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LITIGATING DISCLOSURE CLAIMS

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Appendix A
LITIGATING DISCLOSURE CLAIMS

I. INTRODUCTION\(^1\)

For decades, franchisors have provided prospective franchisees with pre-sale disclosures designed to allow those franchisees to engage in due diligence to assess the costs, benefits, and potential legal and financial risks associated with entering into a franchise relationship.\(^2\)

While the basic intent of such disclosures is to provide sufficient information about the potential advantages and disadvantages associated with purchasing the franchise and to minimize system conflict by providing prospective franchisees with information ordinarily available only through a franchise seller,\(^3\) the adequacy of such disclosures continues to be a hotly-contested issue in franchise litigation.

This paper will discuss disclosure-related claims typically made by aggrieved franchisees, potential new claims available to franchisees as a result of the recently amended federal disclosure framework, the franchisor’s defenses to such disclosure-related claims, and the array of remedies available to injured parties.

II. DISCLOSURE CLAIMS

As more fully set forth below, franchisees who allege that they have not been provided with disclosures consistent with either state or federal law have typically pursued relief under state statutory disclosure frameworks, deceptive trade practices statutes, and/or fraud-based common law theories (e.g., alleging a failure by the franchisor to comply with disclosure requirements under federal law).

A. Disclosure Framework under the Amended Rule and the UFOC Guidelines

In the United States, franchise disclosures requirements are addressed on the federal level, as well as by fifteen states that have enacted their own pre-sale disclosure requirements.\(^4\)

As an initial matter, all U.S.-based prospective franchisees are entitled to written disclosures mandated by the Federal Trade Commission ("FTC")\(^5\) unless the disclosure is exempt from regulation. The FTC originally proffered such regulations on October 21, 1979 (as part of what shall hereinafter be referred to as the “original FTC Rule”) and subsequently amended such disclosure requirements on January 22, 2007 (i.e., under the “Amended Rule”).\(^6\)

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\(^1\) The authors wish to thank Mary Kellerman of Dady & Garner, Will White of Haynes and Boone, LLP and Daniel Oates of Graham & Dunn for their invaluable contributions to the research and development of this paper.


\(^3\) Id.

\(^4\) Id. at ¶ 15444.

\(^5\) Id. at ¶ 15448.

\(^6\) See Introduction to the FTC Compliance Guide, Bus. Franchise Guide (CCH) ¶ 6,085 at p. i.
Presently, all franchise sellers must make their required disclosures pursuant to the Amended Rule.\(^7\)

The Amended Rule, like the original FTC Rule and the UFOC Guidelines, is designed to provide the prospective franchisee with information material to his/her decision to purchase a franchise.\(^8\)

The Amended Rule utilizes an updated version of the familiar UFOC Guidelines multi-“Item” disclosure format (which had become the industry standard prior to the establishment of the Amended Rule),\(^9\) but the Amended Rule was modified to reduce inconsistencies with state franchise disclosure laws in those fifteen states that have separately enacted disclosure frameworks for the benefit of prospective franchisees.\(^10\)

While the Amended Rule, like its predecessor, does not provide an aggrieved franchisee with a private right of action,\(^11\) the violation of the Amended Rule’s disclosure requirements may give rise to a potential claim under: (i) fraud-based common law theories, and/or (ii) state deceptive trade practice statutes (ordinarily referred to as “little FTC Acts”).\(^12\)

When asserting disclosure-related claims against franchisors,\(^13\) franchisee counsel may explore the potential claims discussed below, many of which have proven successful under the

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\(^7\) See id. During the period from July 1, 2007 until July 1, 2008, franchisors could comply with federal disclosure requirements by using any one of the following formats: (1) the original FTC Rule; (2) the Uniform Franchise Offering Circular Guidelines (“UFOC Guidelines”) promulgated by the North American Securities Administrators Association (“NASAA”); or (3) the Amended Rule. Id. In June 2008, NASAA adopted the 2008 Franchise Registration and Disclosure Guidelines as a replacement to its “UFOC” Guidelines and 2007 “Interim” Franchise Guidelines.

\(^8\) See 72 Fed. Reg. at ¶ 15447.

