This long-awaited Ontario Court of Appeal decision comes as a relief for Ontario franchisors after the lower court's unanticipated expansion of a franchisor's disclosure obligations pursuant to the Arthur Wishart Act. With this ruling, the appeal court has provided franchisors with some clarity as to what distinguishes imperfect disclosure from a complete lack of disclosure and guidance as to the circumstances in which these two situations should be distinguished from one another. This decision has also clarified certain types of deficiency that would not be analogous to an egregiously deficient disclosure tantamount to a lack of disclosure for purposes of Section 6(2) of the Arthur Wishart Act.

Finally, the appeal court's decision establishes that the unavailability of certain material information in a franchise disclosure document may be remedied by including safeguard clauses in the franchise agreement, such as:

- provisions confirming the use of reasonable efforts to obtain such information within a certain period; and
- opt-out clauses in favour of the franchisee for a limited time after the missing information is obtained or failed to be obtained.

From a practical perspective, the common industry practice for franchisors to enter franchise agreements before a specific franchise location is selected appears to remain permissible if the relevant safeguards are included.

The decision sends a clear message to the lower courts that a franchisee's right to rescission is an exceptional measure that should not be granted lightly, and that the terms and conditions negotiated between a franchisor and its franchisee cannot be ignored.

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Endnotes

(1) *Raibex Canada Ltd v ASWR Franchising Corp*, 2018 ONCA 62, Paragraph 10 [*Raibex*].

(2) *Ibid*, Paragraphs 5-10.

(3) *Ibid*, Paragraphs 11-13.

(4) *Ibid*, Paragraphs 14-15.

(5) *Ibid*, Paragraphs 16-19.

(6) *Raibex Canada Ltd v ASWR Franchising Corp*, 2016 ONSC 5575.

(7) *Raibex*, *Supra* note 1, Paragraphs 43-44.

(8) *Ibid*, Paragraphs 45-49.

(9) *Ibid*, Paragraphs 50-52.

(10) *Ibid*, Paragraphs 53-54.

(11) *Ibid*, Paragraphs 55-56.

(12) *Ibid*, Paragraphs 57; 67-70.
