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Raibex: Clarification of a Franchisor's Disclosure Obligations or Judicially Created Uncertainty?

David Kornhauser, Corporate Counsel, MacDonald Sager Manis LLP
& Junaid Malik, Student at Law, MacDonald Sager Manis LLP

In late January 2018, the Court of Appeal for Ontario (the "ONCA") released its widely anticipated decision in *Raibex Canada Ltd. v. ASWR Franchising Corp.*[1] The main issue before the ONCA was whether the Motion Judge erred in finding that Raibex Canada Ltd. (the "Franchisee") validly rescinded the franchise agreement (the "FA") pursuant to s. 6(2) of the *Arthur Wishart Act (Franchise Disclosure), 2000*.[2] Under s. 6(2) of the *Wishart Act*, a franchisee is entitled to rescind a franchise agreement without penalty or obligation, within two years of entering into the franchise agreement, if they never received a disclosure document. Various court decisions since the *Wishart Act*[3] came into force have interpreted s. 6(2) rescission rights to apply to situations where a franchisee receives a disclosure document so materially deficient that it is deemed to constitute no disclosure at all—this being the nature of the Franchisee's rescission claim in *Raibex*.

A. BACKGROUND INFORMATION AND FACTS

The salient facts of the case in respect of disclosure are as follows:

- ASRW Franchising Corp. (the "Franchisor") controls the AllStar Wings and Ribs franchise (the "ASWR Franchise");

- The principal of the Franchisee ("Bastaros") was interested in acquiring an ASWR Franchise;

- In September of 2012, Bastaros spoke with the Franchisor's broker ("Maisonneuve"), and informed him that his maximum budget for an ASWR Franchise was $400,000.00;

- Maissoneuve sent Bastaros an email which contained an attachment entitled "Franchise Information Package" (the "FIP"). The FIP contained cost estimates for constructing a new ASWR Franchise from a shell (a "Shell"). The FIP did not contain cost estimates for converting an existing restaurant to an ASWR Franchise (a "Conversion"). However, in Maissoneuve's cover email (the "Cover Email") he included a cost estimate for a Conversion by stating that it could potentially be one-third to one-half the cost of a Shell, totaling $500,000.00 to $600,000.00;

[1] 2018 ONCA 62 [*Raibex*]. As at the date of this article, the authors understand that the Franchisee has sought leave to appeal to the Supreme Court of Canada.

[2] S.O. 2000, c. 3 [*Wishart Act*].

[3] Various court decisions under the *Franchises Act* (Alberta) have also informed the jurisprudence on a franchisor's obligations and a franchisee's rights under franchise legislation.

- On October 16, 2012, Bastaros received the franchise disclosure document (the "FDD"). The FDD did not contain a specific location for the prospective ASWR Franchise as one had yet to be determined at that time, and the FDD did not contain a draft head lease. Furthermore, the FDD indicated that the cost for a Conversion is highly fact specific, but cheaper than building from a Shell. The cost estimates for building a Shell were between $805,500.00 and $1,153,286.00. No cost estimates for a Conversion were provided in the FDD even though all but one of the ASWR Franchises were Conversions;

- Shortly thereafter, Bastaros submitted a preliminary business plan which contained a development budget in the sum of $600,000.00 plus $50,000.00 for working capital;

- The FA, like the FDD, did not specify a site for the ASWR Franchise though it stated that it would be located in Mississauga. The FA also provided that if the Franchisor failed to negotiate a lease for a suitable location within 120 days of the FA being executed, the Franchisee was entitled to terminate the FA upon 20 days' notice and receive a release and refund of all amounts paid to the Franchisor (the "Opt-Out Clause");

- The parties located a mutually acceptable location available for lease. Bastaros participated in the lease negotiations and encouraged the Franchisor to sign the head lease. The head lease had a substantial deposit requirement of nearly $120,000.00. The Franchisor signed the head lease, and the Franchisee signed the sublease without receiving a copy of the signed head lease; and

- Once construction was completed, Bastaros was informed that the Conversion costs exceeded $1,000,000.00. The Franchisor asked the Franchisee to resolve the outstanding construction costs to which the Franchisee refused. The Franchisee rescinded the FA. The Franchisor refused to accept the notice of rescission and instead terminated the FA and assumed control of the location.

