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Franchisors Beware: Terminating Franchise Agreements for Inadequate Financial Disclosure

In a recent decision of the Ontario Court of Appeal, the Court upheld a franchisee's right to rescind a franchise agreement where the franchisor failed to provide adequate disclosure prior to entering into the agreement.

In particular, the Court held that financial statements provided by the franchisor that have not been independently verified or audited are "materially deficient". This insufficient financial disclosure allows the franchisee to terminate the contract between the parties.

The Facts

2240802 Ontario Inc. v. Springdale Pizza Depot Ltd., 2015 ONCA 236, per Epstein J.A., involved a franchise known as Pizza Depot. The individual and corporate plaintiffs advised the franchisor that they had found a location for a new Pizza Depot franchise in April, 2010. The franchisor accepted the plaintiffs as franchisees in May, 2010.

Under the *Arthur Wishart Act (Franchise Disclosure)*, 2000, S.O. 2000, c.3 (the "AWA"), the franchisor was required to provide a disclosure

document to the franchisees, which it did in May, 2010 (the "Disclosure Document"). Ultimately, the parties entered into their franchise agreement and the franchisees began operating their business.

The business soon experienced financial difficulties and the franchisees concluded that the Disclosure Document provided by the franchisor was deficient. Accordingly, pursuant to the AWA, the franchisees delivered a notice of rescission in February, 2012 and commenced an action against the franchisor for rescission and damages in May, 2012. The franchisees then brought a motion for partial summary judgment, seeking a declaration that they had validly rescinded the franchise agreement and that the franchisor was liable to them for damages.

The motions judge held that: (i) the

Disclosure Document was materially deficient; (ii) the Disclosure Document did not comply with the requirements of the *AWA*; (iii) the franchisees validly rescinded the franchise agreement; and (iv) the franchisors were liable to the franchisees for damages, which would be determined at a later date.

On appeal, the Court of Appeal dismissed the appeal. In so doing, the Court provided insight into the type of financial statements and independent financial auditing required by the franchisor to meet the threshold of adequate disclosure under the *AWA*.

Franchisor Disclosure Obligations Under the *AWA*

Under section 5 of the *AWA*, a franchisor must provide a franchise disclosure document to a prospective franchisee no fewer than 14 days before the earlier of the signing of the agreement by the franchisee and the payment of any consideration by the franchisee. Section 5(4) of the *AWA* provides that the disclosure document shall contain: (i) all material facts, including material facts as prescribed; (ii) financial statements; (iii) copies of all proposed franchise agreements and other agreements relating to the franchise to be signed by the prospective franchisee; (iv) statements for the purposes of assisting the prospective franchisee in making informed investment decisions; and (v) other information and copies of documents as prescribed.

Regulations under the *AWA* particularize the disclosure requirements set out in section 5 of the *Act*. Specifically, one of the Regulations under the *AWA* requires that every disclosure document contain a statement indicating whether the franchisor has been found liable in a civil action for misrepresentation, unfair or deceptive business practices, or violating a law that regulates franchises or businesses. Another section of that Regulation requires that every disclosure document include a certificate certifying that the disclosure document contains no untrue information and signed by at least two persons who are officers or directors where the franchisor has more than one officer or director.

Most important for the purposes of this case, section 3 of O. Reg. 581/00 provides that every disclosure document must include a financial statement as follows:

- (a) an audited financial statement for the most recently completed fiscal year of the franchisor's operations; [or]
- (b) a financial statement for the most recently completed year of the franchisor's operations, prepared in accordance with generally accepted accounting principles that are at least equivalent to the review and reporting standards applicable to review engagements set out in the *Canadian Institute of Chartered Accountants Handbook*...

Under section 6 of the *AWA*, a failure to strictly comply with these requirements allows the franchisee to rescind the franchise agreement, without penalty or obligation, no

later than two years after entering into the franchise agreement.

The Court of Appeal noted that the *AWA* is consumer protection legislation. Franchisors are required to comply with the *AWA* and its Regulations. The Court will therefore interpret the *AWA* broadly. In deciding whether the deficiencies in the franchisor's disclosure justify a rescission of the franchise agreement, the Court must decide if they amount to material deficiencies.

In this case, there were three alleged deficiencies with the Disclosure Document: (i) deficiencies in the financial statement (as discussed below); (ii) the failure by the franchisor to disclose ongoing litigation in which another franchisee was claiming rescission based on deficient disclosure; and (iii) the failure by the franchisor to include a certificate signed by at least two officers of the franchisor.

Of these deficiencies in the Disclosure Document, the most relevant to the appeal was that involving the franchisor's financial statement.

Why the Franchisor's Financial Statement Was Materially Deficient

The motions judge held that the financial statements provided by the franchisor in this case did not comply with the *AWA* for the following reasons:

The Financial disclosure, in my view, must comply with the [AWA], in every respect. To have a bookkeeper prepare a statement from the figures provided by the Franchisor, without any

documents being examined or verified, with errors in its transcription and no Notes at the end about on-going or pending litigation, does not give the franchisee a true financial picture.

On appeal, the Court of Appeal noted that there were three “levels of engagement” associated with the presentation of financial statements, namely:

- i. an audit engagement, in which a chartered accountant performs an independent verification of the numbers provided by management;
- ii. a review engagement, in which the chartered accountant verifies the numbers provided by management to satisfy himself or herself that they are reasonable; and
- iii. a compilation engagement, in which a chartered accountant essentially organizes the

numbers provided by management. This simply involves “formatting financial information”. In a compilation engagement, the accountant “provides no assurance as to the accuracy or reliability of numbers”.

In this case, the Court held that the franchisor’s failure to provide the franchisee with statements that were independently verified by an audit engagement or a review engagement level amounted to a “material deficiency” under the AWA. As such, the franchisees were entitled to rescind the franchise agreement.

The Court’s rationale was that prospective franchisees, who may not have significant business expertise, must be able to rely on the information provided to them by the franchisor. This is especially

so with regard to the financial state of the franchisor. In the Court’s view, providing a franchisee with independently verified financial information “is more than a technicality. It is a foundational part of disclosure”.

Conclusion

In short, the Court of Appeal’s decision *Springdale Pizza Depot Ltd.* makes it clear that in the absence of independent verification or auditing, financial information provided by a franchisor to a franchisee will not meet the requirements of adequate disclosure under the AWA. In so ruling, the Court has created an effective enforcement vehicle in the AWA, which has as its primary purpose the protection of vulnerable franchisees.

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