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**WHEN IS A LIE ACTIONABLE? LITIGATING
MISREPRESENTATION CLAIMS AND THE REQUIREMENT
OF REASONABLE RELIANCE**

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I. INTRODUCTION

It is said that the adoption of the Federal Trade Commission's ("FTC") Original Franchise Rule came in response to fraud and abuse that—without any regulation—could otherwise have destroyed the franchise industry. The Original Franchise Rule took effect in 1979 and was substantially revised in 2007.¹ With the Amended Rule, the FTC published a "Statement of Basis and Purpose,"² which provides some advice and guidance on complying with the Amended Rule's required franchise disclosure document ("FDD"). As a threshold matter, the most basic requirements of the Amended Rule are that a FDD must be in plain English and not be misleading or contain any misrepresentations.³

There are several other official publications aimed at assisting franchisors in complying with the required disclosure items of the FDD,⁴ including the FTC's May 2008 Compliance Guide,⁵ the FTC's "Amended Franchise Rule FAQs" (located on the FTC's website),⁶ FTC Staff Advisory Opinions,⁷ and publications⁸ from the North American Securities Administrators Association ("NASAA"), an organization whose "fundamental mission is protecting consumers who purchase securities or investment advice."⁹ Of course, there are also a plethora of scholarly books and articles within the franchise industry and the franchise bar on properly complying with the FDD disclosure requirements.

¹ The 2007 amendment to the Franchise Rule may be referred to herein as the "Amended Rule."

² Statement of Basis and Purpose, 43 Fed. Reg. 59614, at 59621 (Dec. 21, 1978). See also Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities, 72 Fed. Reg. 15445 (March 30, 2007).

³ In addition to the FTC Franchise Rule, a number of states have statutory regimes that similarly require a franchisor to provide detailed disclosures to prospective franchisees. See, e.g., N.Y. GEN. BUS. LAW § 683 (West 2018); CAL. CORP. CODE § 31114 (West 2018); MD. CODE ANN., BUS. REG. § 14-216 (West 2018). There is significant overlap in the FDD disclosures required by the FTC and the disclosures that various states require. As a result, most franchisors prepare a single FDD that meets the FTC requirements and includes state-specific disclosures in appendices to the FDD. In line with that practice, we will use the term "FDD" in this paper to refer to a franchise disclosure document that makes the disclosures required under both federal and state laws.

⁴ 16 C.F.R. § 436.5 (2018).

⁵ FEDERAL TRADE COMMISSION, FRANCHISE RULE COMPLIANCE GUIDE 85 (2008) [hereinafter COMPLIANCE GUIDE] available at <https://www.ftc.gov/tips-advice/business-center/guidance/franchise-rule-compliance-guide>.

⁶ FEDERAL TRADE COMMISSION, AMENDED FRANCHISE RULE FAQs (Dec. 2013), available at <https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs>.

⁷ Federal Trade Commission, Legal Resources, available at https://www.ftc.gov/tips-advice/business-center/legal-resources?type=advisory_opinion&field_industry_tid=313 (last visited Dec. 28, 2017).

⁸ North American Securities Administrators Association, Inc. 2008 Franchise Registration and Disclosure Guidelines, available at <http://www.nasaa.org/wp-content/uploads/2011/08/2008UFOC1.pdf>; North American Securities Administrators Association, Inc. Franchise Commentary Financial Performance Representations (FPR Commentary), available at www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf. The FPR Commentary became effective at the later of November 8, 2017, or 120 days after a franchisor's fiscal year end, if the franchisor had an effective Franchise Disclosure Document as of May 8, 2017.

⁹ North American Securities Administrators Association, Inc., About Us, <http://www.nasaa.org/about-us/> (last visited Dec. 28, 2017).

Despite the Amended Rule and the various publications on compliance therewith, even studious and attentive franchisors may find themselves on the receiving end of allegations by franchisees of fraud, misrepresentation or failure to properly disclose information within the FDD. Indeed, the recent NASAA publication on Item 19 appears to have been prompted by reports from state examiners (and some franchise attorneys) that certain financial performance representations, while technically adhering to Item 19 specifications, were potentially misleading and deceptive. For instance, some franchisors “would furnish financial performance representations featuring only either their top ten or top 10% highest performing outlets. Others would disclose historic company-owned unit net profit data without disclosing that, as opposed to franchised units, the company-owned units paid no royalties and had many of their expenses (rent and employees) paid by their corporate parent.”¹⁰ Accordingly, as NASAA explained, “[e]xaminers agree that it would be helpful to have additional clarification about how franchisors should make an FPR in their disclosure documents.”¹¹

Financial information is an understandably easy target for potential claims of misrepresentation for several reasons. First, it is hard to argue that such information is not an important part of a franchisee's decision to enter into a franchise agreement. Second, financial information, at first blush, appears to be relatively objective. Did a franchisor provide a reasonable estimate of initial investment costs to open a franchised location? Did the franchisor provide skewed financial performance information? However, even when dealing with black and white numbers, a misrepresentation analysis is usually not as straight-forward as it would first appear. This paper will focus on litigating claims of fraud and misrepresentation related to disclosures in the FDD and related statements made by franchisors to franchisees.

II. FDD ITEMS THAT MAY SERVE AS A BASIS FOR MISREPRESENTATION CLAIMS

While FDD items related to financial matters, such as Items 7 and 19, appear to be at the center of many misrepresentation or fraud claims, a disgruntled or underperforming franchisee may scrutinize other (or all) disclosure items they relied upon within the FDD with an eye toward bringing multiple claims. Along those lines, it is common for franchisees (like any other plaintiff) to base multiple causes of action on the same fact pattern. Accordingly, a claim that a franchisor did not properly disclose information in a FDD may result in causes of action including misrepresentation or fraud, breach of contract, violation of state franchise sales/registration laws, and violation of state unfair and deceptive trade practices acts and may be based on multiple items within the FDD. It is important to note that standards of liability, elements of causes of action/violations, and available defenses vary widely from state to state.

A. Item 7 (Estimated Initial Investment Expenses)

Item 7 of the FDD “requires franchisors to set out in a prescribed tabular format a franchisee’s estimated initial investment – i.e., all the expenses required by the franchise agreement and all other costs necessary for a franchisee to commence business.”¹² The FTC

¹⁰ Susan Grueneberg and David J. Kaufmann, *The New Item 19 Commentary and Other Advanced Performance Financial Representation Issues: The Devil is in the Details*, IFA 50th Annual Legal Symposium (2017).

¹¹ North American Securities Administrators Association, Inc., Notice of Request for Comments Regarding a Proposed Franchise Commentary on Financial Performance Representations (September 13, 2016), *available at* <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2016/09/FPR-Commentary-Public-Comment-09132016.pdf>.

¹² COMPLIANCE GUIDE, *supra* note 5, at 48.

does not, however, prescribe an exhaustive list of the types of fees or expenses that must be disclosed in the table, likely because the types of fees will vary depending upon the nature of the franchised business. The expenses to be disclosed cover “only the period prior to the date the franchise opens” and a single line item for “additional funds,” which includes “required expenses that franchisees will incur both before operations begin and during ‘the initial period’ of operations.”¹³ There is no set definition for the “initial period,” although the Compliance Guide suggests “a reasonable period is at least three months.”¹⁴

From a sales perspective, a franchisor may be tempted to minimize the start-up costs to increase the likelihood that a prospective franchisee selects its franchise system. Aside from the fact that this conduct violates the requirements of the Amended Rule (and ethics), such “low balling” could result in litigation. Surprisingly, until 1997, “there were only five reported opinions discussing possible liability for estimated initial investment claims.”¹⁵ Of the five cases, “at least one franchisee claim for misleading start-up costs survived summary judgment when there were additional facts indicating that statements supplementing the circular had misled the franchisees.”¹⁶ Between 1997 and 2000, “two opinions have been reported—both holding that a franchisor may be liable—with no accompanying requirement of scienter.”¹⁷ These seminal cases continue to be cited in decisions today discussing misrepresentations made in the disclosure document.

In *Motor City Bagels, LLC v. American Bagel Co.*,¹⁸ the District Court of Maryland found that there were factual questions precluding summary judgment to either the franchisor or the franchisee on the issue of whether the franchisor violated the Indiana Franchise Act by allegedly misrepresenting start-up costs found in Item 7. Indiana’s Franchise Act has an antifraud provision, and a franchisee may bring a private cause of action for violation of that provision.¹⁹ After explaining that the franchisee had standing to make such a claim, the court reviewed the interpretation of the antifraud provision and the elements necessary to prove a violation of it as established in *Enservco, Inc. v. Indiana Securities Division*.²⁰ The court found issues of fact related to the reasonable reliance element, including whether the franchisor warned the franchisee that the costs could increase if a larger/more extravagant store was built (and, if so, whether the store built was larger), whether the franchisor “verified” the cost estimate of the disclosure document at the request of the franchisee after the franchisor was in possession of

¹³ *Id.*

¹⁴ *Id.*

¹⁵ David A. Beyer & Scott P. Weber, *Estimated Initial Investment Claims: Strict Liability or Strict Folly?*, 19 Franchise L. J., 103, 104 (Winter 2000).

¹⁶ *Id.* at 104. In *Schwartz v. Pillsbury Inc.*, 969 F.2d 840 (9th Cir. 1992), not only did the initial investment range of \$55,000 to \$105,000 underestimate the franchisee’s actual initial investment of \$135,000, the franchisor verbally told the franchisee that its costs would fall into the lower end of the range. Accordingly, the franchisor’s summary judgment was denied.

¹⁷ Beyer & Weber, *supra* note 15, at 104.

¹⁸ 50 F. Supp. 2d 460 (D. Md. 1999).

¹⁹ *Id.* at 468.

²⁰ 623 N.E.2d 416, 423 (Ind. 1993).

knowledge that the costs had increased appreciably and whether the franchisee actually obtained updated start-up cost information prior to signing the franchise agreement.²¹ It is worth noting, as in many cases, the franchisee also brought common law fraud claims based on the same set of facts.

The interplay of these types of factual disputes related to Item 7 representations typically make summary judgment rare. For example, in *Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*,²² a franchisee alleged fraud under the Maryland Franchise Registration and Disclosure Law based on, *inter alia*, the franchisor's disclosure of initial start-up cost estimates under Item 7. The United States District Court for the District of Columbia provided a thorough review of the elements and burdens of fraud claims under Maryland franchise law. The court explained that, like most common law claims for fraud, the Maryland franchise law "renders a franchisor civilly liable to a franchisee for offering to sell, or selling, a franchise 'by means of an untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading,' if the franchisee 'does not know of the untruth or omission.'"²³ In analyzing the facts, the court first noted the statements at issue were cost "estimates," which involve an opinion or judgment, not "assertions of fact."²⁴ Additionally, the court pointed to warnings in the disclosure document that the "listed costs were 'estimates only and may vary for many reasons including the size of your Franchised Unit, the capabilities of your management team, where you locate your Franchised Unit and your business experience and acumen.'"²⁵ The court explained that because "initial start-up disclosures 'are based on estimates, and are clearly labeled as such, courts have been reluctant to impose liability on franchisors' for 'allegedly inaccurate disclosure of start-up costs.'"²⁶

At the summary judgment phase, the court explained that several of the necessary elements of fraud were met (and even undisputed). However, there were other elements of a fraud claim that were wholly disputed. The court held that "(1) whether the initial start-up estimates in the 2007 estimates in the 2007 Offering Prospectus were false, and (2) whether [the franchisee] reasonably relied on those initial start-up estimates—are genuine issues of material fact that preclude summary judgment in either party's favor."²⁷ The crux of issue one was when the franchisor had updated information that it could have provided to the franchisee because failure "to provide updated information that the defendant knows of—whether that information has made it into a formally registered offering prospectus or not—gives rise to liability under" the Maryland franchise law.²⁸ The court also discussed the reliance element,

²¹ *Id.* at 469-471.

²² 70 F. Supp. 3d 376 (D.D.C. 2014).

²³ *Id.* at 400 (citing MD. CODE ANN., BUS. REG., § 13-227(a)(1)(ii)).

²⁴ *Id.* at 400.

²⁵ *Id.* (emphasis in original).

²⁶ *Id.* at 400 (citing David A. Beyer & Scott P. Weber, *Estimated Initial Investment Claims: Strict Liability or Strict Folly?*, 19 Franchise L.J., 103, 104 (Winter 2000)).

²⁷ *Id.* at 401.

²⁸ *Id.* at 403.

explaining both sides of this factual issue. On the one hand, the court acknowledged that the franchisor had years of practice opening vegetarian restaurants, a particular business venture with which the franchisee had no experience. On the other hand, however, the disclosure document contained numerous disclaimers and the franchisee was alleged to be business savvy and had hired accountants to assist it in determining certain financial matters, including start-up cost. Ultimately, the court held that there were triable issues of fact and denied summary judgment.²⁹

The court in *Yogo Factory Franchising, Inc. v. Ying* reached a different result at the dispositive motion stage.³⁰ There, the court dismissed fraud claims related to Item 7 (which alleged build-out costs were understated), in part because “the FDD makes clear that these numbers are estimates” and that such “predictions of future events are not actionable under a fraud claim, because they are not a statement of present or past fact.”³¹ Accordingly, the court found that the franchisee could not reasonably rely upon these estimates of start-up costs as a basis for a fraud claim.³²

Hanley v. Doctors Express Franchising, LLC,³³ provides another example of a franchisee's claims related to Item 7 disclosures. There, a franchisee argued that the franchisor's initial investment estimate was materially inaccurate prior to the franchisee's execution of the franchise agreement. The franchisee primarily argued that the franchisor used information for this Item from the experience and data of an affiliate, rather than the experience of its franchisees, and the franchisor knew that the affiliate's data was materially different from that of its actual franchisees rendering the disclosure unreasonable. As proof of the franchisor's knowledge, the franchisee pled that two weeks after it executed the franchise agreement, the franchisor submitted its renewal disclosure document to California with 15% higher cost estimates (with some categories markedly increased). The franchisee also alleged material misrepresentations related to the three month initial operating funds. Among other causes of action, the franchisee alleged that these facts resulted in a violation of the Maryland franchise law. Citing the decisions in the *Motor City Bagels* and *Maoz Vegetarian* cases, the court found that the franchisee had pled sufficient facts to state a claim and survive the franchisor's motion to dismiss.³⁴

In the relatively recent case of *Coraud LLC v. Kidville Franchise Co.*,³⁵ a franchisee moved for summary judgment against the franchisor on its claims that the franchisor violated the New York Franchise Sales Act and committed negligent misrepresentation related to Item 7 of the disclosure document. Franchisee argued that, in the course of opening its franchised

²⁹ *Id.*

³⁰ No. 13-630, 2014 WL 1783146 (D. N.J. May 5, 2014); see also No. 13-630, 2015 WL 1117369 (D. N.J. March 10, 2015).

³¹ *Id.* at *26.

³² *Id.*

³³ No. 12-795-ELH, 2013 WL 690521 (D. Md. 2013).

³⁴ *Id.* at *22-24.

³⁵ 121 F. Supp. 3d 387 (S.D.N.Y. 2015).

location, it learned of numerous material misstatements and omissions in Item 7.³⁶ The franchisee's primary argument was that the "estimated cost for the leasehold improvements excludes expenses that [the franchisor] tacitly but incorrectly assumed that the landlord would pay for and otherwise failed to reflect [the franchisor's] actual experience."³⁷ The court initially addressed the franchisee's claim under the anti-fraud provision of the New York Franchise Sales Act, holding that there was a genuine dispute regarding "whether the Item 7 estimate of the cost of the 'Leasehold Improvements and Fixtures' constituted a material misstatement" as a matter of law.³⁸ The court also identified trial issues related to the reasonable reliance element under the New York Franchise Sales Act because the franchisee had performed research (including contacting existing franchisees) on buildout costs.³⁹ Finally, the court identified potential issues that the franchisee could have at trial related to causation of damages.⁴⁰ The court found that these same factual issues precluded summary judgment in favor of the franchisee on its negligent misrepresentation claim.⁴¹

These cases are particularly instructive to new franchisors and international brands expanding into the United States. Although it is impossible to fully insulate a franchisor from litigation by a disgruntled franchisee, waiting to complete an FDD until reasonable estimates of start-up expenses from company-owned outlets are available or hiring an experienced consultant may create the type of documentary record that could help prevent or defend against causes of action for misrepresentations in Item 7 estimates. Regardless of the age of the franchisor, all franchisors should be conservative and careful when considering the Item 7 estimates required to be made in an FDD.

B. Items 19 (Financial Performance Representations)

The Amended Rule *allows* franchisors to provide "financial performance representations"⁴² ("FPR") to prospective franchisees in Item 19 of the FDD. Because this is an optional—and not required—disclosure, a franchisor must make the decision whether to communicate its system's historical or projected financial performance information in its FDD. If a franchisor elects not to provide information in Item 19, it must recite a prescribed statement⁴³ in its FDD and it is prohibited under the Amended Rule from providing any financial information

³⁶ *Id.* at 392.

³⁷ *Id.* The franchisee asserted that it spent more than twice the FDD's estimated cost of leasehold improvements and fixtures.

³⁸ *Id.* at 394.