B. MOTION JUDGE'S REASONS

The Motion Judge granted the Franchisee's rescission claim stating that "[t]he lack of disclosure was egregious. The Franchise Disclosure Document had 'stark and material' deficiencies with respect to the lease and costs obligations, such that it amounted to no disclosure."[4]

With respect to the first issue, the Motion Judge cited the ONCA's decision in *Dollar It*,[5] where a disclosure document was held to be so materially deficient as to constitute no disclosure at all because of a missing head lease. Though, the Motion Judge acknowledged that in *Dollar It* the franchisor possessed the head lease and failed to disclose it to the franchisee, the Motion Judge was not persuaded by the Franchisor's argument that "they could not disclose what they did not have. Since no location had been determined, they did not have a head lease." Instead, the Motion Judge held that the substantial deposit illustrated the materiality of the head lease, and that it therefor ought to be disclosed.

[4] 2016 ONSC 5575 at para. 114 (S.C.J.) [*Raibex ONSC Decision*].
[5] *6792341 Canada Inc.* v. *Dollar It Ltd.*, 2009 ONCA 385, 95 O.R. (3d) 291 [*Dollar It*].

With respect to the second issue, the Motion Judge once more cited *Dollar It*, for the proposition that financial disclosure is of the utmost importance. She held that the FDD was materially deficient because it failed to disclose the substantial deposit under the head lease and the costs disclosure contained therein was materially inadequate. The Motion Judge rejected the disclaimer language that the Franchisor had included in the FDD:

> Even more problematic is the statement made in the Franchise Disclosure Document about conversions. The Franchise Disclosure Document opened up the possibility of significantly lower costs for a conversion but still stated that the Franchisor had "no reasonable means of estimating or predicting those costs with any certainty." It also stated that conversion costs were highly site-specific and could "therefore vary dramatically from location to location."
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> If it is necessary to state in a franchise disclosure document that the franchisor has "no reasonable means of estimating or predicting those costs with any certainty" that is as much as admitting that the costs disclosure obligation cannot be met as of then. A broad disclaimer is also no answer to the mandatory statutory disclosure obligations. Again, if a location had been determined, these broad caveats based upon costs being "highly site-specific" would be unnecessary and proper disclosure would be made.[6]

The Motion Judge took notice of Maisonneuve's cross-examination, where he admitted to inaccuracies contained within the Cover Email respecting the Conversion cost estimates. The Motion Judge rejected the Franchisor's argument that disclosure was adequate because the high-end of the Shell estimate included in the FDD was slightly higher than the costs incurred by the Franchisee. The Motion Judge held that the FDD was delivered "prematurely, before the Franchisor was in a position to properly estimate costs".[7]

THE ONCA'S REASONING

The ONCA allowed the Franchisor's appeal and held that the Franchisee was not entitled to rescind the FA. The ONCA discussed two guiding principles with respect to a s.6(2) rescission, referring to two cases it decided which set forth these principles: *Imvescor*[8] and *Dollar It*. Reiterating a proposition held in the former case, the ONCA stated that the two avenues for rescission do not stand on equal footing. Moreover, the ONCA cautioned that the two rescission avenues ought not be blurred or conflated, since the legislature expressly reserved the two-year limitation period for situations where there was a "complete failure to provide a disclosure document." Next, the ONCA affirmed its latter ruling in *Dollar It*—that a disclosure document may be so deficient that it effectively amounts to a complete lack of disclosure.