\(^9\) Id. at ¶ 15448. Under the original FTC Rule, franchisors were deemed to be in compliance with the disclosure requirements when they executed either a disclosure document as outlined in the original FTC Rule, or a document complying with UFOC Guidelines. See Bus. Franchise Guide (CCH) at ¶ 6027(F) (formerly providing that “[t]he Commission will permit franchisors to use the UFOC format in lieu of the disclosure document provided by the [FTC] Rule”). While the Amended Rule essentially adopts the UFOC Guidelines, it also retains aspects of the original FTC Rule that are not included in the UFOC Guidelines or state disclosure laws. See 72 Fed. Reg. at ¶¶ 15448-15449. Some of these new disclosure requirements are discussed, infra, at Section II(C) of this paper.

\(^10\) See 72 Fed. Reg. at ¶¶ 15444 and 15448. The Amended Rule preserves most of the provisions of the original rule, and the SBP associated with the original FTC Rules remains valid unless it conflicts with the Amended Rule. Id. at ¶ 15449. The FTC has also suggested that it will likely adopt the sample UFOC answers and NASAA’s commentaries on the UFOC Guidelines. Id.

\(^11\) See, e.g., Akers v. Bonifasi, 629 F. Supp. 1212, 1221-1222 (M.D. Tenn. 1984); Baum v. Great Western Cities, Inc. v. New Mexico, 703 F.2d 1197, 1209 (10th Cir. 1983); Dreisbach v. Murphy, 668 F.2d 720, 730 (9th Cir. 1981); Fulton v. Hecht, 580 F.2d 1243, 1249 n. 2 (5th Cir. 1978); Alfred Dunhill Ltd. v. Interstate Cigar Co., Inc., 499 F.2d 232, 237 (2d Cir. 1974); and Holloway v. Bristol-Myers Corp., 485 F.2d 986, 988-989 (D.C. Cir. 1973).

\(^12\) Such state common law and statutory theories are discussed, infra, at Section II(E) of this paper.

\(^13\) When pursuing claims against a franchisor, a franchisee should consider whether a franchisor’s control persons may also be liable for disclosure violations. See, e.g., Pagham Chicken, Inc. v. Loghar Restaurant Corp., Bus. Franchise Guide (CCH) ¶ 8,554 (N.Y. Sup. Ct. March 26, 1985); and Geri’s West, Inc. v. Ferrall, 505 N.E.2d 1348, Bus. Franchise Guide (CCH) ¶ 8,824 (III. App. 1987).
“original” FTC Rule -- as well as a handful of new arguments potentially available under the Amended Rule.\textsuperscript{14}

B. Frequently Asserted Claims

Prior to the adoption of the Amended Rule, franchisees frequently pursued claims with respect to the disclosures required under Items 7 (initial investment), 8 (restrictions on sources of product and services), and 19 (earnings claims) of the UFOC Guidelines. As more fully discussed below, the content of these disclosure requirements has, in large part, been maintained under the Amended Rule, and franchisees will likely continue to pursue disclosure-related claims under Items 7, 8, and 19 of the Amended Rule based on the franchisor’s failure to comply with these Items.

1. Item 7 -- Estimated Initial Investment

One of the first questions asked by potential franchisees -- and one of their most significant considerations in making a decision as to whether to purchase a franchise -- regards the initial investment required to open a particular franchise. Recognizing the prominence and significance of this concern, the Amended Rule continues to require franchisors to provide the potential franchisees with information about estimated initial investments. As a result, franchisees will likely continue to litigate claims related to a franchisor’s failure to provide reasonable and accurate cost estimates.

Item 7 requires that franchisors make certain disclosures in regards to expenditures associated with opening a franchise.\textsuperscript{15} For example, the franchisor must disclose the initial franchise fee, training expenses, real property expenses, opening inventory costs, and expenses for other equipment, among other items.\textsuperscript{16} An “initial investment” includes those expenses that are paid through the opening of the franchise and through a three-month period following opening.\textsuperscript{17}

Another category of expenses that must be disclosed is entitled “Additional funds – initial period.”\textsuperscript{18} A “reasonable initial period” is at least three months or whatever time period is standard in the industry.\textsuperscript{19} This category should outline all the costs necessary to operate the franchise for a designated start-up period, including owner’s salary unless otherwise noted.\textsuperscript{20}

\textsuperscript{14} A franchisee that succeeds in proving a disclosure claim may be able to recover compensatory damages, rescind the franchise agreement, and/or recover any consideration that it paid to the franchisor. \textit{See, infra}, at Section IV of this paper.