³⁹ *Id.* at 395.

⁴⁰ *Id.* at 396.

⁴¹ *Id.* at 397.

⁴² "Financial performance representation means any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables." 16 C.F.R. § 436.1(e) (2018).

⁴³ 16 C.F.R. § 436.5(s)(2) (2007).

to prospective franchisees (with few exceptions⁴⁴). If a franchisor chooses to make an Item 19 disclosure, then it must adhere to the strict mandates on the type of information permitted and prohibited in Item 19 and may not furnish any additional financial performance representations to prospective franchisees outside the FDD without satisfying certain requirements.

Under the Original Franchise Rule (which is still being litigated in some instances) an “earnings claim” had to have a “reasonable basis” and the franchisor had to have documented evidence to substantiate the accuracy of the claim.⁴⁵ Additionally, the earnings claim had to be geographically relevant to the prospective franchisee and its proposed location.⁴⁶ The Amended Rule eliminated the geographic relevance requirement. Other changes were also made to Item 19 disclosures by the 2007 amendment. However, the “reasonable basis” requirement backed by “written substantiation” remains.⁴⁷ Very generally, the Amended Rule also requires franchisors to “disclose the bases and assumptions underlying the representation in Item 19”⁴⁸ and to issue an admonition that a prospective franchisee’s actual earnings may differ (without turning the admonition into a disclaimer). Since the Amended Rule became effective, it is estimated that more than half of all franchisors now include FPRs in Item 19 of their FDDs.⁴⁹

Because of the limited exceptions on the prohibition of making financial performance representations outside of the FDD, franchisors and their sales team (and counsel) must understand the depth and breadth of the definition of a financial performance representation. In essence, any comment by a franchisor representative on financial performance to a prospective franchisee could trip the prohibition on representations made outside the FDD.⁵⁰ For instance, “the trap for the unwary comes from the indirect financial performance representation/earnings claim—instances where franchisees project what they believe their franchises will generate in terms of gross revenues, expenses or profits (or even full blown pro forma financial statements for their forthcoming units) and ask franchisor personnel to comment on these projections. Responding to those inquiries by commenting on the accuracy or inaccuracy of the franchisee’s estimated numbers is as prohibited by federal and state law as the franchisor generating those numbers itself.”⁵¹

⁴⁴ These exceptions are part of the required introduction to Item 19: “Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.” 16 C.F.R. § 436.5(s)(1).

⁴⁵ Statement of Basis and Purpose, 43 Fed. Reg. 59614, at 59617 (Dec. 21, 1978).

⁴⁶ *Id.* at 59618.

⁴⁷ 16 C.F.R. § 436.5(s).

⁴⁸ COMPLIANCE GUIDE, *supra* note 5, at 85.

⁴⁹ Dale Cantone, Eric Karp, and Max Schott, *Advanced Drafting of Financial Performance Representations: a Reasonable Basis*, ABA 39th Annual Forum on Franchising W-13, at n. 4 (2016).

⁵⁰ See, e.g., *Berghs v. Planet Antares*, 25 N.E.3d 830 (Ind. Ct. App. 2014) (franchisee claimed franchisor provided false earnings claim outside of the disclosure document prior to entering into the franchise agreement).

⁵¹ *Grueneberg & Kaufmann*, *supra* note 10, at 6.

1. Reasonable Basis For A Historical Performance Representation

The best way for a franchisor to guard against a misrepresentation or fraud claim is to understand and comply with the required “reasonable basis” requirement of Item 19. Under the Compliance Guide, a franchisor must consider how a historical performance representation is “likely to be understood by a reasonable prospective franchisee” and whether the representation is the “typical experience of the system’s franchisees.”⁵² A simple way to evaluate this is to ask: can a franchisee reasonably be expected to achieve the results of the representation being made? If not, the representation is not reasonable, regardless of the caveats or explanatory information provided with the representation.

In making the reasonableness determination, franchisors should take into account various factors, including, without limitation: the financial experiences of the franchisees in the system and, if there are none, what the franchisor in good faith thinks those experiences will be; any particular unique conditions or circumstances that may have contributed to the results being used in the representation; if the data is being taken from franchisees, the accuracy of the reporting methods being used by the franchisees to report the data; the number of franchisees reporting data used in the FPR in comparison to the total number of franchisees in the system; and, if the data is being taken from company-owned locations, any unique material aspects of those locations that may not be present in franchised locations.

The Compliance Guide offers a hypothetical involving a franchisor that makes a representation that franchisees can earn net profits of \$30,000. The Compliance Guide explains that this representation would not be reasonable if only a small minority of franchisees in the system had actually achieved this result.⁵³ Essentially, the representation would not be reflective of the financial results of those in the system and, therefore, there is no basis to think that a franchisee in the system could actually attain such a result. The representation would also not have a reasonable basis if the profits were due to unusual circumstances or a unique characteristic of a sub-set of franchisees. Similarly, using data from only a small number of franchisees in the system may not provide a reasonable basis for a FPR.

State franchise examiners have been evaluating financial performance representations contained in Item 19 based upon a reasonableness standard much the same as that described above—the representation must be based upon “results that have been achieved in th[e] system in the past and could be achieved by franchisees in the future.”⁵⁴ The bottom line is that a representation of past results that are not indicative of future performance, regardless of the reason, does not ultimately have a reasonable basis. And an Item 19 disclosure without a reasonable basis makes a franchisor an easy target for a fraud or misrepresentation claim.

2. Reasonable Basis For A Representation Based On Projections

A reasonable basis for a representation may be based on projections and forecasts or historical performance. While projections and forecasts are related, they are different. A

⁵² COMPLIANCE GUIDE, *supra* note 5, at 135-36.

⁵³ *Id.* at 136. Unfortunately, the Compliance Guide does not go one step further and instruct on specific numbers of franchisees in the system as opposed to those making up the minority in the example.

⁵⁴ Dale Canton, Theresa Leets, Charles S. Modell, and Michelle Webster, *Regulatory Update*, ABA 40th Annual Forum on Franchising W-15 (2017).

projection is an estimate of how much a franchisee is likely to earn and is based on information such as “market studies, statistical analyses, franchisee profit-and-loss statements, as well as other types of information that prudent persons customarily rely on in making business decisions.”⁵⁵ A forecast considers underlying assumptions and factors that may alter a projection such as economic and market conditions that may affect a franchisee’s business as well as a franchisee’s sales, costs of goods sold and operating expenses.⁵⁶

According to the FTC, a projection “made in accordance with the standards issued by the American Institute of Certified Public Accountants (or its successor) presumptively has a reasonable basis.”⁵⁷ This is notable in light of the facts and circumstances test applied to historical performance representations.

The Compliance Guide also instructs practitioners to consider the following in making “reasonable” forecasts: (i) forecasts should be prepared in good faith⁵⁸ with appropriate care by qualified personnel using appropriate accounting principles; (ii) the process used to make the projections should provide for seeking out the best information reasonably available, which information is consistent with the plans of the franchisor; (iii) key factors should be identified as a basis for any assumptions and the assumptions must be appropriate; (iv) the process used to develop the forecasts should provide the means to determine the relative effect of variations in the assumptions, and a comparison of forecasts with results, if available;⁵⁹ and (v) the process should include adequate documentation of the forecast and the process used to develop the projections and adequate review and approval by the responsible party at the franchisor with the appropriate levels of authority.⁶⁰ Arguably, the foregoing seems to be more of a “how to” make a forecast as opposed to a standard to judge its reasonableness. However, the Compliance Guide makes clear that the foregoing, although not a complete basis for determining whether there exists a reasonable basis for the projection, are points that should be satisfied in determining if a reasonable basis exists for the projection.⁶¹

It cannot be stressed enough that a franchisor making an Item 19 disclosure must make a conscious (and documented) effort to confirm the reasonableness of the disclosure. Having done this on the front end, a franchisor should decrease its likelihood of litigation or have a ready defense against claims that the representation was misleading or fraudulent.

3. Case Law Involving Claims Of Misrepresentation Related To Item 19

Regardless of how carefully a franchisor analyzes its Item 19 disclosure for reasonableness and other factors, the obvious downside to making a FPR is that a franchisee

⁵⁵ COMPLIANCE GUIDE, *supra* note 5, at 86, 91.

⁵⁶ *Id.* at 91.

⁵⁷ COMPLIANCE GUIDE, *supra* note 5, at 135-36.

⁵⁸ One would imagine this applies to all representations, just not forecasts.

⁵⁹ This begs the question as to why a franchisor would then use a forecast if historical information were available.

⁶⁰ COMPLIANCE GUIDE, *supra* note 5, at 135-36.

⁶¹ *Id.* at 136.

that does not perform in a manner similar to the FPR may become disgruntled or, worse yet, litigious. While there are many types of cases (and claims) involving Item 19 disclosures, in the vast majority of them, franchisees allege fraudulent or negligent misrepresentation (or fraud in the inducement) on the basis of the FPR.

The first line of attack on an FPR is generally a fraud or misrepresentation claim. In a case of common law fraud, most states require that the franchisee plead: (1) a false statement of material fact; (2) knowledge or belief by the defendant that the statement was false; (3) an intention to induce the plaintiff to act; (4) reasonable reliance upon the truth of the statement by the plaintiff; and (5) damage to the plaintiff resulting from this reliance.⁶² Generally, and as discussed below in detail, these claims fail on the fourth element of reasonable, or justifiable, reliance by the franchisee as to the truth of the statement.⁶³ Many times, the franchisee's reliance is found to be unreasonable or unjustifiable by way of waiver because the franchisee acknowledged warnings and disclaimers in the Item 19 disclosure or the franchise agreement, stating that the information set forth in the FPR should not be considered as a projection of probable sales and that independent investigations as to the profitability of a potential franchise should be undertaken. Indeed, various courts have held that when a franchisor expressly disclaims any warranty concerning representations and a franchisee expressly acknowledges the disclaimer or the need to conduct an independent investigation, the franchisee may not then sue on a claim of fraud based on those very representations.⁶⁴ For example, in *7-Eleven, Inc. v. Spear*,⁶⁵ the franchisor only disclosed sales performance information in its Uniform Franchise Offering Circular ("UFOC") for stores that had operated more than twelve months. The franchisee alleged fraud related to this FPR disclosure because: (1) 7-Eleven did not provide her with the actual sales of the specific store she intended to purchase (which had operated less than twelve months); and (2) by failing to include the actual sales of all stores (or at least the one she was purchasing), the disclosure was misleading (even if true).⁶⁶ The court found that, although the franchisee got less information than she requested on the store, the franchisor's representations were not fraudulent or otherwise impermissible because 7-Eleven made it clear that it was not (and would not be) providing information on stores that had operated less than twelve months and because the UFOC contained disclaimers related to this information and a franchisee's use of it.⁶⁷

⁶² *Avon Hardware Co. v. Ace Hardware Corp.*, 2013 IL App. (1st) 130750, 998 N.E.2d 1281, 1287 (Ill. App. Ct. 2013) (citing *Lagen v. Balchor Co.*, 274 Ill. App. 3d 11, 653 N.E.2d 968 (Ill. App. Ct. 1995)).

⁶³ See, e.g., *Yumilicious Franchise, LLC v. Barrie*, No. 3:13-CV-4841-L, 2015 WL 1822877, at *7 (N.D. Tex. April 22, 2015) (finding that franchisees did not plead numerous elements of fraud claim or claims under the Texas Deceptive Trade Practices Act, including that the franchisor intentionally withheld material information or made statements knowing they were false or that the franchisees detrimentally relied on or were damaged by statements made or omitted by the franchisor).

⁶⁴ See, e.g., *Sherman v. Ben & Jerry's Franchising, Inc.*, No. 1:08-CV-207, 2009 WL 2462539, at *10 (D. Vt. Aug. 10, 2009) (rejecting franchisees numerous alleged claims, including fraud in the inducement related to misrepresentations in the earnings data in Item 19 of the Disclosure Document, because reliance on the alleged misrepresentations was unreasonable due to, *inter alia*, disclaimers and warnings).

⁶⁵ No. 10-cv-6697, 2011 WL 2516579 (N.D. Ill. June 23, 2011).

⁶⁶ *Id.* at *6.

⁶⁷ *Id.* at *7. A franchisee made a similar claim in *Avon Hardware Co. v. Ace Hardware Corp.*, 2013 IL App. (1st) 130750, 998 N.E.2d 1281, 1287 (Ill. App. Ct. 2013). There, the franchisee alleged fraud and violation of the Indiana Franchise Disclosure Act and Illinois Consumer Fraud and Deceptive Business Practices Act, claiming that the franchisor did not include all stores in its FPR but "inflated historical store performance data by 'failing to account for

A franchisee may also allege that the FPR was not indicative of franchised locations. In *Steak N Shake Enters. v. Globex Co., LLC*,⁶⁸ a Colorado court granted summary judgment in favor of the franchisor on claims that the Item 19 disclosures in the FDD (historical and projected financial performances) were not indicative of franchised locations. The court explained that the franchisee conducted a significant amount of external research, including running its own calculations, having a CPA review its calculations, and consulting an attorney, and that the FDD contained warnings and disclaimers, making it unjustifiable for the prospective franchisee to rely solely on the FPR.⁶⁹ The court also held that the mere fact that the franchisee did not do as well as the Item 19 disclosure did not make the projections false.⁷⁰

It is also common for franchisee plaintiffs to assert fraud in the inducement claims. In *Sherman v. Ben & Jerry's Franchising, Inc.*,⁷¹ a franchisee brought a 12-count petition against its franchisor for, among other things, fraud in the inducement by misrepresenting earnings data in Item 19. The Vermont court held that the franchisee's reliance on the alleged misrepresentation was unreasonable as a matter of law because the franchisee had a duty to conduct an independent investigation when put on notice of a franchisor's warnings and disclaimers regarding financial representations (contained in the UFOC and franchise agreement).⁷²

While a fair number of fraud cases are disposed of through dispositive motions, a franchisee's case based on misrepresentation or fraud related to an Item 19 FPR may survive such motions⁷³ if the franchisee is able to show that, in fact, the projections in the FPR are false. In *Hanley v. Doctor's Express Franchising, LLC*,⁷⁴ a franchisee's claim of fraud against the franchisor regarding the FPR survived a motion to dismiss because the plaintiff presented evidence that the franchisor *knew* that the representations were false and misleading when making them. There, the prospective franchisee entered into discussions with Doctor's Express to open an urgent care franchise in Missouri. Prior to signing the franchise agreement, Doctor's Express knowingly made various false and misleading financial representations regarding the

failed or failing stores' and misrepresented store averages to entice the plaintiffs into investing." *Id.* at 1286. The franchisee also alleged that it reasonably relied upon the false and misleading information when it decided to invest in the system. *Id.* The court determined that the "cautionary language in the pro forma and UFOC documents," which stated, *inter alia*, that the information was based only on a small fraction of all Ace stores, "rendered reliance on the statements contained therein immaterial as a matter of law." *Id.* at 1287.

⁶⁸ *Steak N Shake Enters. v. Globex Co., LLC*, 110 F. Supp. 3d 1057, 1084 (D. Colo. 2015).

⁶⁹ *Id.* at 1083.

⁷⁰ *Id.* at 1084. See also *Qdoba Restaurant Corp. v. Taylors, Inc.*, No. 08-cv-01179, 2010 WL 12410 (D. Colo. March 23, 2010) (holding that evidence of franchisee's financial performance did not create an inference that the projections contained in Item 19 were false at the time they were made and/or that the franchisor knew that they were false).

⁷¹ 2009 WL 2462539.

⁷² *Id.* at *2.

⁷³ See, e.g., *Long John Silver's Inc. v. Nickelson*, No. 11-CV-93, 2013 U.S. Dist. LEXIS 18391 (W.D. Ky. Feb. 12, 2013) (franchisee's fraud claims based on financial projections and statements survived summary judgment despite contractual disclaimer).

⁷⁴ 2013 WL 690521 at *24.

performance of their urgent care franchises.⁷⁵ For instance, Doctor's Express provided representations regarding average patient volume which was more than double the average volume of its highest performing urgent care center.⁷⁶ Doctor's Express defended the claims by first arguing that mere projections and estimates are opinions and not fact, as required under the first element of a claim for fraud. The court disagreed and held that inaccurate projections and estimates may be a basis for a fraud claim if there is evidence that they were known to be false when made.⁷⁷ Next, Doctor's Express argued that the franchisee disclaimed any reliance on these statements through express waiver in the franchise agreement, similar to the cases referenced above. The court again disagreed, however, stating that these waivers are effectively void when there is evidence of fraud and may not be used to protect the franchisor against claims related to that fraud.⁷⁸

Overall, a franchisor may do well to take advice from the court in *Doctor's Express*. A franchisor is under no obligation to provide an FPR, but when deciding to do so, the franchisor must make truthful representations based on what it knows at the time it makes that representation. "A disclosure that is knowingly inaccurate because it omits material information known to the franchisor may constitute a violation of [statute] or fraudulent concealment, even in the absence of a duty of disclosure arising from another source."⁷⁹

Similarly, in *Cousin Subsystems, Inc. v. Better Subs Development, Inc.*,⁸⁰ the franchisee survived summary judgment on its intentional fraud claim because the court found that evidence existed that the franchisor did not make future sales predictions in good faith. In this case, the franchisor sued the franchisee for breach of contract and the franchisee counterclaimed for, among other things, fraudulent profit forecasts in violation of state franchise acts.