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[6] *Raibex ONSC Decision* at paras. 82 and 83.
[7] *Ibid*. at para. 85.
[8] *4287975 Canada Inc. v. Imvescor Restaurants Inc.*, 2009 ONCA 308, 98 O.R. (3d) 187, leave to appeal to the S.C.C. refused, [2009] S.C.C.A. No. 244 [*Imvescor*].

Ultimately, the ONCA stated that the inquiry into whether disclosure deficiencies justify rescission under s. 6(2) of the *Wishart Act* depends upon whether the franchisee "can make a properly informed decision about whether or not to invest in a franchise."

The ONCA held that the Motion Judge erred in law in her interpretation and application of s. 6(2) rescission with respect to the head lease and the conversion cost estimates. Equipped with the lower standard of review, correctness, the ONCA reassessed whether the FDD was so materially deficient that it prevented the Franchisee from making an informed decision about investing in the ASWR Franchise.

With respect to the absence of a head lease within the FDD, the ONCA:

- valued that the parties were aware that no location had been specified at the time disclosure was made and that the parties were working collaboratively to resolve this issue;

- emphasized the fact that the FA expressly contemplated the absence of site specificity; and

- found the Opt-Out Clause mitigated against the lack of head lease within the FDD, since it gave the Franchisee the option to walk away from the deal.

The ONCA was clear that its earlier decision in *Dollar It* was correctly decided. To that effect, the ONCA identified the following distinguishing facts with respect to *Dollar It*: the franchisor failed to disclose the head lease while having it in their possession; the absence of an opt-out clause; and the existence of serious other material deficiencies within the disclosure document.

Assessing the cost disclosure issue, the ONCA found that the Franchisee was "put on notice" and that the Franchisor provided enough warnings about the uncertainty of its estimates. The ONCA went on to add that the cost estimates for a Shell provided the Franchisee with "a useful reference point" against which to measure the upper range of possible costs associated with a Conversion. Ultimately, the ONCA concluded that the FDD was not so deficient as to permit a s. 6(2) rescission since the Franchisee was capable of making an informed investment decision.

C. THE AUTHORS' COMMENTARY

The authors respectfully believe that although this decision is clearly pro-franchisor, it is not pro-franchising since rather than creating commercial certainty it creates more uncertainty for both franchisors, franchisees, and their respective counsel.

Firstly, the ONCA seems to obfuscate the standard for material deficiency by citing the divergent phrasing used in several cases (ironically, some of these decisions were rendered by the ONCA itself), stating the following:

> Whether deficiencies in a disclosure document are so serious as to amount to no disclosure for the purposes of the *AWA* must be determined on the facts of each

> case: *Dollar It*, at para. 78. The necessary degree of deficiency has been described in several ways, including "materially deficient" (*Mendoza v. Active Tire & Auto Inc.*, 2017 ONCA 471 (CanLII), 414 D.L.R. (4th) 676, at para. 19; *Imvescor*, at para. 43; *2240802 Ontario Inc. v. Springdale Pizza Depot Ltd.*, 2015 ONCA 236 (CanLII), 331 O.A.C. 282, at para. 51), "serious non-compliance" (*Mendoza*, at para. 37), "fundamentally inadequate and deficient disclosure" (*2212886 Ontario Inc. v. Obsidian Group Inc.*, 2017 ONSC 1643 (CanLII), 67 B.LR. (5th) 103, at para. 27), and "stark and material deficiencies" (*Dollar It*, at para. 74).
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> Whatever terminology is employed, the inquiry into whether disclosure deficiencies are such that they justify rescission under s. 6(2) ultimately focuses on whether the franchisee has been "effectively deprived … of the opportunity to make an informed [investment] decision": *Caffé Demetre Franchising Corp. v. 2249027 Ontario Inc.*, 2015 ONCA 258 (CanLII), 125 O.R. (3d) 498, at para. 63. In my view, the seriousness of any given failure to comply with s. 5 must be measured by reference to the underlying purposes of s. 5 and the *AWA* more broadly: to "obligate a franchisor to make full and accurate disclosure to a potential franchisee so that the latter can make a properly informed decision about whether or not to invest in a franchise": *1490664 Ontario Ltd. v. Dig This Garden Retailers Ltd.*, 2005 CanLII 25181 (ON CA), 256 D.L.R. (4th) 451 (Ont. C.A.), at para. 16 (emphasis added); *Dollar It*, at para. 16; *Mendoza*, at para. 14. For example, this court found that the disclosure document in *Dollar It* amounted to a complete lack of disclosure because there was "simply no way anyone reviewing [the] document could make an informed decision about whether or not to invest in th[e] franchise": *Dollar It*, at para. 68.[9]