\textsuperscript{15} 16 C.F.R. § 436.5(g).

\textsuperscript{16} \textit{Id.} at § 436.5(g)(1).

\textsuperscript{17} Federal Trade Commission, \textit{Franchise Rule Compliance Guide}, at 10 (May 2008), \textit{available at} \url{http://www.ftc.gov/bcp/franchise/franchise-rule-compliance-guide.pdf} (last visited July 25, 2008). Therefore, “initial investment” does not include future obligations, such as rent.

\textsuperscript{18} \textit{Id.} at § 436.5(g)(1)(iii).

\textsuperscript{19} \textit{Id.}

\textsuperscript{20} \textit{Id.}
The “Additional funds” category must also describe the franchisor’s basis for arriving at the amounts reflected.\textsuperscript{21} The franchisors must present this information in table form, outlining the type of expenditure, amount, method of payment, when payment is due, and to whom the payment is to be made.\textsuperscript{22}

A prospective franchisee’s reliance on an understated cost estimate\textsuperscript{23} may result in the franchisee’s purchasing the franchise even though he or she may not have the funds necessary to fund the initial development of the franchised location. As a result, Item 7 claims arise when a franchisee asserts that the initial cost estimate is understated, calling into question whether the franchisor had a material basis upon which to make the initial investment estimate. For example, the initial investment estimate may fail to disclose that it does not take into account varying demographics (e.g., rent costs), or that it is based on the experience of corporate stores or licensed locations as opposed to franchise stores (with a different cost structure).

2. **Item 8 -- Restrictions on Sources of Products and Services**

Another piece of information that is of great interest to potential franchisees is whether they are required to purchase inventory and other items from designated suppliers and, if so, whether the franchisor is receiving a financial benefit from these vendors. This information is crucial because such arrangements between franchisors and vendors could have a palpable effect on a franchisee’s cost of sourcing the products and services needed for operation of the franchise from third party vendors.

The Amended Rule Item 8 continues to require that franchisors identify any obligation on the part of the franchisee to purchase or lease goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, or comparable items, related to establishing the franchised business either from the franchisor, its designee, or suppliers approved by the franchisor, or under the franchisor’s specifications.\textsuperscript{24}

For purposes of the Item 8 disclosure, a franchisor must specify:

- the good(s) and/or service(s) required to be purchased;
- whether certain suppliers are the only approved third party suppliers of the product;

\textsuperscript{21} *Id.*

\textsuperscript{22} *Id.* at § 436.5(g).

\textsuperscript{23} Franchisees asserting claims under Item 7 should be aware that at least one court has found that reliance upon promises *that contradict the initial investment disclosure under Item 7* is not reasonable. For example, in *American Casual Dining, L.P. v. Moe’s Southwest Grill, LLC*, the franchisee received a UFOC from the franchisor that provided an estimate of the initial investment required to develop and open a franchise. 426 F. Supp. 2d 1356 (N.D. Ga. 2008). The franchisee claimed that the franchisor’s representatives also made representations about the cost of food and labor when the parties were negotiating. *Id.* After opening the franchise, the franchisee discovered that the initial investment substantially exceeded what the franchisor represented it would be. However, the court rejected the franchisee’s fraud claim, holding that it was not reasonable for the franchisee to rely upon promises that were directly contradicted by the terms in the UFOC. *Id.* Because the UFOC explained that the range of costs that it gave would vary based on actual rental prices in the area of the restaurant and other site-specific requirements or regulations, the UFOC effectively implied that the figures were not intended as a forecast of the actual cost to any particular franchisee. *Id.*

\textsuperscript{24} 16 C.F.R. § 436.5(h).
• any interest that the franchisor or an officer of the franchisor has in a specified third party supplier;

• the franchisor’s criteria for approving alternative third party suppliers;

• whether the franchisor will derive a benefit as a result of the franchisee’s required purchases;

• the existence of system cooperatives;25

• the existence of any payments to be made to the franchisor from a third party supplier;26

• whether the criteria for approving suppliers are available to franchisees;27

• whether the franchisor provides material benefits to franchisees who use the designated suppliers,28 and

• any arrangement whereby the franchisor negotiates purchasing arrangements with suppliers on the behalf of franchisees.29

Obviously, the recurring themes with respect to Item 8 involve the franchisor’s disclosure of its interests arising out of its dealings with system suppliers and how such interests on the part of the franchisor may impact the franchisee.