A fraud claim may also be premised upon the way in which information is delivered in Item 19. Accordingly, a franchisor should use caution in its explanation of the information contained in the Item 19 disclosure. In *Rocky Mountain Chocolate Factory, Inc., v. SDMS, Inc.*,⁸¹ the franchisor stated in its Item 19 disclosure: "We do not have access to nor knowledge of the expenses or cost incurred by each of the 169 franchised stores."⁸² The franchisee alleged fraud, claiming that the franchisor maintained profit and loss statements for each of its company owned stores and also required franchisees, pursuant to their franchise agreements, to provide quarterly profit and loss statements to the franchisor. The franchisee survived summary judgment because the court found material facts existed as to whether the franchisor's statement was false and whether the franchisee reasonably relied upon the statement.⁸³ This

⁷⁵ *Id.* at *3.

⁷⁶ *Id.* at *20-21.

⁷⁷ *Id.* at *23.

⁷⁸ *Id.* at *30.

⁷⁹ *Id.* at *22.

⁸⁰ No. 09-C-0336, 2011 WL 4585541, at *8 (E.D. Wis. Sept. 30, 2011).

⁸¹ No. 06-cv-11212, 2007 WL 4268962 (D. Colo. Nov. 30, 2007).

⁸² *Id.* at *3.

⁸³ *Id.*

case is instructive because, while the franchise laws do not require a franchisor to provide cost or expense information outside of Item 7, making a false affirmative statement about why cost or expense information is not included in Item 19 may result in liability to the franchisor.

Similarly, a franchisor may face liability for providing misleading or no definitions for terms used in financial performance representations. In *Martinez v. Stratus Franchising, LLC*,⁸⁴ the master franchisee, in a three-tiered janitorial franchise system, used the terms "gross revenue," "gross annual billing," and "projected gross revenue per year." During sales presentations to prospective franchisees, the franchisor used the term "total income."⁸⁵ The franchisees filed a class action lawsuit, alleging fraud,⁸⁶ claiming the use of the words "total income" constituted a representation that the numbers presented as gross revenue would ultimately fall to the bottom line.⁸⁷ While the franchisor prevailed after trial and on appeal, the lesson to be learned from this case is that the franchisor could have avoided extremely expensive litigation had the relevant terms been carefully defined and used consistently in the manner now contemplated by the FPR Commentary.

In addition to facing claims from franchisees related to Item 19 disclosures in the FDD (or FPRs made outside of the FDD), franchisors could face enforcement actions from state regulators for misleading or fraudulent disclosures.⁸⁸

While most cases involving Item 19 appear to relate to representations made in the disclosure document, the case of *Randall v. Lady of America Franchise Corporation*,⁸⁹ is instructive as it relates to franchisors opting not to make a FPR in its disclosure document. In *Randall*, the franchisor stated in its FDD that it did not furnish nor authorize its salespersons to furnish any oral or written information concerning actual or potential sales, costs, income or profits of the system. The plaintiffs, characterized by the court as "disappointed current and former Lady of America franchisees,"⁹⁰ alleged that at the franchisor's discovery day and other events for prospective franchisees, representatives for the franchisor made oral representations about potential profits. The franchisees alleged first that the earnings claims were false. The franchisees further alleged that the act of making representations outside of the disclosure

⁸⁴ No. 49A02-1509-PL-1317, 2016 WL 3402546 (Ind. Ct. App. June 21, 2016) (unpublished).

⁸⁵ *Id.* at *2.

⁸⁶ Interestingly, the court found that representations made to franchisees by the franchisor on gross revenue or total income were not actionable because those representations did not meet the definition of financial performance representation in the Franchise Rule.

⁸⁷ *Id.* at *5.

⁸⁸ See, e.g., *Federal Trade Commission v. Minuteman Press*, 53 F. Supp. 2d 248 (E.D.N.Y. 1998) (holding franchisors committed unfair and deceptive trade practice by making false gross sales and profitability claims and violated franchise disclosure rule); *Federal Trade Commission v. Gingiss International, Inc.*, Bus. Franchise Guide (CCH) ¶ 10,218 (N.D. Ill. May 10, 1993) (consent decree entered for \$25,000 fine for franchisor's misleading earnings claim caused by franchisor swapping franchisee information on salary expenses with company-owned stores which were not compatible to stores being sold to franchisees). While these were decided under the Original Franchise Rule, they are instructive with respect to FPRs made under the Amended Rule.

⁸⁹ 532 F. Supp. 2d 1072 (D. Minn. 2007).

⁹⁰ *Id.* at 1074.

document (even if the representations were true) rendered the statement in Item 19 false.⁹¹ While the court acknowledged that a “negative earnings claim” is contemplated under the rules governing UFOCs,” it acknowledged that the statement in the disclosure document could nevertheless be actionable as fraud.⁹² In a lengthy opinion, the court denied (for the most part) the franchisor’s motion for summary judgment and allowed the claims to proceed to trial for determination by a jury. Accordingly, while obvious advice, it is important to remember that when a franchisor client declines to make an Item 19 disclosure, the franchisor may not make financial performance representations elsewhere, unless permitted by law.

C. Other FDD Items That May Serve As A Basis For A Fraud Claim

1. Item 3 (Litigation)

Item 3 requires “the disclosure of certain lawsuits involving the franchisor and other entities associated with the franchisor – i.e., predecessors, parents, and affiliates – in addition to certain lawsuits involving any person identified in Item 2.”⁹³ Two types of pending lawsuits must be disclosed: (1) any administrative, criminal, or material civil action that alleges a violation of a franchise, antitrust, or securities law, or that alleges fraud, unfair or deceptive practices, or comparable allegations and (2) any civil lawsuits involving the franchisor or any related entity (including any person identified in Item 2) “other than ordinary routine litigation incidental to the business, which are material in the context of the number of franchisees and the size, nature, or financial condition of the franchise system or its business operations.”⁹⁴ A franchisor must also disclose whether it or certain specified related entities/persons have been a party to any material civil actions involving the franchise relationship in the last fiscal year and certain other types of legal actions within 10 years before the issuance date of the disclosure document.

This Item is of particular interest to franchisees as it may give a prospective franchisee a glimpse into the stability of the system. For instance, several lawsuits between the franchisor and existing or former franchisees could signal disharmony within the system or, if the franchisor is involved in high stakes litigation with a third party, a bad result could threaten the financial health of the franchisor. Accordingly, if a franchisor fails to properly disclose a lawsuit or attempts to minimize the importance of the lawsuit in its description, a failed or disgruntled franchisee could take the position that had it known about the lawsuit (or been provided an accurate description of the lawsuit), it would not have entered into the franchise agreement—a fraud in the inducement claim.

In *Yogo Factory Franchising, Inc. v. Ying*, the franchisee asserted a counterclaim alleging, among other things, fraudulent inducement by the franchisor based, in part, on representations made (or which should have been made) in the franchise disclosure document, including claims related to Item 3.⁹⁵ The court initially dismissed the claims, based on

⁹¹ *Id.* at 1080.

⁹² *Id.* at 1074.

⁹³ COMPLIANCE GUIDE, *supra* note 5, at 34.

⁹⁴ COMPLIANCE GUIDE, *supra* note 5, at 34.

⁹⁵ Case No. 13-630, 2014 WL 1783146 (D. N.J. May 5, 2014); *see also* Case No. 13-630, 2015 WL 1117369 (D. N.J. March 10, 2015).

cautionary statements made in the franchise disclosure document, the integration clause of the franchise agreement, and the franchisee's responses to the franchise questionnaire, but allowed time for the franchisee to cure the pleadings (to the extent deficiencies could be cured).⁹⁶ Thereafter, the franchisee filed an amended complaint, which the court dismissed for the same reasons, noting that no new factual allegations were pled to cure the issues raised by the court in its initial order.⁹⁷ While this case was dismissed by the court, it is illustrative of circumstances where disclosure items that a franchisor believes to be minor could result in protracted (and expensive) litigation if the relationship between the parties goes south (this case, for instance, spanned more than two years prior to final dismissal).

2. Item 4 (Bankruptcy)

In Item 4, franchisors must disclose not only the bankruptcy history of the franchisor itself, its affiliates, and predecessors, but also any of its parents.⁹⁸ Importantly, the disclosure of affiliate and parent information is not limited—as it is for Item 2 and Item 3—to affiliates or parents that guarantee performance or back the franchisor financially.⁹⁹ Bankruptcy history must be disclosed for all affiliates and parents: any bankruptcy in which an affiliate or a parent was involved during the 10-year reporting period immediately before the issuance date of the disclosure document. In addition, franchisors must disclose bankruptcies involving any officer or general partner of the franchisor, and “any other individual who will have management responsibility relating to the sale or operation of franchises offered” by the disclosure document, including those of any company of which they were a principal officer or general partner.¹⁰⁰

Again, this Item may have important implications to a prospective franchisee as it could indicate an unhealthy financial picture for the system or key players involved with the franchisor. A franchisor's or affiliated party's bankruptcy could affect both the franchisee's investment in the franchise and its relationship with the franchisor. Accordingly, a franchisor's failure to properly disclose bankruptcy items could result in a fraud in the inducement claim against the franchisor if the franchisee fails or underperforms.

In *Altruist, LLC v. Medex Patient Transport, LLC*,¹⁰¹ the franchisee filed a demand for arbitration against the franchisor alleging intentional misrepresentation/fraud in the inducement, negligent misrepresentation, breach of contract, breach of the covenant of good faith and fair dealing, violation of the Tennessee Consumer Protection Act (“TCPA”), and misrepresentation by concealment, basing its claims, in part, on omissions within the franchise disclosure document. After the arbitrator entered an award in favor of the franchisee, the franchisor sought to vacate the award (on the ground that the arbitrator manifestly disregarded the law) and the franchisee sought to confirm the award.¹⁰² The franchisor argued, in part, that the arbitration

⁹⁶ *Id.* at *39.

⁹⁷ 2015 WL 1117369 at *24-25.

⁹⁸ 16 C.F.R. § 436.5(d).

⁹⁹ COMPLIANCE GUIDE, *supra* note 5, at 42.

¹⁰⁰ COMPLIANCE GUIDE, *supra* note 5, at 42.

¹⁰¹ No. 3:17-cv-01179, 2018 WL 1704111 (M.D. Tn. April 9, 2018).

¹⁰² *Id.* at *2.

award should be vacated due to the integration clause found within the franchise agreement.¹⁰³ The Court explained:

Among other things, a FDD requires the disclosure of bankruptcy by certain individuals within the preceding ten years, but Medex [the franchisor] failed to disclose that Kyle Calvert had filed bankruptcy on July 20, 2013. The arbitrator found this failure to be a material breach upon which Altruist reasonably relied, and supported its claim for fraudulent inducement. It was not error for him to consider evidence on this issue because the integration clauses specifically allowed Altruist to rely on the representations in the FDD.¹⁰⁴

The franchisee also based its TCPA claim on the omission by the franchisor of the individual's bankruptcy filing in Items 3 and 4. The Court confirmed the arbitrator's award of rescission of the franchise agreement (with a judgment in excess of \$400,000) in favor of the franchisee on its claims of breach of contract, fraudulent inducement, and violation of the TCPA based, in part, upon the franchisor's failure to disclose an individual's bankruptcy in its FDD.

3. Item 8 (Restrictions On Sources Of Products And Services)

Item 8 of the Amended Rule requires the disclosure of obligatory purchases, restrictions on sources of products and services, and the amount of any revenue franchisors may receive from required suppliers.¹⁰⁵ It also requires the disclosure of purchasing or distribution cooperatives.¹⁰⁶

In *The Cleaning Authority, Inc. v. Neubert*,¹⁰⁷ the franchisees counterclaimed against the franchisor for, among other things, fraud in the inducement related to improper disclosures (and omissions) in the FDD and violation of the South Carolina Unfair Trade Practices Act. The franchisees alleged that the franchisor failed to disclose rebates, kickbacks and other payments from an affiliate, represented that it would consider alternate suppliers (Item 8) but refused to do so, and intentionally provided inaccurate information for its franchisees (Item 20). On a motion to dismiss, the court found that, related to a specific supplier, a "reasonable reader of the [FDD] would have understood that he or she had no option when it came to a source for advertising mailers."¹⁰⁸ Additionally, the court found that the franchisees failed to plead facts to establish the materiality of the financial relationship between the franchisor and the affiliate. Accordingly, the court dismissed the claims for fraud.¹⁰⁹

¹⁰³ *Id.* at *10-11.

¹⁰⁴ *Id.* at *12.

¹⁰⁵ COMPLIANCE GUIDE, *supra* note 5, at 51.

¹⁰⁶ COMPLIANCE GUIDE, *supra* note 5, at 55.

¹⁰⁷ No. 10-203, 2011 WL 666892 (D. Md. 2011).

¹⁰⁸ *Id.* at *4.

¹⁰⁹ *Id.*

In *Massey, Inc. v. Moe's Southwest Grill, LLC*,¹¹⁰ the franchisee contended that the franchisor misrepresented information in Item 8, asserting that affiliates of the franchisor derived income from purchases by the franchisee that the franchisor failed to disclose. The franchisee's claims survived dispositive motions to a trial on the merits. While the court found that the statements made in Item 8 did not constitute actionable fraud,¹¹¹ the court found the statements constituted an unfair or deceptive act under the FTC regulations. The court explained that because the FTC Rule requires disclosure of whether the franchisor or its affiliates "will or may derive revenue" from purchases required by the franchisee, a disclosure may be forward-looking and still be actionable.¹¹² Because the evidence confirmed that an affiliate of the franchisor was in discussions about a business relationship that could result in revenue to the affiliate, the potential arrangement was required to be disclosed. The court found the omission of the potential arrangement in Item 8 to be an unfair or deceptive act under the Tennessee Consumer Protection Act.¹¹³ However, the court also found that the franchisee failed to offer sufficient evidence to establish actual damages related to the omission, causing the franchisee's claim to fail.¹¹⁴ This case is important for many reasons, including the proposition that, at least under the law applied in this case, while a fraud claim for an affirmative misrepresentation or omission in a disclosure document may not be actionable, a franchisee may be able to succeed with the same set of facts under a different cause of action.

In *Tubby's #14, Ltd. v. Tubby's Sub Shops, Inc.*,¹¹⁵ the franchisee alleged that the franchisor failed to disclose in Item 8 an affiliate and the franchisor's financial arrangement with that affiliate, violating the Michigan Franchise Investment Law and the FTC Rule and constituting actionable common law fraud. On the franchisor's motion for summary judgment, the franchisee pointed to the fact that in later years, the franchisor *did* disclose the affiliate and the financial arrangement, "showing that they were aware of their previous non-compliance."¹¹⁶ The court found that there was a genuine issue of material fact about whether the franchisor made the proper disclosures in Item 8 and, if they did not, whether such failure constituted actionable fraud or a violation of the relevant franchise acts.¹¹⁷

4. Item 11 (Franchisor's Assistance, Advertising, Computer Systems & Training)

Item 11 of the Amended Rule requires the disclosure of the franchisor's obligations under the franchise agreement to furnish assistance to franchisees.¹¹⁸ The disclosure

¹¹⁰ No. 1:07-cv-0741, 2015 WL 438513 (N.D. Ga. February 3, 2015).

¹¹¹ *Id.* at *45-46.

¹¹² *Id.* at *58.

¹¹³ *Id.* at *59.

¹¹⁴ *Id.* at *64-65.

¹¹⁵ No. 04-70918, 2006 WL 2796181 (E.D. Mich. September 27, 2006).

¹¹⁶ *Id.* at *25.

¹¹⁷ *Id.* at *23.

¹¹⁸ COMPLIANCE GUIDE, *supra* note 5, at 63.

requirements encompass pre-opening assistance (e.g., site selection), as well as any ongoing assistance, such as advertising and training, during the operation of the franchise.¹¹⁹

In *Yogo Factory Franchising, Inc. v. Ying*, discussed above, the franchisee of three franchise agreements claimed, among other things, fraudulent inducement by the franchisor based, in part, on representations by the franchisor made in Item 11 of the disclosure document.¹²⁰ The franchisee focused on the franchisor's claim in Item 11 that the franchisor would provide a training program to the franchisee and its manager and that it could provide additional training after the opening of the store.¹²¹ Essentially, in an argument raised by many disgruntled franchisees, the franchisee argued that the franchisor misrepresented the amount of support that the franchisor would provide. The court found that the franchisee's reliance on the representations made prior to the franchise agreement were not reasonable in light of the integration clause in the franchise agreement and the franchise questionnaire.¹²² Additionally, the court found that allegations that the franchisor failed to provide training in the manner set forth in the franchise disclosure document was a breach of contract claim, not a fraud claim, dismissing the fraud claims.¹²³

It is worth briefly noting the case of *Governara v. 7-Eleven, Inc.*,¹²⁴ wherein the franchisee alleged a breach of contract claim based upon the franchisor's disclosure in Item 11 of training and services. The court dismissed this breach of contract claim because it found that the training referenced in the disclosure document was completely within the discretion of the franchisor to determine and that there were no allegations by the franchisee that training was necessary due to changes in the franchise system.¹²⁵

Accordingly, while it is not surprising that a franchisee would raise lack of assistance or training in a lawsuit against a franchisor, the specific language of the disclosure document will control whether a fraud or breach of the franchise disclosure document claim survives to trial.