Of particular confusion is that in the ONCA's decision in *Mendoza*, the rescission was upheld despite the fact that the franchisee admitted that he had not read the entire disclosure document. Does the ONCA's decision in *Raibex* now change the test for determining whether a franchisee has a right to rescind? Prior to *Raibex*, the test was objective as it pertained to material non-compliance of the *Wishart Act*. In *Raibex*, the ONCA appears to have revised the test to one that subjectively assesses whether the Franchisee was able to make an informed investment decision.

Secondly, the authors respectfully disagree that the cost estimates for a Shell build-out contained within the FDD met the Franchisor's disclosure obligations and allowed the Franchisee to make a fully informed business decision. Although the ONCA appears to accept the waiver language contained in the FDD, it appears that the waiver language is in fact misleading since most of the Franchisor's experience in building ASWR Franchises was in respect of Conversions. The factual record clearly shows that Bastaros informed the Franchisor of his financial constraints, and reasonably chose a Conversion because of the representations contained in the Cover Email. The FDD did not provide the reasonable basis for that cost estimate as required under the *Regulation*. Moreover, the Franchisee's conduct in negotiating the lease and in encouraging the Franchisor to sign the lease should not mitigate against a franchisor's disclosure obligations. Finally, the obligation to require a franchisee to accept a

[9] *Raibex* at paras. 48 and 49.

significantly higher build out of a franchised location which is beyond the franchisee's known financial capability appears to relegate the relationship to a commercial fiction.

Finally, the ONCA unconvincingly reasoned its way into the lower standard of review. Whether the Motion Judge erred in her interpretation and application of s. 6(2) rescission is not an error of law, but instead, an error of mixed fact and law. The ONCA adopted the principle first articulated in *Dollar It* that, "[w]hether deficiencies in a disclosure document are so serious as to amount to no disclosure for the purpose of the *AWA* [the W*ishart Act*] must be determined on the facts of each case."[10]

Moreover, when the ONCA tasked itself with reassessing the Motion Judge's errors, it stated as follows: "As noted above, whether a breach of s.5 is sufficiently serious to engage s.6(2) should be determined on a case-by-case basis, with a view to all relevant circumstances …".[11]

Thus, the ONCA ought to have reviewed the Motion Judge's decision only for palpable and overriding error. The Motion Judge was due this level of deference because she was in the best position to appreciate the facts surrounding the FDD.

While franchisors will rejoice the *Raibex* decision, it expressly does not overrule the ONCA's earlier decisions rendered in *Dollar It* or *Mendoza*. As such, lawyers would be well advised to treat the *Raibex* decision with caution when relying upon its reasons in support of their franchisor clients. Lawyers must now exercise greater caution and reservation in advising their franchisee clients as to whether they have a right to rescind since the test may no longer be whether the franchise disclosure document failed to strictly comply with the *Wishart Act*. Instead, according to *Raibex*, the test is whether the particular franchisee was able to make an informed investment decision regardless of whether the franchisor strictly complied with the *Wishart Act*. The impact that this decision will have on a franchisee's right to rescind based on s. 6(2) will no doubt be informed by the existing rescission cases now winding their way through the courts as well as in the rescission cases which arise after *Raibex*.

[10] *Ibid*. at para. 48.
[11] *Ibid.* at para. 49.