Most Item 8 litigation results from a franchisor failing to disclose vendor rebates or other material consideration that the franchisor receives as a result of franchisees’ purchases from designated suppliers. For example, in Substantial Investments, Inc. v. D’Angelo Franchising Corp., the UFOC stated that franchisees must purchase products from a supplier designated by the franchisor.30 One supplier charged the franchisees a flat delivery fee and then rebated a portion of the delivery fee to the franchisor – a fact that was not disclosed in the UFOC.31 Even though the UFOC stated that the franchisor “may derive revenue as a result of your purchases of approved suppliers or from approved suppliers,” the court refused to dismiss the franchisee’s Robinson-Patman Act claim because the scheme forced the franchisees to operate at a competitive disadvantage.32

25 Id. at § 436.5(h)(9).

26 Id. at § 436.5(h)(1)-(11).

27 Id. at § 436.5(h)(4)(1).

28 Id. at § 436.5(h)(11).

29 Id.


31 Id.

32 Id.
Franchisees asserting claims referencing Item 8 should be careful to argue that they were required to purchase from certain suppliers from which the franchisor ultimately received undisclosed rebates. For example, in *Team Tires Plus, Ltd. v. Heartlein*, a franchisor was granted summary judgment on a franchisee claim that the franchisor had engaged in fraud by omission (based on the franchisor’s having received undisclosed rebates from vendors who charged the franchisees inflated prices).\(^{33}\) The court held that because the UFOC gave franchisees the right to purchase goods from any third-party vendor (and thus did not contain a requirement that franchisees purchase from designated suppliers), the agreements between the franchisor and the vendors were not required disclosures.\(^{34}\) *Team Tires Plus* has been interpreted as requiring Item 8 disclosure only of rebates (and other financial benefits to the franchisor) resulting from required purchases.

Item 8 litigation also arises in the context of claims by franchisees that their franchisor has not negotiated favorable supply agreements for the benefit of the system. In *C.K.H., LLC v. The Quizno’s Master, LLC*, a franchisee argued that the franchisor breached its contractual obligation under Item 8 to negotiate supply contracts for the benefit of franchisees when the franchisor received rebates from the suppliers.\(^ {35}\) While the court ultimately rejected the franchisee’s claim (because the UFOC also stated that the franchisor had the right to receive payments from suppliers and to use any volume discounts it received in any matter it deemed appropriate – including keeping the discounts for itself and not passing them on to the franchisees), franchisors must be careful that their Item 8 disclosures not imply an intention to negotiate favorable supply arrangements for the benefit of their franchisees if the franchisor is not, in fact, undertaking to negotiate for the benefit of its franchisees.\(^ {36}\)

Another argument that franchisees may assert under Item 8 stems from the broad definition of any “payment” to be disclosed, which term includes “the sale of similar goods or services to the franchisor at a lower price than to franchisees.”\(^ {37}\) Franchisors are, accordingly, required to disclose revenue resulting from transactions where they purchase goods from a third-party supplier, and then resell those goods at a higher price to franchisees. Failure to disclose these markups violates the Amended Rule and is likely actionable under state disclosure laws or as the basis of a common law fraud or misrepresentation claim.

**The Amended Rule**

The Amended Item 8 also mandates additional disclosures with respect to any supplier in which an officer of the franchisor owns an interest.\(^ {38}\) Litigation may arise as to whether a

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33 Bus. Franchise Guide (CCH) ¶ 12,821 (D. Minn. 2004).

34 Id.

35 Bus. Franchise Guide (CCH) ¶ 13,027 (D. Colo. 2005). In this case, the court assumed that the UFOC was a contract between the franchisee and the franchisor.

36 Id.; see also Siemer v. Quizno’s Franchise Co. LLC, No. 07-C-2170, 2008 WL 904874 (N.D. Ill. 2008) (rejecting the same argument when the UFOC and the franchise agreement repeatedly said that the franchisors would derive a benefit from the contracts with suppliers, and did not say that contracts would be negotiated for the sole benefit of the franchisees).

37 16 C.F.R. § 436.5(h)(8).

franchisor officer's *de minimis* ownership interest in a supplier has been properly disclosed. The factual question to be resolved will be whether the ownership interest is "material."\(^{39}\) Franchisors are well-advised to err on the side of disclosure (as franchisee attorneys will likely argue that such interests are necessarily material).