5. Item 20 (Outlets & Franchisee Information)

Item 20 of the Amended Rule requires the disclosure of statistical information on the number of franchised outlets and company-owned outlets for the preceding three-year period in tabular form.¹²⁶ The first table provides a systemwide summary of outlets, indicating the net changes in the number of outlets – both franchised and company-owned – over the last three years.¹²⁷ The second table tracks transfers of outlets, state by state, over the last three

¹¹⁹ COMPLIANCE GUIDE, *supra* note 5, at 63.

¹²⁰ No. 13-630, 2014 WL 1783146 (D. N.J. May 5, 2014); *see also* No. 13-630, 2015 WL 1117369 (D. N.J. March 10, 2015).

¹²¹ *Id.* at *8.

¹²² *Id.* at *23-24.

¹²³ *Id.* at *28.

¹²⁴ No. 13-cv-6094, 2014 WL 4476534 (S.D.N.Y. August 20, 2014).

¹²⁵ *Id.* at *18-19.

¹²⁶ COMPLIANCE GUIDE, *supra* note 5, at 95.

¹²⁷ COMPLIANCE GUIDE, *supra* note 5, at 95-96.

years.¹²⁸ The third table shows, state by state, changes in the status of franchised outlets over the last three years.¹²⁹ Similarly, the fourth table displays, state by state, changes in the status of company-owned outlets over the last three fiscal years.¹³⁰ Finally, the fifth table projects new outlet openings in each state and shows the number of franchise agreements that have been signed but have not yet opened an outlet. Item 20 also requires disclosure of contact information for current franchisees.¹³¹

While this Item would seem an unlikely source of litigation, there have been cases involving a franchisor's disclosure under Item 20. In *JMF, Inc. v. Medicine Shoppe International, Inc.*,¹³² on a motion for summary judgment, the United States District Court for the District of North Dakota held that a franchisor could have violated the anti-fraud provisions of the North Dakota Franchise Investment Law through an alleged misstatement in Item 20 of its FDD. The franchisor projected opening 0-1 new stores in the state in its FDD. The franchisee claimed that this representation was fraudulent because the franchisor, in reality, did not intend to offer any new franchise locations in the state so as to avoid triggering a "most favored nations" provision in the existing franchisees' agreements. Importantly, the North Dakota Franchise Investment Act contains both an anti-fraud provision and a civil liability provision, which the Court confirmed allows franchisees to "bring an action for damages, for rescission, or for such other appropriate relief as the court may deem advisable."¹³³ Accordingly, the franchisees' claims for fraud under Item 20 of the FDD survived summary judgment.

In *The Cleaning Authority* case discussed above,¹³⁴ former franchisees alleged fraud in the inducement based, in part, on an allegation that the franchisor intentionally provided inaccurate contact information for franchisees in Item 20. The court dismissed the claim on a motion to dismiss, holding that the franchisees failed to allege what information was inaccurate in Item 20, failed to allege that they tried to contact specific franchisees and were unable to do so, and failed to allege why, if their allegation was correct, "contact with those specific franchisees was material to the [franchisees'] decision-making."¹³⁵

III. LITIGATING FDD MISREPRESENTATION CLAIMS

There are a number of considerations and doctrines unique to litigating FDD misrepresentation claims. This section discusses the common causes of action and general considerations applicable when litigating FDD misrepresentation claims, and then examines several important doctrines applicable to those claims, including the distinctions between affirmative misrepresentation claims and fraud in the omission claims, distinctions between

¹²⁸ COMPLIANCE GUIDE, *supra* note 5, at 96.

¹²⁹ COMPLIANCE GUIDE, *supra* note 5, at 96.

¹³⁰ COMPLIANCE GUIDE, *supra* note 5, at 96.

¹³¹ COMPLIANCE GUIDE, *supra* note 5, at 102-103.

¹³² No. 3:09-cv-73, Bus. Franchise Guide CCH ¶ 14,692 (D.N.D. Sept. 19, 2011).

¹³³ *Id.* (citing N.D. CENT. CODE § 51-19-12 (2018)).

¹³⁴ 2011 WL 666892 at *2.

¹³⁵ *Id.* at *4.

promises of future performance and affirmative misrepresentations of existing fact, the element of materiality, the element of reliance, and the effect of disclaimers.

A. Common Causes Of Action And General Considerations

There is no private cause of action for violations of the FTC's Franchise Rule, 16 C.F.R. § 436, *et seq.*¹³⁶ Accordingly, when faced with potentially incomplete, misleading, or false disclosures in a FDD, franchisees have to look to common law and/or state statutory law for redress. Common causes of action in these cases typically include common law fraud theories, including intentional fraud, negligent misrepresentation, and/or fraudulent omission, and theories implicating various state statutory schemes, including state franchise disclosure laws and Little FTC Acts.

One common cause of action—and the most obvious—is intentional fraud. As discussed above, fraud generally “consists of some deceitful practice or willful device, resorted to with intent to deprive another of his right, or in some manner to do him an injury.”¹³⁷ In the franchising context, fraud usually occurs when a franchisor knowingly makes an untrue statement of fact which induces a prospective franchisee to enter into the franchise agreement. The specific elements of a fraud claim vary by jurisdiction, but generally include: (1) a false representation of material fact; (2) knowledge of the falsity by the party making the representation; (3) intent to deceive; (4) reasonable reliance by the recipient of the representation; and (5) an actual loss or damages suffered by the recipient of the representation.¹³⁸

Another commonly pled cause of action is negligent misrepresentation. While negligent misrepresentation shares many of the elements of intentional fraud, it differs in two important ways. First, in some jurisdictions, the party asserting a cause of action for negligent misrepresentation must establish that the franchisor had a duty, as a result of a special relationship, to ensure that reasonable care was taken with respect to the accuracy of any representations of fact that may have led the franchisee to enter the contract.¹³⁹ That duty may

¹³⁶ See, e.g., *Yumilicious Franchise, L.L.C. v. Barrie*, No. 3:13-CV-4841-L, 2015 WL 2359504, at *4 (N.D. Tex. May 18, 2015), *aff'd*, 819 F.3d 170 (5th Cir. 2016) (“Courts in this and other circuits have recognized that there is no private right of action for violations of the [FTC’s Franchise Rule].”); *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*, 70 F. Supp. 3d 376, 382 (D.D.C. 2014) (no private right of action is available to franchisee for franchisor’s failure to furnish required information under Franchise Rule) (collecting cases); *Robinson v. Wingate Inns Int’l, Inc.*, No. 13-cv-2468 (CCC), 2013 WL 6860723, at *2 (D.N.J. Dec. 20, 2013) (“It is well-settled that there is no private cause of action for violation of the FTC franchise disclosure rules.”) (citations omitted); *Vino 100, LLC v. Smoke on the Water, LLC*, 864 F. Supp. 2d 269, 281 (E.D. Pa. 2012) (“Private parties [] are not permitted to enforce § 5 of the Federal Trade Commission Act. Only the FTC may do so.”).

¹³⁷ BLACK’S LAW DICTIONARY (10th ed. 2014) (accessed electronically via Westlaw).

¹³⁸ For example, under New York law there are five elements for common law fraud: (1) a material misrepresentation of an existing fact; (2) made with knowledge of the falsity; (3) an intent to induce reliance thereon; (4) justifiable reliance upon the misrepresentation; and (5) damages. *Mitchell v. Diji*, 134 A. D. 3d 779, 781 (N.Y. App. Div. 2015). Under Washington law, in contrast, there are nine elements for common law fraud: (1) representation of an existing fact; (2) materiality; (3) falsity; (4) defendant’s knowledge of its falsity; (5) intent of defendant that it should be acted upon by the plaintiff; (6) plaintiff’s ignorance of its falsity; (7) plaintiff’s reliance on the truth of the representation; (8) plaintiff’s right to rely upon it; and (9) damages suffered by the plaintiff. *Adams v. King County*, 164 Wash. 2d 640, 662 (Wash. 2008).

¹³⁹ See, e.g., *Century Pac., Inc. v. Hilton Hotels Corp.*, 528 F. Supp. 2d 206, 231 (S.D.N.Y. 2007), *aff’d*, 354 F. App’x 496 (2d Cir. 2009).

not exist automatically.¹⁴⁰ If such a duty does exist, and if the franchisor did not use reasonable care to ensure the truth of the statement, then the wronged party may have an action for negligent misrepresentation. Second, the intent requirement for negligent misrepresentation is less than that required for intentional misrepresentation.¹⁴¹ Negligent misrepresentation can also occur in cases when a party makes a careless statement of fact or does not have sufficient reason for believing the statement's truth.

Fraudulent omission is another common cause of action in these circumstances. In a nutshell, fraudulent omission is common law fraud based on the failure to disclose a material fact that a party has a duty to disclose.¹⁴² Fraudulent omission can prove to be quite difficult to prosecute because it requires a showing, at least to some extent, that the nonexistence of something had an effect on the party alleging fraud. However, fraudulent omission is also not as easily waived or disclaimed as affirmative fraud,¹⁴³ and for that reason, omission claims are becoming more and more common.

In addition to common law causes of action, there are several states with franchise disclosure laws that provide for a private right of action.¹⁴⁴ These rights of action arm franchisees with claims when the FDD includes false or misleading statements, or omits statements necessary for a disclosure to be complete and not misleading.¹⁴⁵ Some of these laws also make certain defenses available to the franchisor when, for example, the franchisee knew or should have known the relevant facts, notwithstanding the false or misleading statement, or the franchisor exercised reasonable care and did not know the untruth or omission (or if the franchisor had exercised reasonable care it would not have known the untruth or omission).¹⁴⁶

¹⁴⁰ *Id.* at 231 ("Typically, there is no special relationship between the parties to an arms-length transaction.").

¹⁴¹ *Am. Casual Dining, L.P. v. Moe's Sw. Grill, L.L.C.*, 426 F. Supp. 2d 1356, 1365 (N.D. Ga. 2006) (noting that under Georgia law, "[n]egligent misrepresentation is similar to fraud and requires the same elements of proof, the only difference being whether the defendant knowingly or negligently made the misrepresentations.").

¹⁴² The specific elements of a fraudulent omission claim vary by jurisdiction. For example, under Texas law there are 6 elements including: (1) the defendant concealed or failed to disclose a material fact within its knowledge to the plaintiff; (2) the defendant had a duty to disclose that fact; (3) the defendant knew the plaintiff was ignorant of the fact and the plaintiff did not have an equal opportunity to discover the truth; (4) the defendant intended to induce the plaintiff to take some action by concealing or failing to disclose the fact; (5) the plaintiff relied on the defendant's nondisclosure; and (6) the plaintiff was injured as a result of acting without that knowledge. *In re Arnette*, 454 B.R. 663, 689 (N.D. Tex. 2011) (citing *Horizon Shipbuilding, Inc. v. Blyn II Holding, LLC*, 324 S.W.3d 840, 850 (Tex. App. 2010)). Under Kentucky law, in contrast, the elements include: (1) the defendant had a duty to disclose a material fact; (2) the defendant failed to disclose that fact; (3) that failure to disclose induced the plaintiff to act; and (4) the plaintiff suffered actual damages. *Vogel v. E.D. Bullard Co.*, 597 F. App'x 817, [] (6th Cir. 2014).

¹⁴³ See *infra* Sections II.B.1. and II.E; Elliot Ginsburg & Carmen D. Caruso, *Fraud by Omission: An Argument for Broader Disclosures and Renewed Enforcement*, 35 Franchise L.J. 1 (Summer 2015).

¹⁴⁴ See, e.g., CAL. CORP. CODE § 31300 (West 2018); HAW. REV. STAT. § 482E-9(b) (West 2018); 815 ILL. COMP. STAT. 705/26 (West 2018).

¹⁴⁵ *Id.*

¹⁴⁶ See, e.g., CAL. CORP. CODE § 31300 (West 2018) (providing for a private right of action unless "the defendant proves that the plaintiff knew the facts concerning the untruth or omission, or that the defendant exercised reasonable care and did not know, or, if he or she had exercised reasonable care, would not have known, of the untruth or omission."); WASH. REV. CODE § 19.100.190(2) (West 2018) (providing for a private right of action but also that rescission is "not available to the plaintiff if the defendant proves that the plaintiff knew the facts concerning the

Finally, in states without their own disclosure laws, wronged franchisees may be able bring state unfair trade practices actions alleging FTC Franchise Rule violations.¹⁴⁷ The statutes authorizing such actions are commonly referred to as “Little FTC Acts,” and the claims are commonly referred to as “Little FTC Act” claims. The crux of these claims is that the failure to provide a compliant FDD before entering into a franchise business relationship violated the FTC Franchise Rule, which in turn violated the state’s Little FTC Act. To succeed on such a claim, a franchisee usually has to establish “(1) an FTC Rule violation; (2) that a particular state’s Little FTC Act applies; (3) that an FTC Rule violation can serve as a predicate for a violation of the applicable Little FTC Act; (4) that the claim is timely; and (5) that each of the applicable Little FTC Act’s elements is met.”¹⁴⁸ Of course, not all Little FTC Acts are applicable in the franchise context. Some just apply to consumer or similar relationships and not to commercial relationships.¹⁴⁹ Others only apply to the sale of goods and/or services generally, which has led some courts to hold that this limitation precludes claims relating to franchise sales because a franchise is not a good or service.¹⁵⁰ Other states require a showing that the alleged conduct injures, or has the potential to injure, the public as a whole.¹⁵¹

Litigating these types of claims is highly factual and can be complex. As discussed below, there are a number of subtle nuances involved of which a practitioner should be aware. For example, some claims require reasonable reliance, while some incorporate a rebuttable presumption of reliance in the franchisee’s favor; some representations are not actionable because they are forward looking; some states impose a strict standard of materiality based on the FTC Franchise Rule and some impose a looser standard based on federal securities laws;

untruth or omission or that the defendant exercised reasonable care and did not know or if he or she had exercised reasonable care would not have known of the untruth or omission.”).

¹⁴⁷ See generally Bethany L. Appleby, Robert S. Burstine, and John M. Doroghazi, *Cause of Action Alchemy: Little FTC Act Claims Based on Alleged Disclosure Violations*, 36 Franchise L.J. 429 (Winter 2017).

¹⁴⁸ *Id.* at 434.

¹⁴⁹ See, e.g., MICH. COMP. LAWS § 445.902 (West 2018) (not providing a right of action in commercial relationships); MO. ANN. STAT. § 407.025 (West 2018) (limiting private rights of action to disputes relating to items for household use); 73 PA. STAT. ANN. § 201-9.2(a) (West 2018) (providing a private right of action to any person who purchases or leases goods or services primarily for personal family or household purposes); CAL. CIV. CODE § 1761 (West 2018); GA. CODE ANN. § 10-1-392 (West 2018); HAW. REV. STAT. ANN. § 480-1 (West 2018); MISS CODE ANN. § 75-24-15 (West 2018); VA. CODE ANN. § 59.1-198 (West 2018).

¹⁵⁰ See, e.g., *Meineke Discount Muffler v. Jaynes*, 999 F.2d 120, 125 (5th Cir. 1993) (holding that a franchisee could not state a claim under the Texas Deceptive Trade Practices Consumer Protection Act because the basis of the claims focused on the validity of the franchisor’s ownership of its trademarks and service marks, and those are intangible property rights, not goods or services).

¹⁵¹ See, e.g., *Abbouds’ McDonald’s LLC v. McDonald’s Corp.*, No. 04-cv-1895P, 2005 WL 2656591, at *5-6 (W.D. Wash. Oct. 14, 2005), *aff’d*, 2006 WL 1877247 (9th Cir. July 7, 2006) (granting summary judgment to the franchisor on a Washington state Little FTC Act claim where the franchisee failed to show any members of the public at large were at risk of being similarly injured by the franchisor, particularly given that the franchisor did not actively solicit the public to find new franchisees); *D&K Foods, Inc. v. Bruegger’s Corp.*, No. L-97-2304, Bus. Franchise Guide (CCH) ¶ 11,506 (D. Md. Sept. 30, 1998) (granting franchisor’s motion to dismiss Washington state Little FTC Act claim because the plaintiffs failed to allege sufficient facts to show that the franchisor’s purported misrepresentations regarding the financial performance of existing franchise outlets were actionable because the “transactions did not involve the public in any way.”); *Rhino Linings USA, Inc. v. Rocky Mountain Rhino Lining, Inc.*, 62 P.3d 142, 146 (Colo. 2003) (directing trial court to vacate a judgment entered under the Colorado Consumer Protection Act because the evidence at trial did not establish a significant public impact).

and some claims may be subject to disclaimer, merger, or integration clauses and associated defenses. A practitioner must take all of these nuances into account to craft an informed prosecution or defense theory of the case.

