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Mendoza v Active Tire & Auto Centre Inc. – The role of an "informed decision" in rescission

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A recent decision from the Ontario Superior Court adopts a new approach to a claim for rescission under section 6(2) of the *Arthur Wishart Act, (Franchise Disclosure), 2000* (SO 2000, c 3) (*AWA*). Instead of looking to whether the franchisor's disclosure was materially deficient amounting to no disclosure at all, this recent decision looks to whether the franchisee made an "informed decision" on the basis of the disclosure provided.

Late last year, the Ontario Superior Court of Justice released its decision in *Mendoza v Active Tire & Auto Centre Inc.* (2016 ONSC 3009). This was a motion for summary judgment by a franchisee seeking rescission of a franchise agreement pursuant to section 6(2) of the *AWA*. In his decision, Justice Dow appears to have added a different consideration to the test for rescission under this section, considering whether the franchisee had made an "informed decision" to enter the franchise relationship instead of objectively assessing the disclosure to determine if it was "materially deficient." While this less strict, more subjective approach to section 6(2) is a welcome development for franchisors, it diverges from prior Ontario decisions, including those from the Ontario Court of Appeal.

In this case, the Mendozas entered into a franchise agreement with Active Tire & Auto Centre (Active Tire) to operate an Active Tire franchise effective June 1, 2015. The franchise was not successful and on August 31, 2015, the Mendozas provided Active Tire with a notice of rescission.

Pursuant to section 6(2) of the *AWA*, "a franchisee can rescind a franchise agreement, without penalty or obligations, no later than two years after entering into the franchise agreement if the franchisor never provided the disclosure document." Seeking to rescind the franchise agreement on the basis of this provision, the Mendozas alleged the following disclosure deficiencies:

1. Only one officer/director of Active Tire signed the disclosure certificate in contravention of section 7(2) of Regulation 581/00 to the *AWA*.
2. The financial statements were not entirely prepared on an "audited" or "review engagement" basis contrary to s. 3(1) of Regulation 581/00 to the *AWA*.
3. Active Tire failed to deliver all the requisite documents at one time as part of one document as required by section 5(3) of the *AWA*.
4. An irrevocable letter of credit described in the Application for Dealership varied significantly from what was actually signed.
5. Active Tire failed to disclose the underlying assumptions and information as part of the financial projections as required by section 6.2 of Regulation 581/00 to the *AWA*.

Justice Dow recognized that there were deficiencies in the disclosure document, "principally the absence of the second signature of an officer or director and [t]he (*sic*) abbreviated, most recent financial statements." In assessing the Mendozas' claim for rescission, Justice Dow considered whether the disclosure document allowed the franchisee to make an "*informed decision to enter into the franchise agreement.*" Justice Dow concluded it did. In coming to his conclusion, Justice Dow pointed to the "extensive nature of the material provided by Active Tire to Mendoza" and the franchisee's refusal to answer questions on cross-examinations regarding which portions of the 175-page disclosure document were deficient or misleading.

The "informed decision" approach diverges from prior Ontario case law, which holds that section 6(2) of the *AWA* is triggered where there are "stark and material deficiencies in the disclosure document" [see *Caffé Demetre Franchising Corp. v 2249027 Ontario Inc.* (2015 ONCA 258), citing *4287975 Canada Inc. v Imvescor Restaurants Inc.*, (2009 ONCA 308)]. Justice Dow's approach appears to assess the subjective knowledge of the franchisee as opposed to assessing whether the franchisor's disclosure was objectively, materially deficient in light of the requirements of the *AWA*. In contrast to Justice Dow's decision, Ontario courts have found the disclosure deficiencies at issue in this case to be sufficient to trigger rescission under section 6(2). For example, in *2240802 Ontario Inc. v Springdale Pizza Depot Ltd.* (2012 ONCA 2360) (*Springdale Pizza*), the court considered three deficiencies: (1) failure to provide financial statements in accordance with the regulations to the *AWA*; (2) failure to provide a certificate in accordance with the *AWA*; and (3) failure to disclose ongoing litigation. In *Springdale Pizza*, the court stated the following:

[58] In my view, the ***failure to provide financial statements in accordance with s. 3(1) of the regulations – in other words, statements that have been independently verified to an audit engagement or review engagement level – by itself constitutes a material deficiency***.

[59] The other two deficiencies discussed above – the failure to include reference to the ongoing litigation in which a franchisee was claiming rescission based on deficient disclosure and the failure to provide a certificate in accordance with the Act – serve to strengthen the conclusion that the respondents' disclosure was not just deficient but materially deficient such that it amounted to no disclosure under s. 6(2) of the Act (emphasis added).

Similarly, in *Sovereignty Investment Holdings Inc. v 9127-6907 Quebec Inc.* ([2008] O.J. No. 4450, 171 A.C.W.S. (3d) 597), there were four key deficiencies in the franchisor's disclosure document: (1) failure to include financial statements; (2) failure to include statements related to earnings projections; (3) failure to provide the disclosure at once in one single document; and (4) failure to include the franchisor's certificate. In this case, the court stated that each of these deficiencies on its own was fatal to the franchisor's assertion that it provided a disclosure document (see para 15) and held that the franchisee was entitled to rescission under section 6(2) of the *AWA*. Moreover, in *6792341 Canada Inc. v Dollar It Ltd.* (2009 ONCA 385) there were various issues with the disclosure provided, including the failure to provide a dated and signed franchisor's certificate. The Ontario Court of Appeal allowed the franchisor's appeal and held that the franchisee was entitled to rescission, stating that "the failure to include the mandated Certificate alone would be enough to conclude that there was no disclosure as required by the Act" (see para 32). These cases, among others, affirm the strict approach to disclosure requirements under the *AWA* as dictated by the Ontario Court of Appeal in *1490664 Ontario Ltd. v Dig this Garden Retailers Ltd.* ([2005] OJ No 3040, 141 ACWS (3d) 741).

While Justice Dow's less strict, more objective approach to section 6(2) is a welcome development for franchisors, it is a clear departure from prior case law, and the franchise bar will no doubt be keeping an eye out for its application. This case is under appeal. As such, it is premature to assess its broad applicability going forward.