3. **Item 19 -- Financial Performance Representations (f/k/a "Earnings Claims")**

Perhaps the most important question asked by prospective franchisee investors is simply: "How much can I expect to make?" Not surprisingly, "false or misleading representations about the success of franchise systems and business opportunities were perhaps the most prevalent misrepresentations identified in the [FTC's] original rulemaking record."\(^{40}\) Recognizing the importance of profitability predictions to a prospective franchisee, the Amended Rule continues to impose a strict requirement on franchisors to either make a reasonable, accurate, and documented representation or to affirmatively disclaim any intention to make a performance representation.\(^{41}\) The Amended Rule replaces the phrase "earnings claim" with the phrases "financial performance representation" and "financial performance projection." A substantial amount of disclosure-related litigation deals with this particular issue.

Item 19 gives franchisors the option of either making a financial performance representation or making no claim about the potential earnings of a franchise and affirmatively so identifying the franchisor's intention to make no such claim through use of a "negative disclosure."\(^{42}\) If a franchisor elects to make a financial performance representation, the manner in which such representation may be made is tightly regulated.\(^ {43}\)

When a franchisor elects to make an earnings claim under Item 19, such claims must not only be accurate, they must also have a reasonable basis and be supported by back-up documentation available upon request to a prospective franchisee.\(^ {44}\) The disclosure must include an indication as to whether the representation is about historical or future performance;

\(^{39}\) *Id.* at § 436.5(h)(3); *see also* 72 Fed. Reg. ¶¶ 15444, 15487-88.

\(^{40}\) *See* 72 Fed. Reg. at ¶ 15451.

\(^{41}\) "Financial performance representation" is defined to mean:

> [A]ny 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.

*See* 72 Fed. Reg. at ¶ 15456. The reference to "actual" and "potential" performance representations captures both claims about past performance and assurances about future performance. *Id.* The change in terminology expands required Item 19 disclosures to include performance representations beyond earnings. For example, representations regarding occupancy rates for hotel franchises would be included as "financial performance representation." *Compliance Guide, supra* note 17, at 85.

\(^{42}\) 16 C.F.R. § 436.5(s).

\(^{43}\) *See generally* *id.*

\(^{44}\) *Id.* at § 436.5(s)(3).
specifics about each; and the material bases for any representations made.\textsuperscript{45} Courts have held that a franchisor violates the FTC Rule when, having elected to make an "earnings claim" (i.e., any oral, written, or visual representations that suggest potential sales or net profit levels) to a prospective franchisee, the franchisor fails to provide the prospective franchisee with substantiating documentation.\textsuperscript{46}

A franchisor who makes a negative disclosure under Item 19 may violate the FTC Rule if its representatives actually make earnings claims outside of the context of the written UFOC or Franchise Disclosure Document.\textsuperscript{47}

Item 19 claims frequently arise in the context of common law fraud and negligent misrepresentation actions. A performance representation will be deemed fraudulent either if it is knowingly false or when material facts regarding any affirmative representation are concealed with the intent to deceive.\textsuperscript{48} As more fully discussed in Section II(E)(1) below, the FTC Rule may be used to establish the existence of an affirmative disclosure duty, even though the Amended Rule, in and of itself, creates no private right of action.\textsuperscript{49} A franchisor’s failure to disclose information required by Item 19 (or, for that matter, with respect to any disclosure Item addressed under the Amended Rule) may constitute fraud by omission.

Item 19 litigation may also arise where: (i) the franchisor has no basis for the earnings claims or financial performance representations made in the disclosure document itself; and/or (ii) agents of the franchisor make performance related claims outside the context of the disclosure document itself (e.g., as part of an oral sales pitch).

The district court in Minnesota addressed both issues in \textit{Randall v. Lady of America Franchise Corp.}\textsuperscript{50} Franchisees brought an action under the Minnesota Franchise Act, claiming that the franchisor’s representatives made various misrepresentations about the prospective profitability of its franchises\textsuperscript{51}—notwithstanding the franchisor’s having contemporaneously made a \textit{negative UFOC disclosure} (stating that no earnings claims were made).\textsuperscript{52} The court noted that, in this situation, a franchisor may violate its disclosure obligations in two ways. Obviously, the franchisor could violate its legal duties to the franchisee if the earnings claims were false or without basis. Additionally, even if the earnings claims made were true, the fact that earnings claims were orally conveyed (in contradiction to the negative disclosure set forth in the UFOC) amounted to a violation. Notably, the \textit{Lady of America} court sustained the

\textsuperscript{45} \textit{Id.} at § 438.5(s)(3)(i)-(iii).