Additionally, discovery can be extensive in litigating these types of cases. The basic inquiry almost always boils down to the following questions: (1) what did the franchisor know about the truthfulness and completeness of the representation; (2) what did the franchisee know about the truthfulness and completeness of the representation; and (3) what did the franchisee do based upon the representation (or omission). Often there is extensive e-discovery to locate contemporaneous email communications in these cases. A franchisee is likely to seek drafts of the FDD representation in question, and internal communications related to that representation by the franchisor's executives, officers, managers, and employees. Issues such as privilege are implicated when the franchisor's in-house or outside attorney drafts, or assists in drafting, the FDD and/or the representation involved. A franchisor is likely to seek information related to the franchisee's pre-agreement business projections, business plans, and/or pro formas.¹⁵² A franchisor is further likely to seek information related to any other considerations the franchisee employed in purchasing the franchise, including any information the franchisee learned or should have learned during his or her due diligence efforts.

B. The Misrepresentation

1. Affirmative Misrepresentations And Fraud By Omission

An affirmative misrepresentation claim concerns the truthfulness of a statement of fact. An omission claim concerns a statement of fact which may be 'facially' true, but the statement omits information necessary so that it is not misleading. This is a critical distinction for several reasons.

First, in many jurisdictions a fraudulent omission claim requires the alleged defrauding party to have had a duty of disclosure to the claimant. The duty can arise in several different circumstances, including when: (1) there exists a confidential or fiduciary relationship between the parties; (2) a statute imposes a duty of disclosure; (3) a party has partially disclosed material facts to another party but created the impression of full disclosure; (4) a material fact is peculiarly within the disclosing party's own knowledge; (5) a disclosing party subsequently acquires information that he or she knows will make untrue or misleading a previous representation that, when made, was true or believed to be so; (6) a disclosing party learns that the other party is about to act in reliance upon a false representation in a transaction with him or her; and (7) a disclosing party knows that the other party is about to enter into a transaction with him or her and is under a mistake as to facts basic to the transaction, and would, based on customs of the trade or other objective circumstances, reasonably expect a disclosure of those facts.¹⁵³

¹⁵² Many times, even if a franchisee is not required to submit a business plan or pro forma to the franchisor prior to purchasing the franchise, the franchisee will be required to submit one to a lender in furtherance of any efforts to secure financing for their franchise. The franchisee's communications with the lender (and business projections made to the lender) can be highly fruitful areas of discovery.

¹⁵³ See Elliot Ginsburg & Carmen D. Caruso, *Fraud by Omission: An Argument for Broader Disclosures and Renewed Enforcement*, 35 Franchise L.J. 1, at 3 (Summer 2015) (citing *Rivermont Inn, Inc. v. Bass Hotels & Resorts, Inc.*, 113 S.W.3d 636, 641 (Ky. Ct. App. 2003); *Plaintiffs' State & Sec. Law Settlement Class Counsel Entwistle & Cappucci LLP v. Bank of New York Mellon*, 43 Misc.3d 887, 900 (N.Y. Sup. Ct. 2014); Restatement (Second) of Torts § 551 (Am. Law Inst. 1977)).

For example, in *Wyndham Hotels and Resorts, LLC v. Northstar Mt. Olive, LLC*,¹⁵⁴ the United States District Court for the District of New Jersey dismissed a claim for negligent misrepresentation by omission because the franchisee failed to show that the franchisor owed it any duty of disclosure. The court recognized that under New Jersey law generally three types of transactions give rise to a duty to disclose: (1) where a fiduciary relationship exists; (2) where the transaction itself calls for perfect good faith and full disclosure; and (3) where one party expressly reposes a trust and confidence in the other.¹⁵⁵ The court held none of those transactions were involved, and thus the franchisor did not have a duty to disclose the allegedly omitted information.¹⁵⁶

Similarly, in *7-Eleven, Inc. v. Spear*,¹⁵⁷ the United States District Court for the Northern District of Illinois rejected a franchisee's counterclaims alleging a franchisor's omission of same store sales information for a franchised unit purchased by a franchisee. The franchisee alleged the franchisor "had knowledge that the [] store was operating unprofitably and/or below its projections and / or expectations or was otherwise performing inconsistent with the averages set forth in the Franchise Offering Circular provided to [the franchisee]," but did not disclose it to the franchisee.¹⁵⁸ The court rejected franchisee's claim for common law fraudulent omission, reasoning that the franchisor had no common law duty to disclose under the circumstances.¹⁵⁹

Conversely, in *Century Pacific, Inc. v. Hilton Hotels Corp.*,¹⁶⁰ the United States District Court for the Southern District of New York declined to dismiss a franchisee's fraudulent omission claim where the franchisee alleged that the franchisor had a duty to disclose its plans to sell the franchise system but instead withheld the information with the intent to defraud the franchisee. The franchisor argued that the omission was not actionable because the law imposed no duty on a franchisor to disclose to a franchisee the possibility or probability of such a sale.¹⁶¹ The court disagreed, holding that, under New York law, the franchisee had adequately alleged that the franchisor had a duty to disclose its intent to sell because the franchisor affirmed its commitment to the brand prior to the sale in response to questions from the franchisee regarding its long-term intentions with respect to the brand, and because the franchisor knew that the franchisee's decision to enter into the franchise agreements may have been made on false information.¹⁶²

¹⁵⁴ *Wyndham Hotels and Resorts, LLC v. Northstar Mt. Olive, LLC*, No. 10-2583 (RBK/AMD), 2013 WL 1314747, at *11-12 (D.N.J. Mar. 28, 2013).

¹⁵⁵ *Id.* at *11-12 (citing *South Broward Hosp. Dist. v. MedQuist Inc.*, 516 F. Supp. 2d 370, 397 (D.N.J. 2007)).

¹⁵⁶ *Id.*

¹⁵⁷ No. 10-cv-6697, 2011 WL 2516579 (N.D. Ill. June 23, 2011).

¹⁵⁸ *Id.* at *3.

¹⁵⁹ *Id.* at *7.

¹⁶⁰ No. 03 Civ. 8258(SAS), 2004 WL 868211 (S.D.N.Y. Apr. 21, 2004).

¹⁶¹ *Id.* at *9.

¹⁶² *Id.*

A second issue unique to fraud by omission claims, as opposed to affirmative misrepresentation claims, involves the element of reliance. Courts have opined that it is practically impossible to prove reliance in cases involving nondisclosure of a material fact because a person cannot affirmatively rely on something that he or she does not know.¹⁶³ Courts have set forth a number of ways of dealing with reliance in such circumstances. Some have established a rebuttable presumption of reliance.¹⁶⁴ Other courts hold that reliance can be inferred depending on the context of the omission,¹⁶⁵ or that the plaintiff must establish that he or she was unaware of the omitted fact, but that had it been disclosed, he or she would have changed his or her behavior.¹⁶⁶ Jurisdiction-specific research is essential when prosecuting or defending an omission claim because the applicable reliance standard varies significantly.

2. False Misrepresentations And Promises Of Future Performance

A fraudulent inducement and/or misrepresentation claim requires a statement concerning past or presently existing facts. Claims relating to or predicting future performance or vague generalities and opinions are generally not actionable. Statements that amount to indefinite generality, puffing, and salesmanship also cannot give rise to fraud because such statements are typically “offered and understood as an expression of the seller’s opinion only, which is to be discounted as such by the buyer, and on which no reasonable [person] would rely.”¹⁶⁷ This is a critical distinction that arises in many FDD misrepresentation cases.

For example, in *Live Cryo, LLC v. CryoUSA Import & Sales, LLC*,¹⁶⁸ the United States District Court for the Eastern District of Michigan dismissed fraud claims in part because they were based on forward-looking projections and not statements of past or present facts. In that

¹⁶³ See, e.g., *Morris v. Int’l Yogurt Co.*, 107 Wash. 2d 314, 328, 729 P.2d 33, 41 (Wash. 1986) (summarizing the standard under the SEC’s Rule 10b-5 and stating: “it is virtually impossible to prove reliance in cases alleging nondisclosure of material facts. The inquiry that would normally be made in a case of affirmative misrepresentation—did the plaintiff believe the defendant’s representation, and did that belief cause the plaintiff to act—does not apply in a case of nondisclosure. [] Since there is no affirmative representation in a nondisclosure case, a plaintiff who was required to prove reliance would have to show that he believed the opposite of the omitted fact, and this would be practically impossible to prove.”) (citations omitted); *Edens v. Goodyear Tire & Rubber Co.*, 858 F.2d 198, 207 (4th Cir. 1988) (“Requiring a plaintiff to show a speculative state of facts, i.e., how he would have acted if omitted material information had been disclosed ... would place an unnecessarily unrealistic evidentiary burden on the ... plaintiff.”).

¹⁶⁴ *Morris*, 107 Wash. 2d at 329, 729 P.2d 33, 41 (“The federal approach adopting a rebuttable presumption of reliance under Rule 10b-5 in cases of nondisclosure of a material fact makes sense. . . It is reasonable to apply this standard to cases involving a franchisor’s failure to disclose a material fact in violation of [the Washington Franchise Investment Protection Act].”).

¹⁶⁵ *Edens*, 858 F.2d at 206 (in action alleging breach of franchise agreement based on fraudulent conduct, court held: “Direct proof of reliance on the concealment [is] not required for it [is] practically impossible to prove, by direct evidence, reliance on that which [has] been intentionally concealed.”); *Castle Aero Fla. Int’l, Inc. v. Mktg. & Fin. Servs., Inc.*, Nos. 12-1818 (PAM/JJG), 11-2672 (PAM/JJG), 2014 WL 2993727 at *22 (D. Minn. 2014) (“[I]n cases alleging fraud by concealment, reliance can be inferred when, like here, a defendant suppresses material facts, knows that a plaintiff is being induced into an agreement based on incorrect assumptions, and remains silent.”).

¹⁶⁶ *Juarez v. Jani-King of California, Inc.*, 273 F.R.D. 571, 584 (N.D. Cal. 2011) (“To prevail on its concealment claim, Plaintiffs must show . . . Plaintiffs were unaware of the fact and would not have acted as they did with knowledge of the fact . . .”).

¹⁶⁷ W. PAGE KEETON, ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 109, at 757 (5th ed. 1984).

¹⁶⁸ 2017 WL 4098853 (E.D. Mich. Sept. 15, 2017).

case, the franchisee of a cryotherapy service concept received a booklet at a pre-sale business meeting which included a return on investment worksheet which projected that the franchisee could earn as much as \$30,350 per month, assuming fifty clients per day at a cost of \$45.00 per session.¹⁶⁹ The worksheet further represented that most locations average 10 clients a day within 90 days, that some locations reach the 25 client-per-day mark fairly quickly, and that one location averaged about 50 clients per day.¹⁷⁰ At first blush, it would appear that the representations involved in this case were statements of past or present facts; however, the franchisee did not allege that the statements regarding the number of clients per day were fraudulent, only that they were designed to induce reliance on the plaintiff's part, and that there was no factual basis for the prediction that it could replicate the success of the locations disclosed.¹⁷¹ In dismissing the claims, the court reasoned that "although misrepresentations about the actual earnings of [the franchisor's other locations] might amount to actionable fraud, [the franchisee did not] allege that those figures were in any way false, but only that [the franchisor's] projections that [the franchisee] could do as well as the [disclosed locations] did not pan out."¹⁷² Accordingly, the court held that the representations were "merely erroneous conjectures as to future events which are not actionable."¹⁷³

Similarly, in *Fabbro v. DRX Urgent Care, LLC*,¹⁷⁴ the Third Circuit Court of Appeals affirmed the dismissal of a franchisee's claims that a franchisor misrepresented the initial startup costs and capital requirements in its financial disclosure documents. The court held that the estimates were nothing more than predictions as to the future course of events, and that there was no allegation that the initial estimates were inaccurate at the time they were made or known to be false by the franchisor.¹⁷⁵ The court reasoned that the "manifest nature" of the representations were express estimates.¹⁷⁶ The court further reasoned that "to hold otherwise would likely transfer annual reports and advertisements into sources of endless litigation."¹⁷⁷

Another instructive decision on this issue is *Massey, Inc. v. Moe's Southwest Grill, LLC*.¹⁷⁸ There, as discussed above, a franchisee alleged that an FDD's Item 8 disclosure falsely represented that neither the franchisor nor its affiliates would derive income from the franchisees' purchases of required supplies. The franchisee alleged that these representations were false because the CEO of the franchisor had an interest in an approved food supplier, and

¹⁶⁹ *Id.* at *2.

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at *8.

¹⁷² *Id.*

¹⁷³ *Id.*

¹⁷⁴ 616 F. App'x. 485 (3d Cir. 2015).

¹⁷⁵ *Id.* at 488.

¹⁷⁶ *Id.* at 489.

¹⁷⁷ *Id.* (quoting *Miller v. Fairchild Indus., Inc.*, 629 A. 2d. 1293, 1303 (Md. 1993)).

¹⁷⁸ No. 1:07-CV-0741-RWS, 2015 WL 438513 (N.D. Ga. Feb. 3, 2015).

other approved food suppliers were allegedly the franchisor's affiliates.¹⁷⁹ Based on these allegations, the franchisees asserted, among other claims, fraud and negligent misrepresentation.¹⁸⁰ After a bench trial, the court ruled for the franchisor, holding that the FDD's Item 8 representations related to future performance rather than present facts, and therefore were not actionable representations under a fraud theory.¹⁸¹

With the foregoing in mind, one may surmise that an FDD's projections of startup costs are never actionable. However, in most jurisdictions, those projections have to be made in good faith and based on the franchisor's then-present understanding of the data, and representations of future events that are made in bad faith can form the basis for a fraud cause of action.¹⁸²

For example, in *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*,¹⁸³ a franchisee alleged that the startup cost estimates in a franchisor's UFOC underestimated the actual startup costs for its franchise, and that the franchisor knew the representations were inaccurate at the time they were made. The UFOC estimated initial investment ranges from \$149,000 to \$269,000 for a start-up franchisee and \$137,000 to \$248,500 for a conversion franchisee.¹⁸⁴ The UFOC also contained two tables that provided itemized price ranges for various anticipated expenditures. The UFOC indicated that in compiling the estimates, the franchisor "relied on our and our shareholders' 15 years of combined industry experience and experience in establishing and assisting our franchisees in establishing and operating 23 [] Units which are similar in nature to the Franchised Unit you will operate."¹⁸⁵ Finally, the UFOC included the disclaimer that "[t]he amounts shown are estimates only and may vary for many reasons including the size of your Franchised Unit, the capabilities of your management team, where you locate your Franchised Unit and your business experience and acumen."¹⁸⁶ The franchisee alleged that it was forced to spend over twice the high end of the franchisor's cost projections, and that the

¹⁷⁹ *Id.* at *16.

¹⁸⁰ *Id.*

¹⁸¹ *Id.* See also *Papa John's Int'l, Inc. v. Dynamic Pizza, Inc.*, 317 F. Supp. 2d 740, 749 (W.D. Ky. 2004) (holding that a franchisee's claims for fraudulent inducement and misrepresentation failed because, among other reasons, "all of the statements made by [the franchisor] concerned future events, were statements that were merely predictive, and were statements which Defendants could not [have] reasonably relied upon."); See also *Healy v. Carlson Travel Network Assocs., Inc.*, 227 F. Supp. 2d 1080 (D. Minn. 2002) (granting franchisor summary judgment and holding that, under the Illinois Franchise Disclosure Act and common-law fraud, only misstatements of present material facts are actionable, and the franchisee alleged no such misstatements when it alleged fraud with respect to future earnings representations); *Haque Travel Agency, Inc. v. Travel Agents Intern., Inc.*, 808 F. Supp. 569 (E.D. Mich. 1992) (holding that statements of franchisor that total investment of capital necessary would be about \$85,000, that agency would "turn around" within 12 to 18 months, that agency's gross profit once business was established would be approximately \$300,000 and that franchisor would play substantial role in operation of franchise were not fraudulent under Michigan law).

¹⁸² See *Bixby's Food Sys., Inc. v. McKay*, 193 F. Supp. 2d 1053, 1065 (N.D. Ill. 2002) (noting that Illinois courts have created an exception for promises of future conduct where the promises are made in bad faith with the intent to deceive).

¹⁸³ 795 F.Supp.2d 365 (D. Md. 2011). The summary judgment decision in this case was discussed above. See *supra* notes 22-29 and accompanying text.

