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Mendoza v. Active Tire & Auto Centre Inc.: Court of Appeal Rejects Informed Decision Test for FDD's

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The recent decision by the Ontario Court of Appeal in *Mendoza v. Active Tire & Auto Centre Inc.*,[1] rejected the lower court's informed decision test for rescission under section 6(2) of the *Arthur Wishart Act (Franchise Disclosure), 2000* (the "AWA"). The Court of Appeal confirmed that the test for rescission under section 6(2) of the AWA is whether the disclosure document was "materially deficient" and granted summary judgment to the franchisees rescinding the franchise agreement.

Background

The franchisee was provided with various documents at different times, including a disclosure document. The parties signed a franchise agreement effective June 1, 2015. After operating the franchise at a loss for approximately three months, the franchisee provided Active Tire with a notice of rescission on August 31, 2015. The notice of rescission alleged deficiencies in the franchise disclosure document, as follows:

1. The disclosure certificate was not signed by two officers or directors;
2. The financial statements were stale dated;[2]
3. The required documents were not delivered as a single document;
4. An irrevocable letter of credit was different than the one actually signed; and
5. The assumptions and information required by subsection 6.3 of Part II of the Regulations under the AWA regarding projections were missing.

Justice Dow concluded that although the disclosure document had not complied with the requirements of the AWA, the deficiencies were neither significant nor misleading and the documents it did provide allowed the franchisee to make an informed decision to enter into the franchise agreement. In coming to this conclusion, Justice Dow pointed out the extensive nature of the material given by Active Tire and the franchisee's refusal to answer questions regarding which portions of the disclosure document were deficient or misleading.

[1] 2017 ONCA 471 [*Mendoza*].

[2] General, Ontario Regulation 581/00 at subsection 3(1) of Part II requires that the disclosure document include either audited or review engagement financial statements. Subsection 3(2) of Part II states that if 180 days have not yet passed since the end of the most recently completed fiscal year and a financial statement has not been prepared and reported for that year, the disclosure document shall include a financial statement for the previous fiscal year that is prepared in accordance with the requirements in clause 3 (1) (a) or (b). The disclosure document was provided to the franchisee in early 2015 and included the financial statement for the 2013 fiscal year because the franchisor's 2014 financial statement was not yet complete. At the time the disclosure document was delivered, the 180-day grace period had already passed.

Justice Dow's decision focused on whether the franchisee made an informed decision to enter the franchise relationship, instead of objectively assessing the disclosure document. This subjective approach to section 6(2) of the AWA diverged from previous Ontario decisions. Deficiencies with a disclosure certificate and in the financial statement have been repeatedly confirmed in other Ontario cases to be material deficiencies.

Court of Appeal Decision

The Court of Appeal agreed with Justice Dow that the crucial deficiencies in the disclosure document were the absence of a second signature of an officer or director on the disclosure certificate and the most recent financial statements; however the Court of Appeal concluded that these deficiencies were material and thus fatal to the disclosure document. The Court of Appeal made several comments regarding these deficiencies, which reinstated the Court's strict enforcement of the disclosure obligations pursuant to the AWA.

Firstly, the Court of Appeal stated that Justice Dow did not appreciate the point of subsection 7(1)(e) of the AWA, which provides franchisees the right to damages against the directors and officers who sign the disclosure document. Justice Dow improperly disregarded the absence of a second signature on the disclosure document because the franchisee became familiar with the directors and officers of the franchisor. The Court of Appeal stressed that the point of subsection 7(1)(e) of the AWA is to force signatories to ensure that the disclosure document is complete and accurate and the absence of a second signature on the disclosure certificate was clearly a material deficiency.

Secondly, the Court of Appeal rejected Justice Dow's conclusion that since the financial statements provided were delivered only two weeks after the statutory grace period, the deficiency was neither significant nor misleading. The Court of Appeal confirmed that the absence of the most recent financial statements was a material deficiency. In coming to this conclusion, the Court of Appeal emphasized that if franchisors were able to disregard the obligation to produce current financial statements than franchisees would be unable to rely on the protections contained in the AWA.

The Court of Appeal's decision is consistent with prior Ontario cases and the intent of the AWA, which imposes significant disclosure obligations on franchisors for the benefit of the franchisees. The most important take away from the Court of Appeal's decision is that where the disclosure document is deficient, the conduct and subjective knowledge of the franchisee does not matter. The franchisor's obligations do not change or diminish depending on whether the particular franchisee reviewed and/or studied the disclosed material. Lawyers should advise franchisors to review their disclosure practices to ensure compliance with the AWA.