\textsuperscript{46} See \textit{e.g.}, \textit{FTC v. Minuteman Press}, 53 F. Supp. 2d 248, 259 (E.D. N.Y. 1998).

\textsuperscript{47} \textit{Compliance Guide}, supra note 177, at 86.


\textsuperscript{49} See discussion of "Rodopoulos" claims, \textit{infra} Part II(E)(1).

\textsuperscript{50} 532 F. Supp. 2d 1071, 1080 (D. Minn. 2007).

\textsuperscript{51} \textit{Id.} at 1078-1081.

\textsuperscript{52} \textit{Id.} at 1080.
franchisees’ claims notwithstanding the existence of a contractual disclaimer as to the existence of any pre-signing earnings claim.\textsuperscript{53}

The term “financial performance representations” arguably also encompasses statements other than those quantified in terms of dollars and cents. For example, in *Commercial Property Investments, Inc. v. Quality Inns International, Inc.*, a hotel franchisee brought a common law fraud claim against the franchisor.\textsuperscript{54} The franchisee’s claims were premised on representations made by the franchisor with respect to occupancy rates for similar hotels (which a franchisee might reasonably be anticipated to utilize in calculating its prospective revenue stream). The court refused to dismiss the franchisee’s fraud claims on summary judgment, despite a clause in the franchise agreement disclaiming any performance representations, because the performance representations were not squarely contradicted by the general disclaimer in the written agreement.\textsuperscript{56}

Another issue commonly litigated under Item 19 claims is the question of reliance. Drawing on the longstanding common law requirement that a plaintiff must prove reasonable reliance in order to pursue a claim of fraud, some courts have held that a franchisee’s reliance on a statement that is directly contradicted by a writing is unreasonable.\textsuperscript{56} (In other words, franchisees may have difficulty proving reasonable reliance on earnings claims made outside of the UFOC or other disclosure document when the disclosure document specifically states that no such claims have been made.) Note, however, that in *Lady of America*, the court held that “reasonable reliance” is not among the elements that a franchisee must prove in order to pursue a statutory disclosure claim.\textsuperscript{57}

The Amended Rule continues to require that a franchisor affirmatively address its intention to make any financial performance representations” (formerly described as “earnings claims”).\textsuperscript{58}

**The Amended Rule**

The definition of “financial performance representations” includes representations regarding non-monetary measures of performance,\textsuperscript{59} representations made either expressly or

\textsuperscript{53} See *id.* at 1090 (holding that a “disclaimer cannot change the historical facts of what representations were made. Rather, the disclaimer is attempting to change the legal effect of those representations. Instead of telling the franchisee, ‘You waive your right to sue me for any misrepresentation when you sign this agreement,’ the franchisor tells the franchisee, ‘You waive your right to sue me for certain misrepresentations--those you fail to list before signing this agreement.’). *But see Lang, Lang & Suhor Investors, L.L.C. v. The American Bagel Co.*, Bus. Franchise Guide (CCH) ¶ 11,447 (D. Md. April 29, 1998) (holding that a franchisee’s reliance on earnings claims was unreasonable when the UFOC stated that no earnings claims were made).

\textsuperscript{54} 938 F.2d 870, 875 (8th Cir. 1991).

\textsuperscript{55} *Id.* at 875-876.

\textsuperscript{56} See *Cantlock v. The Pillsbury Co.*, 719 F. Supp. 791, 829 (D. Minn. 1989) (noting that “a party cannot reasonably rely upon allegedly fraudulent promises which are directly contradicted by the terms of an applicable offering statement”). *But see Lang*, Bus. Franchise Guide (CCH) ¶ 11,516 (noting that reliance is not necessarily unreasonable when a franchisee receives a UFOC containing a negative disclosure prior to receiving other earnings claims).

\textsuperscript{57} *Randall*, 532 F. Supp. 2d at 1085-87.