¹⁸⁴ *Id.* at 374.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* at 368.

franchisor subsequently revised its UFOC the next year with estimated startup costs \$132,000 to \$225,000 higher than those cited in the previous year.¹⁸⁷

In denying the franchisor's motion to dismiss those claims, the court cited an exception to the general rule that "cost projections are 'statements of opinion rather than statements of material fact' and therefore 'cannot constitute fraud' because 'they are not susceptible to exact knowledge at the time they are made.'"¹⁸⁸ The court cited Maryland law that whether "reliance on future projections of profit is reasonable depends both upon the manner in which the projections are represented and what in fact was known by the person claiming inferior knowledge."¹⁸⁹ The court found that the UFOC had encouraged the franchisee to rely on the cost estimates by specifically itemizing various cost categories and providing sub-estimates for each one and by stating the estimates were based on 15 years of industry experience.¹⁹⁰ Despite the franchisor's assertions that cost projections were statements of opinion and thus not a basis for fraud, the court held that erroneous projections could potentially result in a finding of fraud.¹⁹¹

Similarly, in *Motor City Bagels, LLC v. Am. Bagel Co.*,¹⁹² discussed briefly above, the franchisee alleged the franchisor committed a violation of the Indiana Franchise Act and common law fraud when it allegedly understated the amount of the initial investment necessary to operate the business. The franchisee claimed it received a 1993 UFOC estimating the initial investment at \$240,400 to \$304,500 per store.¹⁹³ The franchisor updated those figures in its subsequent UFOC and increased the estimated investment to \$288,300 to \$376,000, but the franchisee alleged it was never given the 1994 UFOC before signing an area development agreement.¹⁹⁴ At the summary judgment stage, the court sustained the franchisee's claims, holding that the franchisee "presented evidence of a false representation of a material, pre-existing fact: assuming that the plaintiffs did not receive an updated copy of [the franchisor's]

¹⁸⁷ *Id.*

¹⁸⁸ *Id.* at 376 (quoting *Flynn v. Everything Yogurt*, No. HAR92-3421, 1993 WL 454355 (D. Md. Sept. 14, 1993)).

¹⁸⁹ *Id.* (quoting *Payne v. McDonald's Corp.*, 957 F. Supp. 749, 761 (D. Md. 1997)).

¹⁹⁰ *Id.*

¹⁹¹ Procedurally, this ruling was made on a motion to dismiss. *Id.* at 372. On such a motion, the court accepts the well-pleaded allegations of the complaint as true, and must construe the factual allegations in the light most favorable to the plaintiff. *Id.* See also *Andersen v. Griswold Int'l, LLC*, No. 14-cv-02560-EDL, 2014 WL 12694138 (N.D. Cal. Dec. 16, 2014) (denying franchisor's motion to dismiss fraud claims where the franchisee alleged that the franchisor misrepresented the feasibility of its homecare independent contractor business model, because though the viability of that business model going forward was a prediction of a future event, the franchisor allegedly represented to the franchisee that federal laws would protect the independent contractor model even if state law changed, and concealed that the model was being challenged in other jurisdictions). As discussed above, however, on summary judgment the court concluded that there were factual disputes as to whether the initial investment estimates were false when made, and, therefore, the court refused to enter summary judgment on the fraud claims related to the initial investment estimates. See *supra* notes 22-29 and accompanying text.

¹⁹² 50 F. Supp. 2d 460, 466–71 (D. Md.1999); see *supra* notes 18-21 and accompanying text.

¹⁹³ *Motor City Bagels, LLC*, 50 F. Supp. 2d at 466.

¹⁹⁴ *Id.*

UFOC in November 1994, then the cost information contained in the disclosure document was not based on the latest available data as the defendants had represented.”¹⁹⁵

In a similar vein, in *Robinson v. Perpetual Services Corp.*,¹⁹⁶ a franchisee alleged a franchisor committed fraud and negligent misrepresentation when it assured the franchisee during the sales process that it would not solicit other franchises in the area, and then a short time later began soliciting other franchises in the area. The franchisor argued the statement was not actionable because it was of future intent and only a later change in circumstances compelled the franchisor to solicit other franchises in the area.¹⁹⁷ The court disagreed, observing that under Iowa law, “a statement of intent to perform a future act is actionable if when made the speaker had an existing intention not to perform,” and affirming the jury’s verdict against the franchisor on that basis.¹⁹⁸

Given the foregoing, jurisdiction specific research is critical when faced with a representation that may concern opinions or future performance rather than past or present facts. A cause of action for fraudulent misrepresentation of past or present facts will exist. But unfulfilled promises or statements as to future events likely cannot be the basis for a fraud action, unless the representations are made in bad faith or the franchisor had no intention of performing at the time the representation is made.

C. Materiality

Most jurisdictions require a plaintiff to prove “materiality” in misrepresentation claims. The following cases illustrate the typical facts, issues, and arguments involved in litigating that element.

In *Motor City Bagels, L.L.C. v. American Bagel Co.*,¹⁹⁹ the court determined that, under the Indiana Franchise Act, updated information concerning the start-up costs for a franchise was material because it would alter the total mix of information available to the prospective franchisee. There, the franchisee claimed that it was provided with a 1993 UFOC which showed initial investment expenses for the franchise ranging from \$240,400 to \$304,500.²⁰⁰ However, the franchisee claimed that the franchisor had already drafted (and filed) its 1994 UFOC, which showed initial investment costs ranging from \$288,300 to \$376,000.²⁰¹ The court held the information was “unquestionably material as it would significantly alter the total mix of information available to a prospective franchisee.”²⁰² The court noted that “[a] comparison of the

¹⁹⁵ *Id.* at 473.

¹⁹⁶ 412 N.W.2d 562 (Iowa 1987).

¹⁹⁷ *Id.* at 565.

¹⁹⁸ *Id.* (citing *Hagarty v. Dysart-Geneseo Cmty. School Dist.*, 282 N.W.2d 92, 95 (Iowa 1979); *Grege v. Ross*, 231 N.W.2d 863, 867 (Iowa 1975)).

¹⁹⁹ 50 F. Supp. 2d 460 (D. Md. 1999).

²⁰⁰ *Id.* at 469.

²⁰¹ *Id.*

²⁰² *Id.* at 470.

initial investment costs reported in the 1993 UFOC with the figures listed in the 1994 UFOC shows a nearly twenty percent increase at the low end of the range (from \$240,400 to \$288,300) and a twenty-three percent rise at the high end (from \$304,500 to \$376,000).²⁰³ The court further noted that "the initial investment cost constituted a central assumption in the [franchisees'] business plan and changes in this variable clearly have a dramatic impact on the profitability of such enterprises."²⁰⁴

Conversely, in *Harb v. Norrell Corp.*,²⁰⁵ the United States District Court for the Western District of Washington held that the percentage of franchisees that had or had not met their franchise agreement sales quotas was not material. In assessing the materiality of the fact, the court used the Supreme Court's formulation of the definition of "material" under federal securities laws²⁰⁶ from *TSC Industries, Inc. v. Northway, Inc.*,²⁰⁷ under which an item of information is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote," or, put another way, there is a substantial likelihood that a reasonable investor would have viewed the information as "having significantly altered the 'total mix' of available information."²⁰⁸ The court reasoned that the information regarding the sales quotas was not material because:

[t]he Minimum Performance Criteria contained in [the franchisor's] franchise agreements varied depending on the population of the franchisee's exclusive territory. Further, whether a particular franchisee met or did not meet the requirements under his or her franchise agreement with [the franchisor] depends to a significant degree on the unique market conditions in the territory, and the franchisee's ability and diligence. As a consequence, information about how other franchisees performed during some time period under *their* Minimum Performance Criteria in *their* exclusive territories had little relevance to how plaintiffs could expect to perform in the future in their exclusive territories.²⁰⁹

Along those same lines, in *Something Sweet, LLC v. Nick-N-Willy's Franchise Company, LLC*,²¹⁰ the Washington Court of Appeals held that an anticipated change in the way new

²⁰³ *Id.*

²⁰⁴ *Id.* See also *Enservco, Inc. v. Indiana Sec. Div.*, 623 N.E.2d 416 (Ind. 1993) (holding that where a franchisor failed to disclose that underground testing equipment associated with its system was tested by Environmental Protection Agency (EPA), and that results indicated that equipment did not meet EPA standards, the information was "material" because "[t]he performance capacity of the [piece of equipment] is a piece of information which a reasonable investor would certainly consider crucial to an investment decision. A reasonable investor would likely have viewed the EPA test results as 'having significantly altered the total mix' of available information.").

²⁰⁵ *Harb v. Norrell Corp.*, No. C91-1448, Bus. Franchise Guide (CCH) ¶ 10,231 (W.D. Wash. 1993).

²⁰⁶ *Id.* at 6.

²⁰⁷ 426 U.S. 438, 449 (1976).

²⁰⁸ *Id.* (citations omitted).

²⁰⁹ *Harb*, Bus. Franchise Guide (CCH) ¶ 10,231, at 6-7.

²¹⁰ 156 Wash. App. 817 (Wash. Ct. App. 2010).

system stores might operate in the future was not material. There, the FDD indicated that the franchisor offered two different models of franchises: outlet stores which sold “take and bake” pizzas that customers purchased and baked at home and restaurants which permitted customers to either, “take and bake” the pizza or purchase a cooked pizza to eat on premises.²¹¹ The franchisee selected an outlet model.²¹² The franchisee claimed that the franchisor knew and failed to disclose that it was planning to discontinue the outlet store model when the franchisee purchased the franchise.²¹³ The appellate court upheld the lower court’s grant of summary judgment to the franchisor.²¹⁴

As these cases illustrate, there are several important legal and factual issues involved in litigating the materiality of a deceptive representation, omission, or practice. First, there can be complex questions surrounding what legal standard applies to the term “material.” Though the FTC Rule itself does not provide a definition of the term “materiality,” the FTC’s guidance in the Statement of Basis and Purpose provides insight into the standard.²¹⁵ According to the FTC, a deceptive representation, omission, or practice is material if it is “likely to affect consumers’ conduct or decisions with respect to the product at issue.”²¹⁶

That said, since there is no private right of action for an FTC Rule violation,²¹⁷ the standard applicable to the meaning of the term “material” is usually driven by the governing state statutory (or common law) standard. This can significantly complicate an FDD misrepresentation case because it means that there may be information not otherwise required to be disclosed under the FTC Rule that could nevertheless be considered material to a prospective franchisee and the basis of a misrepresentation claim under state law. This issue is further complicated by the fact that the 2007 amendment to the FTC Rule specifically added a

²¹¹ *Id.* at 819.

²¹² *Id.* at 821.

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ Before 2007, the FTC Rule included the following definition of the term “material”:

any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchise business or which has any significant financial impact on a franchisee or prospective franchisee.

16 C.F.R. 436.2(n). In 2007, when the rule was amended, the FTC removed the definition, and, in response to comments in the rulemaking process, stated that it believed that the definition was “not necessary” because “an understanding of materiality under the final amended Rule can best be gained by looking to long-established Commission jurisprudence” on Section 5 of the FTC Act. Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15444, at 15455 (March 30, 2007). The FTC further clarified that when interpreting Section 5 it regards “a representation, omission, or practice to be deceptive if: (1) it is likely to mislead consumers acting reasonable under the circumstances; and (2) it is material; that is, *likely to affect consumers’ conduct or decisions with respect to the product at issue.*” *Id.* (emphasis in original).

²¹⁶ Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15444, at 15455 (March 30, 2007). According to the FTC, under this standard, “‘materiality’ is determined by a reasonable consumer standard, or in the franchise context, by the reasonable prospective franchisee standard.” *Id.*

²¹⁷ See *supra* note 136.

prohibition against adding materials or information to a disclosure document other than that specifically circumscribed in the Rule or by state law not preempted by the Rule.²¹⁸

This issue was addressed by the Colorado Court of Appeals in *Colorado Coffee Bean, LLC v. Peaberry Coffee, Inc.*²¹⁹ In that case, the franchisee asserted that the franchisor fraudulently failed to disclose that its parent company (which operated the company-owned outlets) had suffered significant financial losses.²²⁰ Under the FTC Rule, the parent company was not acting as a guarantor, so the franchisor was not required to include the parent's financial statements in its FDD.²²¹ In defense of its failure to disclose the parent company's financial losses, the franchisor argued that the FTC Rule's prohibition on non-required information meant that the franchisor was actually prohibited from including its parent company's financial performance.²²² The court rejected the argument, noting that the relevant provision of the FTC Rule deals only with "financial statements" and that the FTC Rule "does not preclude franchisors . . . from giving other non-deceptive information orally, visually, or in separate literature so long as such information is not contradictory to the information in the disclosure statement."²²³ On this point, the court quoted the Statement of Basis and Purpose's statement that "franchisors are always free to disseminate additional truthful material information to a prospective franchisee."²²⁴

Additionally, it should be noted that there appears to be a disconnect between the "materiality" disclosure standard intended for franchisors under the FTC Rule, and the "materiality" disclosure standard applicable to federal securities laws that some states apply to

²¹⁸ 16 C.F.R. § 436.6(d) ("Do not include any materials or information other than those required or permitted by part 436 or by state law not preempted by part 436."). See also Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15444, at 15515-6 (March 30, 2007) (confirming the "Rule's policy prohibiting franchisors from including additional materials in their disclosures, except for information 'required or permitted by this Rule or by state law not preempted by this Rule.'"). In response to this provision, several commentators expressed concern during the rule making process that this creates an "unfair trap for franchisors and subfranchisors" that "need to include information in a disclosure document that it believes is material or possibly material (even though the information is not required or permitted under federal or state law) or that it believes will help a prospect to better understand required information or its significance." STAFF REPORT TO THE FEDERAL TRADE COMMISSION ON REVISIONS TO THE FTC RULE, at 213, available at <https://www.ftc.gov/sites/default/files/documents/reports/staff-report-bureau-consumer-protection-federal-trade-commission-and-proposed-revised-trade/0408franchiserulerpt.pdf>). In response to those comments, the FTC reaffirmed that it is "inappropriate for a franchisor to add unauthorized information to a disclosure document" aside from "brief footnotes or clarifications to ensure that a required disclosure is complete and not misleading." *Id.* at 214. The FTC further explained this "could unnecessarily bulk-up the disclosures, or offer an opportunity to distract attention away from potentially negative disclosures." *Id.* That said, the FTC also cautioned the "prohibition on adding to a disclosure document is a narrow one," and that "[f]ranchisors are always free to provide prospective franchisees with non-deceptive and noncontradictory information outside of a disclosure document." *Id.*

²¹⁹ 251 P. 3d 9 (Colo. 2010).

²²⁰ *Id.* at 15.

²²¹ *Id.* at 22.

²²² *Id.*

²²³ *Id.*

²²⁴ *Id.* (quoting Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15444, at 15516 n.733, 15531 n.886 (March 30, 2007)).

their state franchise disclosure statutes.²²⁵ Under the FTC's intended standard, a representation, omission, or practice is "material" if it "is likely to affect the consumer's conduct or decision with regard to a product or service."²²⁶ As FTC guidance provides, "[i]f so, the practice is material, and consumer injury is likely because consumers are likely to have chosen differently but for the deception."²²⁷ However, under the traditional formulation of materiality applicable to federal securities laws, a representation, omission, or practice is "material" if a reasonable market participant would "consider it important" in making a decision to transact business because such information "alters the total mix" of information available.²²⁸ The difference between these two standards is significant, and litigators must carefully consider which standard is applicable in a given case.

D. Reliance

Under the common law of almost all jurisdictions, reliance is a critical element underpinning both fraud and negligent misrepresentation theories. It typically must be justifiable or reasonable, and it must have been detrimental for the person to have relied on the misrepresentation. However, some state franchise disclosure laws and state Little FTC Acts do not require reliance. Therefore, those types of claims may provide a vehicle for franchisees that cannot demonstrate reliance, either because of an integration, merger, or disclaimer clause (discussed in the next section), or because of the factual circumstances involved. Moreover, as discussed above, some states alter reliance standards in the face of omissions claims.²²⁹

In most circumstances, the question of whether a franchisee relied on a representation in an FDD is highly factual. In order to develop arguments regarding the element of reliance, counsel is likely to explore the facts and circumstances surrounding what the franchisee knew before receiving the representation, when the franchisee received the representation, what the franchisee did with the representation thereafter, and what information the franchisee learned (or could have learned) thereafter regarding the fact or subject matter at the heart of the representation. Valuable sources of proof include franchisee business plans, pro formas, and projections, as well as materials gathered and created during the franchisee's own due diligence.

²²⁵ Several states have expressly adopted the "materiality" standard applicable to federal securities laws. See, e.g., *Enservco, Inc. v. Indiana Sec. Div.*, 623 N.E.2d 416, 423 (Ind. 1993) (adopting the U.S. Supreme Court's formulation of the materiality standard articulated in *T.S.C. Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)); *Proimos v. Fair Auto. Repair, Inc.*, 808 F.2d 1273, 1276-7 (7th Cir. 1987) (noting that the "materiality" standard under the Illinois Franchise Disclosure Act is the same as that under the SEC's Rule 10b-5 formulation); but see *7-Eleven, Inc. v. Spear*, No. 10-cv-6697, 2011 WL 2516579, at *7 (N.D. Ill. June 23, 2011) (holding that under the Illinois Franchise Disclosure Act a franchisor "was not under an obligation to disclose every piece of information that may have been material to [the franchisee's] investment decision" but was "obligated to provide disclosure in accordance with the Guidelines").

²²⁶ Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15444, at 15455 (March 30, 2007); FTC POLICY STATEMENT ON DECEPTION (Oct. 14, 1983), available at https://www.ftc.gov/system/files/documents/public_statements/410531/831014deceptionstmt.pdf.

²²⁷ FTC POLICY STATEMENT ON DECEPTION, *supra* note 227.

²²⁸ *T.S.C. Industries*, 426 U.S. at 449; *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988).

²²⁹ See *supra* notes 164-167 and accompanying text.

For example, in *Solanki v. 7-Eleven, Inc.*,²³⁰ the United States District Court for the Southern District of New York denied a franchisor's motion for summary judgment on a franchisee's claims under the New York Franchise Sales Act. There, the franchisee alleged that the franchisor's presale revenue estimates should have been included in the FDD, and that its earnings estimates were false.²³¹ At or shortly after the parties' initial meeting to discuss the store, the franchisor provided the franchisee with an FDD and a business plan outline to complete.²³² At a subsequent meeting, the franchisee presented his completed business plan, which was approved by the franchisor.²³³ The franchisor never provided the franchisee with any sales projections that it had created, and no projections prepared by either party ever were included in the FDD.²³⁴ During its first year of operation, the store failed to achieve the business plan's projected sales levels, and the franchisor terminated the franchise agreement at the franchisee's request.²³⁵ The franchisee then filed suit.²³⁶ In its motion for summary judgment, the franchisor argued that the franchisee had admitted to making up his mind that he wanted to buy the specific store at issue before he ever received the FDD.²³⁷ Therefore, according to the franchisor, the franchisee could not have relied on any alleged financial representations.²³⁸

The court, however, disagreed, holding that the distinction between *wanting* to buy a franchise and conclusively *deciding* to do so based on information received was a disputed issue of material fact for trial.²³⁹ The court reasoned that:

making up one's mind that he *wants* to buy a particular store and making up one's mind that he is committed to actually go through with the purchase based on information are two different things. [The franchisee] testifies in his declaration that while he expressed his desire to acquire the store prior to viewing the Franchise Disclosure Document—desire that he testifies in both his deposition and his declaration was necessary to get [the franchisor] to provide the Franchise Disclosure Document in the first place—he did not decide or make a commitment to do so until afterwards. Thus, whether [the franchisee] relied on [the

²³⁰ No. 12 Cvi. 00027(LES), 2014 WL 320236 (S.D.N.Y. Jan. 29, 2014).

²³¹ *Id.* at *3.

²³² *Id.* at *1.

²³³ *Id.* at *2.

²³⁴ *Id.*

²³⁵ *Id.*

²³⁶ *Id.* at *3.

²³⁷ *Id.* at *4.

²³⁸ *Id.*

²³⁹ *Id.*

franchisor's] alleged representation is a disputed issue of material fact for trial.²⁴⁰

Conversely, where it can be shown that a franchisee did extensive due diligence and relied on its own projections, not the franchisor's representations, those facts may preclude a finding of reasonable reliance. For example, in *JM Vidal Inc. v. Texdis USA, Inc.*,²⁴¹ a franchisee sued a franchisor in the United States District Court for the Southern District of New York under the Washington Franchise Investment Protection Act (WFIPA) because the franchisor allegedly made fraudulent misrepresentations and unlawful earnings claims. In granting the franchisor's motion for summary judgment and dismissing these claims, the court reasoned that, in addition to extensive disclaimers in the franchise agreement (discussed below), the record showed that the franchisee was an experienced retailer that aggressively pursued the franchisor (a European company) for a U.S. franchise.²⁴² The franchisee had written to the franchisor that based on its analysis, a franchise in Seattle would be "very successful" and that obtaining a franchise quickly was an "emergency."²⁴³ The franchisee further performed his own due diligence and made his own performance projections.²⁴⁴ The court determined that reliance by the franchisee on alleged earnings claims under these circumstances was not justified.²⁴⁵

Similarly, in *Steak 'n Shake Enterprises, Inc. v. Globex Co., LLC*,²⁴⁶ the United States District Court for the District of Colorado granted summary judgment to a franchisor on a franchisee's common law fraud claims. There, the franchisee claimed the franchisor's Item 19 was false or misleading in a number of ways, including "having higher projected sales volumes than actual sales, having projections which significantly overstated the expected profit, understating projected costs, and withholding operating expenses of four franchised restaurants which would have shed light on the misleading nature of representations in Item 19."²⁴⁷ The court held that the franchisee could not have justifiably relied on the information in Item 19 in part because the franchisee conducted its own extensive research—"[it] had [its] CPA look at the numbers in Item 19, [it] consulted with [its] attorneys, and [it] did [its] own calculations."²⁴⁸

²⁴⁰ *Id.*

²⁴¹ 764 F. Supp.2d 599 (S.D.N.Y. 2011).

²⁴² *Id.* at 605.

²⁴³ *Id.*

²⁴⁴ *Id.*

²⁴⁵ *Id.* at 614.

²⁴⁶ 110 F. Supp. 3d 1057, 1084 (D. Colo. 2015), *aff'd*, 659 F. App'x 506 (10th Cir. 2016).

²⁴⁷ *Id.* at 1084.

²⁴⁸ *Id.* See also *Cold Stone Creamery, Inc. v. Lenora Foods I, LLC*, 332 F. App'x 565, 567 (11th Cir. 2009) (affirming dismissal of a franchisee's statutory fraud claims because, among other things, the record demonstrated that the franchisee had conducted an independent investigation and understood the franchise agreement it signed); *BP West Coast Products LLC v. SKR, Inc.*, 989 F. Supp. 2d 1109, 1120 (W.D. Wash. 2013) (dismissing franchisee's claims for fraud and negligent misrepresentation because the evidence established that the franchisee did not rely on the franchisor's allegedly inaccurate statements regarding the estimated gross margins that the franchisee could earn on the sale of gasoline and other products because the franchisee relied on estimates provided by third parties and the franchisee's independent research); *Century Pacific, Inc. v. Hilton Hotels Corp.*, 354 F. App'x. 496, 499 (2nd Cir.

Reliance standards under state franchise disclosure statutes and Little FTC Acts can prove vexing for even the most experienced litigants. However, some states' franchise disclosure statutes do not require reliance as an element of a claim. For example, in *Governara v. 7-Eleven, Inc.*,²⁴⁹ the court declined to dismiss a New York Franchise Sales Act ("NYFSA") Section 683 claim on reliance grounds because reasonable reliance was not a required element of this section of the NYFSA. Section 683 of the NYFSA enumerates the information that franchisors must disclose in a written statement when advertising and selling franchises.²⁵⁰ While the court dismissed the franchisee's claims for fraudulent misrepresentation under NYFSA Section 687, it observed that "reliance is not a required element of a claim under § 683, and [the franchisee] failed to cite any cases holding otherwise."²⁵¹

E. Disclaimers

1. Common Scenarios

Various documents that a franchisee executes in the process of purchasing a franchise may contain disclaimers. There are generally three types of disclaimers involved in the franchise context: integration clauses, non-reliance clauses, and no-authority clauses. Other types of contractual clauses that may be characterized as a type of disclaimer include acknowledgments and waivers. Franchisors have enjoyed considerable success in defending against affirmative misrepresentation claims through the use of merger, integration, and non-reliance clauses in franchise agreements and other documents.

Merger/integration provisions generally provide that the franchise agreement is the entire agreement between the parties and that all prior understandings, representations or agreements are superseded by the written agreement. Provisions disclaiming reliance are also common. Those provisions are typically in the franchise agreement, or documents ancillary to the transaction, and state that the franchisee disclaims the existence of any representations, guarantees or promises other than those set forth in the FDD or the franchise agreement, and further states that the franchisee has not relied upon any such representations, guarantees or promises when entering into the franchise agreement. Such disclaimers are often accompanied by a statement in Item 19 of the franchisor's FDD that the franchisor has not authorized anyone

2009) (holding that a franchisee could not demonstrate reliance on a franchisor's statement regarding its commitment to retaining ownership of the brand after the evidence showed that the franchisee knew at the time it bought the franchise that the brand might be sold); *Guesthouse Int'l Franchise Sys., Inc. v. British Am. Props. MacArthur Inn, LLC*, No. 3:07-0814, 2009 WL 278214 (M.D. Tenn. Feb. 5, 2009) (holding that a franchisee could not claim reasonable reliance on statements in a UFOC because the franchisee did not assert that it had ever read the UFOC and even asserted that no UFOC was delivered).

²⁴⁹ No. 13-CV-6094 (LAP), 2014 WL 4476534 (S.D.N.Y. Aug. 20, 2014).

²⁵⁰ *Id.* at *4.

²⁵¹ *Id.* See also *Volvo Trucks N. Am. v. Andy Mohr Truck Ctr.*, No. 1:12-cv-448-WTL-DKL, 2013 WL 2938913, at *4 (S.D. Ind. June 14, 2013) (dismissing claims for violation of Indiana's Franchise Disclosure Act because the franchisee could not show reasonable reliance, but sustaining claims under the Indiana Unfair Practices Act and Indiana Crime Victims' Act because those claims do not require reliance) *aff'd on reh'g*, 2013 WL 12177049 (S.D. Ind. Oct. 17, 2013); *Randall v. Lady of Am. Franchise Corp.*, 532 F.Supp.2d 1071, 1086 (D. Minn. 2007) (holding that reasonable or justifiable reliance is not required under the Minnesota Franchise Act, and observing that "of course, some kind of reliance—reasonable or unreasonable—is required, because a franchisee can only recover for damages that are caused by a franchisor's violation of the Minnesota Franchise Act").

to make any financial performance representations (other than those contained in Item 19) to prospects and that if a prospect receives any such representations, it should alert the franchisor to its existence.

For example, in *Healy v. Carlson Travel Network Association, Inc.*,²⁵² a “closing checklist” played a significant role in the court’s decision to dismiss all of the plaintiff’s fraud-related claims on summary judgment. There, at the closing of the sale of the franchise, the franchisee was given a “Franchise Closing Checklist”—a one-page list of statements for the franchisee to initial, certifying that he fully understood certain key points of the franchise relationship.²⁵³ The court held that summary judgment was warranted on the franchisee’s fraud claim for future expected earnings because the franchisee “specifically disclaimed that he had been given or relied on any oral or written promises, representations or assurances of any specific actual, projected or pro forma sales, profits, earnings or breach even point” for his franchise.²⁵⁴

From a franchisor’s perspective, disclaimers are used to ensure finality and preclude post-deal claims for fraudulent inducement. A franchisor is likely to argue that a franchisee should not be permitted to rely on extra-contractual statements upon which they contract not to rely. Additionally, disclaimers can serve legitimate business purposes and help a franchisor root out fraud and dishonest sales personnel.²⁵⁵

Franchisees, on the other hand, are likely to view such disclaimers as designed to make it more difficult to succeed in proving an actionable misrepresentation claim. A franchisee is likely to argue that the franchise agreements and ancillary documents are one-sided, as the franchisor drafts them, and can thus control the language to insulate itself from legitimate misrepresentation claims.

In FDD misrepresentation cases where a disclaimer is involved, a detailed comparison between the alleged misrepresentation and the specific language of the disclaimer is critical. For example, in *Fantastic Sams Salons Corp. v. PSTEVO, LLC*,²⁵⁶ the United States District Court for the Northern District of Illinois granted a franchisor’s motion to dismiss a franchisee’s fraudulent misrepresentation counterclaim. There, the franchisee alleged that prior to entering into the parties’ franchise agreement, the franchisor presented him with an FDD falsely stating that he would only need three months of working capital to open a franchise, and that he could expect the franchise to be profitable thereafter. The franchisee asserted that these disclosure documents were consistent with oral representations made by the franchisor’s agents and with statements published on its website.²⁵⁷ The franchisor argued that two disclaimers in the

²⁵² 227 F. Supp. 2d 1081, 1082 (D. Minn. 2002).

²⁵³ *Id.* at 1082.

²⁵⁴ *Id.*

²⁵⁵ See *Emfore Corp. v. Blimpie Assocs., Ltd.*, 860 N.Y.S.2d 12, 51 A.D.3d 434 (N.Y. App. Div. 2008) (holding that by requesting franchisees to disclose whether a franchisor’s representatives made statements concerning the financial prospects for the franchise during the sales process, franchisors can effectively root out dishonest sales personnel and avoid sales secured by fraud).

²⁵⁶ No. 15 C 3008, 2016 WL 8856662 (N.D. Ill. Jan. 15, 2016).

²⁵⁷ *Id.* at *1.

franchise agreement precluded the franchisee from claiming that he relied on the franchisor's or its agents' representations regarding projected profitability.²⁵⁸ The disclaimers stated: (1) "No oral, written or visual claim or representation which contradicted the disclosure document was made to me, except: _____," and (2) "No oral, written or visual claim or representation which stated or suggested any sales, income, or profit levels was made to me, except: _____."²⁵⁹ After each disclaimer, the franchisee wrote the word "none" and initialed his response.²⁶⁰ The court found that the first disclaimer was not effective to bar the franchisee's claims because the alleged misrepresentation made by the franchisor's agents and contained on its website was consistent with, rather than contradicted by, the disclosure documents.²⁶¹ However, the franchisor successfully argued that the second disclaimer expressly disclaimed the representation on which the franchisee had allegedly relied, and the court dismissed the claim.²⁶²

Similarly, in *Sherman v. Ben & Jerry's Franchising, Inc.*,²⁶³ the United States District Court for the District of Vermont granted, in part, a franchisor's motion to dismiss a franchisee's claims regarding allegations of fraudulent inducement, fraudulent nondisclosure, fraud, and negligent misrepresentation pertaining to the information set forth in Item 19 of the franchisor's Uniform Franchise Offering Circular. The plaintiffs alleged that the information contained in Item 19 of the franchisor's UFOC was false and misleading, and that it improperly induced them into entering into a franchise relationship.²⁶⁴ In partially granting the franchisor's motion to dismiss, the court found the UFOC and franchise agreement contained specific disclaimers that there were no guarantees of success or profits and that the plaintiffs acknowledged that no such representations had been made.²⁶⁵ The court also found that the plaintiffs represented to the franchisor in signing the franchise agreement that they conducted an independent investigation of the business of running a shop.²⁶⁶ The court concluded that such disclaimers and acknowledgements precluded the plaintiffs from claiming justifiable reliance on the information contained in Item 19 of the UFOC.²⁶⁷

²⁵⁸ *Id.* at *2.

²⁵⁹ *Id.*

²⁶⁰ *Id.*

²⁶¹ *Id.*

²⁶² *Id.*

²⁶³ No. 1:08-CV-207, 2009 WL 2462539 (D. Vt. Aug. 10, 2009).

²⁶⁴ *Id.* at *2.

²⁶⁵ *Id.* at *3.

²⁶⁶ *Id.*

²⁶⁷ *Id.* at *4. See also *Avon Hardware Co. v. Ace Hardware Corp.*, 2013 IL App (1st) 130750, 998 N.E.2d 1281, 1285 (Ill. App. Ct. 2013) (rejecting an appeal by franchisees based in Illinois and Indiana that the franchisor had presented them with financial pro formas that unlawfully overstated the franchisees' likelihood of success and concluding that the franchisees could not have relied, as a matter of law, on pro formas which had included disclaimer language stating that the pro formas were "merely estimates and should not be considered as the actual or potential sales, profits or earnings that will be realized by any specific store operator").

It should be noted that the FTC and several states discourage disclaimers in the FDD itself. The FTC's Franchise Rule provides that it is "an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act for any franchise seller covered by part 436 to . . . disclaim or require a prospective franchisee to waive reliance on representations made in the disclosure documents and in its exhibits or amendments."²⁶⁸ However, this prohibition is not a total ban on disclaimers. In adopting the 2007 Amended Rule, the FTC stated that:

After carefully reviewing the record, the Commission is persuaded that a limited disclaimer prohibition, rather than a total ban, is warranted. As an initial matter, the Commission is convinced that integration clauses and waivers serve valid purposes, including ensuring that a prospective franchisee relies solely on information authorized by the franchisor or within the franchisor's control in making an investment decision. For example, a franchisor reasonably may seek to disclaim responsibility for unauthorized claims made by former or existing franchisees, or unattributed statements found in the trade press. Therefore, at the very least, integration clauses and waivers protect a franchisor from unauthorized statements or representations made by non-agent, third parties.²⁶⁹

Additionally, the prohibition applies only to representations in the disclosure documents.²⁷⁰ Therefore, some franchise agreements, with this prohibition in mind, expressly exclude from the disclaimer provisions any statements made in the FDD.²⁷¹

One common argument to avoid disclaimers in a franchise agreement is that the franchisee did not read or understand the disclaimer. However, that argument is generally not effective. For example, in a case involving claims that a franchisor made improper earnings claims, and that the franchisee was fraudulently induced to sign a franchise agreement with false information from historical earnings of existing franchisees, the Georgia Supreme Court reversed a favorable jury verdict and remanded the case for a new trial.²⁷² In *Legacy Academy, Inc., v. Mamilove, LLC*, the evidence at trial revealed that the franchisor first made the allegedly

²⁶⁸ 16 C.F.R. § 436.9(h) (2018).

²⁶⁹ Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15444, at 15533-36 (March 30, 2007).

²⁷⁰ "At the same time, we are persuaded that franchise sellers should not be able to use integration clauses or waivers to insulate themselves from false or deceptive statements made in a franchisor's disclosure document. This is particularly true of those sections of the disclosure document pertaining to matters other than the terms of the franchise agreement that cannot be negotiated, such as the franchisor's prior business experience, litigation history, financial performance representations, and financial statements. The Commission has long recognized that the integrity of a franchise's disclosures is critical to prospective franchisees who rely on franchisee from voluntarily waiving specific contract terms and conditions set forth in his or her disclosure document during the course of franchise sales negotiations." *Id.* at 15533-36.

²⁷¹ See, e.g., *La Macaron, LLC v. Le Macaron Dev. LLC*, No. 8:16-CV-918-17TGW, 2016 WL 6211718, at *4 (M.D. Fla. Oct. 24, 2016) (noting that a nonreliance provision expressly excluded statements in the FDD, and thus fraud claims based on statements in the FDD were not barred by the nonreliance provision).

²⁷² *Legacy Acad., Inc., v. Mamilove, LLC*, 771 S.E.2d 868 (Ga. 2015).

misleading earnings claims and then, later, delivered the FDD and the franchise agreement on the same day the franchisee signed them— without reading them.²⁷³

The franchisor claimed that the trial court erred in denying its motion for a directed verdict on the fraud, negligent misrepresentation, and statutory fraud claims, and that the court of appeals erred in affirming this denial.²⁷⁴ The Georgia Supreme Court agreed, stating that a party who has the capacity and opportunity to read a written contract cannot later claim fraud in the procurement of his or her signature to the contract based on differing extra-contractual representations.²⁷⁵ The court determined that because the pre-contractual earnings claim upon which the franchisee and its owners allege they relied expressly contradicted the disclaimer and acknowledgment provisions of the franchise agreement, the franchisee's reliance on the earnings claims was unreasonable as a matter of law.²⁷⁶ The court held that absent any evidence of fraud that prevented the franchisee from reading the agreement, the franchisor should have prevailed on these claims.²⁷⁷

2. Specificity Of The Disclaimer

Some courts make a distinction between general boiler-plate disclaimers and more specific disclaimers. Specific disclaimers generally have more power to bind a franchisee than general disclaimers, and are thus generally more effective to bar an FDD misrepresentation claim.

For instance, in *C&M Hardware v. True Value Co.*,²⁷⁸ the Wisconsin Court of Appeals declined to enforce two exculpatory clauses in the parties' agreement. The franchisee sued the franchisor for misrepresentations that were allegedly made to induce it to become a franchisee.²⁷⁹ The trial court granted the franchisor's motion for summary judgment based on the language in two different exculpatory provisions in the parties' contract.²⁸⁰ The Wisconsin Court of Appeals reversed the ruling on these misrepresentation claims after determining that the exculpatory language failed to clearly, unambiguously, and unmistakably explain to the franchisee the risks it was accepting, and the form of the exculpatory provisions did not alert the franchisee of the nature and significance of the document being signed.²⁸¹

One of the provisions at issue stated that True Value had made "NO REPRESENTATIONS OR WARRANTIES EITHER EXPRESS OR IMPLIED REGARDING THE

²⁷³ *Id.* at 869-870.

²⁷⁴ *Id.*

²⁷⁵ *Id.* at 871-872.

²⁷⁶ *Id.* at 871.

²⁷⁷ *Id.* at 872.

²⁷⁸ 348 Wis.2d 761 (Wis. Ct. App. 2013).

²⁷⁹ *Id.* at 761.

²⁸⁰ *Id.*

²⁸¹ *Id.*

PERFORMANCE OF [the franchisee's] BUSINESS," and the other was a standard integration clause that identified the written contract as the entire and complete agreement between the parties.²⁸² However, under Wisconsin law, an exculpatory clause in a contract must specifically identify the tort that is being disclaimed.²⁸³ The court of appeals concluded that the contract did not clearly indicate that the franchisor required the franchisee to waive its right to any tort claims in general, let alone misrepresentation claims in particular.²⁸⁴ It noted that neither exculpatory provision was sufficiently conspicuous to provide C&M with adequate notice of its nature and significance, since the two disclaimers appeared on separate pages of the contract, but on neither the first nor the last page.²⁸⁵ The provisions did not have a heading or other feature that would draw attention to them, and were merely two sentences among 35 paragraphs of "often opaque legalese."²⁸⁶ Based on these deficiencies, the court concluded that the exculpatory clauses were void and unenforceable as against Wisconsin public policy, and it reversed the trial court's summary judgment with respect to the franchisee's misrepresentation claims.²⁸⁷

Similarly, in *D.T. Woodard, Inc. v. Mail Boxes Etc., Inc.*,²⁸⁸ the California Court of Appeals, reversed a trial court's grant of summary judgment in favor of a franchisor regarding its former franchisees' claims for negligent misrepresentation and violation of the California Franchise Investment Law and the California Corporations Code. The franchisor was acquired by another company, which changed the name of the franchise and altered the franchise system.²⁸⁹ The new franchisor undertook to persuade franchisees of the acquired brand to convert to the new brand. The franchisee plaintiff converted its existing franchises consistent with the rebranding encouraged by the new franchisor.²⁹⁰ Subsequently, the plaintiff brought suit against the new franchisor, alleging that the new franchisor had misled it into converting its stores, thus committing negligent misrepresentation and breaching the California Franchise Investment Law and the California Corporations Code.²⁹¹ The trial court granted the franchisor's motion for summary judgment, finding that the plaintiff failed to show any false statements of material fact or justifiable reliance on the basis of certain disclaimers in certain market test studies that were provided to the franchisee.²⁹² The franchisee appealed, and in reversing the summary judgment, the court of appeals found that, among other things, the disclaimers the

²⁸² *Id.*

²⁸³ *Id.*

²⁸⁴ *Id.*

²⁸⁵ *Id.*

²⁸⁶ *Id.*

²⁸⁷ See also *Carousel's Creamery, L.L.C. v. Marble Slab Creamery, Inc.*, 134 S.W.3d 385, 395 (Tex. Ct. App. Jan. 15, 2004) (holding that a merger and integration clause did not bar a negligent misrepresentation claim because it contemplated only contractual obligations, not tort claims).

²⁸⁸ No. B228990, 2012 WL 90084 (Cal. Ct. App. Jan. 12, 2012).

²⁸⁹ *Id.* at *2.

²⁹⁰ *Id.*

²⁹¹ *Id.* at *3.

²⁹² *Id.*

franchisor put in certain market test summaries were not effective to preclude the franchisee's reliance on misrepresentations and omissions of fact in the reporting of test results and of the testing procedures that produced those results.²⁹³ The court noted that "[t]he disclaimers did not advise or warn franchisees to disregard test results, and elsewhere defendants reported tests results in such a way as to emphasize their reliability."²⁹⁴

Commentators have observed that the distinction between general and specific disclaimers strikes a reasonable balance in the franchisor-franchisee context:

It places responsibility on franchisors to make their disclaimer provisions obvious and specific rather than broadly worded. Broad, generalized disclaimers may be less likely to jump out to a prospective franchisee as applying to representations that have been made to them. Specific disclaimers, however, should have a red flag effect, and a scrupulous franchisee should be alerted to a conflict between the provision and representations being made outside of the agreement.²⁹⁵

3. Anti-Waiver State Statutes

Several state franchise laws void contractual provision that purport to waive a franchisee's rights under the statute.²⁹⁶ Franchisees typically argue that these types of provisions thus render a disclaimer void to the extent it waives a franchisee's rights. A 2007 decision from the United States District Court for the District of Minnesota summarizes the rationale and operation of such state statutes:

The court recognizes that, under its broad interpretation of [the Minnesota Franchise Act], franchisors cannot use contractual provisions to protect themselves from being sued for misrepresentation under the Minnesota Franchise Act. Consequently, even scrupulously honest franchisors will have to defend against some misrepresentation claims that would not be brought – or that would be quickly dismissed – if contractual disclaimers were enforceable. But under the interpretation of section 80C.21 advocated by [the franchisor] – that is, under a rule in which courts give effect to contractual disclaimers regardless of whether franchisors have actually made false statements of material facts – a certain number of franchisees who have been lied to will have no redress against dishonest franchisors. The Minnesota legislature has decided to burden

²⁹³ *Id.* at *8.

²⁹⁴ *Id.*

²⁹⁵ Erin E. Conway, *No Fair! Finding an Equitable Balance in Enforcement of Disclaimer Provisions in Franchise Agreements and Franchise Disclosure Documents*, 33 Franchise L.J. 323, 335 (Winter 2014).

²⁹⁶ See, e.g., MINN. STAT. ANN. § 80C.21 ("Any condition, stipulation or provision, including any choice of law provision, purporting to bind any [covered franchisee] to waive compliance or which has the effect [of] waiving compliance with any provision of Sections 80C.01-80C.22 or any rule or order thereunder is void.").

franchisors, and protect franchisees, and this Court is bound to enforce that decision.²⁹⁷

Coraud LLC v. Kidville Franchise Co.,²⁹⁸ discussed briefly above, serves as a useful illustration of how these anti-waiver provisions can save a franchisee's claims. The United States District Court for the Southern District of New York held that a provision in a franchise agreement disclaiming a franchisee's reliance on statements made outside of the franchise disclosure document was sufficient to defeat a claim for common law fraud, but was insufficient to bar a cause of action for statutory fraud under the New York Franchise Sales Act ("NYFSA").²⁹⁹ Prior to the sale of the franchise, the franchisor had made representations regarding market and demographic analysis, projected revenues, costs, and profits of the franchise.³⁰⁰ When the franchisee's revenues and costs significantly differed from the franchisor's projections, it filed suit, claiming that the representations made by the franchisor and its franchise sales team during the negotiation process constituted both common law and statutory fraud.³⁰¹ The franchisor moved to dismiss both claims based on a clause in the franchise agreement that disclaimed liability for representations as to "volume, sales, income or profits [of the franchised business]" not expressed in the disclosure document.³⁰² The court held that the franchisee could not prevail on its common-law fraud claim because the disclaimer covered "the very matter" about which it alleged it was defrauded.³⁰³ Significantly, however, the court found that the anti-waiver clause in the NYFSA voided any franchise agreement provision that relieves an individual of a duty or liability established under the NYFSA, including provisions that may waive fraud claims like the disclaimer in the franchise agreement at issue.³⁰⁴ The court noted that policies underlying the NYFSA supported this interpretation and that the NYFSA was enacted to protect New York residents who may be defrauded by aggressive salespeople who do not provide full and complete information.³⁰⁵ Accordingly, the court granted the franchisor's motion to dismiss the franchisee's common-law fraud claim but denied its motion to dismiss the claims under the NYFSA.³⁰⁶

²⁹⁷ *Randall v. Lady of Am. Franchise Corp.*, 532 F. Supp. 2d 1071, 1089 (D. Minn. 2007).

²⁹⁸ 109 F. Supp. 3d 615 (S.D.N.Y. June 12, 2015).

²⁹⁹ *Id.* at 620.

³⁰⁰ *Id.* at 618.

³⁰¹ *Id.* at 619.

³⁰² *Id.* at 620.

³⁰³ *Id.*

³⁰⁴ *Id.* at 620-621.

³⁰⁵ *Id.* at 621.

³⁰⁶ *Id.* See also *Solanki v. 7-Eleven, Inc.*, No. 12 Cvi. 00027(LES), 2014 WL 320236, at *5 (S.D.N.Y. Jan. 29, 2014) (reasoning that a disclaimer of reliance can only be upheld as to common law fraud claims, and since the franchisee's claims were made under the NYFSA, which prohibits the waiver of any duty or liability imposed by the act, the disclaimer was ineffective); *Emfore Corp. v. Blimpie Associates, Ltd.*, 860 N.Y.S.2d 12, 51 A.D.3d 434, 435 (N.Y. App. Div. 2008) (dismissing a franchisee's common law fraud claim in light of a disclaimer contained in a questionnaire that a franchisee executed at or around the time it purchased the franchise, but holding that the franchisee's statutory claim remained viable and that the disclaimers only created an issue of fact as to the extent and reasonableness of the franchisee's reliance on the alleged earnings claims, and did not bar the claims entirely,

However, courts may draw a distinction between a waiver of one's rights, and an acknowledgement of non-reliance.³⁰⁷ For example, in *Moxie Venture L.L.C. v. The UPS Store, Inc.*,³⁰⁸ a court dismissed a franchisee's claim against a franchisor under the Minnesota Franchise Act ("MFA"). The franchisee alleged that the franchisor had fraudulently induced it to enter into the franchise agreement by misrepresenting the best location for the franchisee's store and the franchisee's anticipated revenue, cash flow, and operating profits in violation of the MFA.³⁰⁹ The franchisor moved to dismiss the MFA claim on the grounds that the franchisee could not demonstrate that it reasonably relied on any alleged misrepresentations in light of the franchise agreement's express disclaimers.³¹⁰ In dismissing the MFA claim, the court observed that the franchisee had expressly acknowledged through the disclaimer provisions that it had not relied on any representations regarding anticipated earnings before entering into the franchise agreement.³¹¹ The franchisee argued that because the MFA voids any contractual provision that purports to waive a franchisee's rights under the statute (including the statute's prohibition against material false statements), the disclaimer provisions were invalid as a matter of law.³¹² The court held, however, that the disclaimers did not have the effect of waiving any of the franchisee's statutory rights and merely served as an acknowledgment of the franchisee's non-reliance.³¹³ The court's conclusion on that point is contrary to the *Randall* decision quoted above and authored by another judge in the District of Minnesota.³¹⁴

because waivers are barred by the NYFSA); *but see Governara v. 7-Eleven, Inc.*, No. 13-CV-6094 (LAP), 2014 WL 4476534, at *4-7 (S.D.N.Y. Aug. 20, 2014) (declining to dismiss a franchisee's NYFSA Section 683 claim because reasonable reliance is not a required element of the claim, but dismissing the franchisee's NYFSA Section 687 claim, reasoning the franchisee could not establish reasonable reliance in light of a disclaimer of reliance contained in the franchise agreement, in which the franchisee confirmed he did not rely on statements contrary to, or outside of, the FDD, and rejecting argument that the nonreliance disclaimer violated the NYFSA's non-waiver provision.).

³⁰⁷ See e.g., *Ellering v. Sellstate Realty Sys. Network, Inc.*, 801 F. Supp. 2d 834, 845 (D. Minn. 2011) ("[H]ere, the Court concludes it is impossible for Plaintiffs to show reasonable reliance upon the alleged misrepresentations. This is not simply because of the 'general disclaimer' in the UFOC [], which in the Court's view should have planted seeds of doubt in the [franchisees] minds about [the franchisor's] representations. Rather, it is because the [franchisee] expressly acknowledged in the [agreement] that they 'ha[d] not relied upon any guarantee, warranty, projection, forecast or earnings claim, whether express, implied, purported or alleged, in entering into' that agreement. . . . Under these facts, the Court concludes, as a matter of law, that [the franchisees] cannot show reasonable reliance upon the alleged misrepresentations.").

³⁰⁸ 156 F. Supp. 3d 967 (D. Minn. Jan. 12, 2016).

³⁰⁹ *Id.* at 969.

³¹⁰ *Id.* at 969-70.

³¹¹ *Id.* at 970.

³¹² *Id.*

³¹³ *Id.*

³¹⁴ *Supra* note 298. *But see Long John Silver's Inc. v. Nickleson*, 923 F. Supp.2d 1004, 1018 (D. Ky. Feb. 12, 2013) (denying in part a franchisor's motion for summary judgment against a franchisee's claims of violations of the Minnesota Franchise Act and common law fraud, based on the franchisor's allegedly false and misleading statements concerning future profitability and the past performance of other franchisees). In the *Nickleson* case, the franchisor argued that any reliance on representations about profitability was unreasonable because of the multiple disclaimers about costs and projected revenue in the franchising documents. *Id.* at 1016. While the court acknowledged that those disclaimers were relevant to a determination of reasonable reliance, it also noted that conflicting Minnesota case law on the subject could have led the franchisee to reasonably believe that such disclaimers would not be

IV. CONCLUSION

As this paper demonstrates, there are a number of considerations and doctrines unique to litigating FDD misrepresentation or fraud claims. While there are common causes of action and defenses to be expected when litigating FDD misrepresentation claims, there are significant differences between the laws of the states. For a franchisor, understanding its obligations under the Amended Rule, carefully drafting the disclosures, and documenting the basis for its disclosures will guard against lawsuits and, if a lawsuit is filed, assist in defending against it. For a franchisee discovering fraud or misrepresentations in the FDD, counsel should understand all of the possible causes of action available as some fair far better in the courts than others.

upheld in court. *Id.* at 1017. Therefore, the court held that there was a genuine issue of material fact regarding whether the franchisee reasonably relied on the alleged misrepresentations, and it denied summary judgment. *Id.* at 1018.

SPEAKER BIOGRAPHIES

The Honorable Nicole S. Zellweger is a judge for the Twenty-First Judicial Circuit (St. Louis County) of Missouri. Prior to taking the bench, Judge Zellweger was a partner with Stinson Leonard Street LLP and was the head of its franchise and distribution practice group. During her years in private practice, Judge Zellweger assisted franchise clients in their litigation and transactional needs all over the country. For more than ten years, Judge Zellweger has been a regular author and speaker for the American Bar Association Forum on Franchising. Judge Zellweger has been recognized many consecutive years as a "Franchise Times Legal Eagle" and a "Rising Star" in franchise and dealership law by *Super Lawyers* and included several times in the *International Who's Who of Franchise Attorneys*. Nicole graduated *Order of the Coif* from Washington University in St. Louis School of Law. She resides in St. Louis, Missouri, with her family.

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