\textsuperscript{58} 16 C.F.R. § 436(s)(2).
by implication, and references to either actual or potential performance.\textsuperscript{60} The Amended Rule specifically allows franchisors to make financial performance representations in the media when the information is directed to the general public and not specifically to prospective franchisees and the franchisor meets all requirements imposed by the FTC with respect to media claims.\textsuperscript{61}

In the event that the franchisor does not make any representations under Item 19, it must include an additional statement that the franchisee should not rely on unauthorized representations.\textsuperscript{62}

Finally, the Amended Item 19 states that a franchisor’s disclosure in regard to expense information does not qualify as a financial performance representation under Item 19.\textsuperscript{63} Therefore, a franchisor’s provision of cost and expense disclosures (e.g., as required under Item 7), or outside of the disclosure document itself, will not give rise to a violation of the franchisor’s disclosure obligations under Item 19.

C. New Theories Available under the Amended Rule

While the Amended Rule maintains many of the familiar disclosure requirements established under either the original FTC Rule and/or the UFOC Guidelines,\textsuperscript{64} new wrinkles under the Amended Rule may be the subject of litigation in the years to come.

While there is a paucity of decisions relating to disclosure issues arising under the Amended Rule, the following Items bear review by franchise sellers as the information required under each of these Items would be highly material to the decision by any prospective franchisee as to whether to purchase a franchise.\textsuperscript{65}

1. Items 1 & 12 -- Competition & Distribution Issues

Prospective franchisees have good reason to be interested in assessing whether they will face same-brand competition from other franchisees, their franchisor, the franchisor’s parents, and/or the franchisor’s affiliates.

\textsuperscript{60} See Commercial Property Investments, 938 F.2d at 875.

\textsuperscript{61} Gerald C. Wells & Dennis E. Wieczorek, A Road Map to the New FTC Franchise Rule, 27 Franchise L.J. (Fall 2007).

\textsuperscript{62} Id.

\textsuperscript{63} Id.

\textsuperscript{64} Id.

\textsuperscript{65} See, generally, 72 Fed. Reg. at ¶ 15444.

\textsuperscript{60} As an initial matter, even the definition of what constitutes a “franchise” relationship may be read as being broader than many state statutory requirements. This is so because, as detailed in the FTC’s Compliance Guide, p. 5, the sort of fee “payment” required to establish a franchise relationship may arise out of a payment to the putative franchisor for advertising assistance, training, and promotional literature, among other items not necessarily characterized as “franchise fees” for purposes of state disclosure statutes.
As was the case under UFOC Guidelines, the Amended Rule with respect to Item 12 accordingly requires the franchisor’s disclosure with respect to:

(1) the conditions, if any, under which a franchisor will approve the relocation of the franchisee’s business and the franchisee’s establishment of additional outlets; and (2) any present plans on the part of the franchisor to operate a competing franchise system offering similar goods or services.

Under Item 1 of the Amended Rule now requires the franchisor to identify its parent companies and their principle business addresses.66 “Parent” is defined as “an entity that controls another entity directly, or indirectly through one or more subsidiaries.”67 Such disclosure is necessary to allow franchisees to determine whether there are company-owned outlets with which the franchisee would be forced to compete (and that would not, otherwise, have been subject to disclosure as an “affiliate” under the original FTC Rule).68

Disclosure of controlling parents is necessary to “ensure that a prospective franchisee understands who may control or influence the franchisor’s operations.”69 The expanded definition of “parent” is based on the rationale that a prospective franchisee may be unable to thoroughly evaluate a franchise opportunity without being aware of whether another entity may actually control the franchisor -- particularly if that entity controls multiple brands.70

As described in the SBP, the FTC found compelling the written submission of a Pearle Vision franchisee who found himself in competition with company-owned Sears optical locations that were operated by a common parent, Cole National Corporation. The FTC concluded that “the disclosure of parent information would have alerted prospective Pearle Vision franchisees that their franchisor is owned by a company that operates competing outlets.”71 The Amended Rule would require that Cole be disclosed as a “parent,” thereby more fully informing a prospective franchisee of the competitive pressures he or she might face.72

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66 16 C.F.R. § 436.5(a)(1). The Amended Rule broadly requires the franchisor to disclose “[t]he name and principle business address of the franchisor; any parents; and any affiliates that offer franchises in any line of business or provide products or services to the franchisees of the franchisor.”

67 16 C.F.R. § 436.5(m). The focus on this definition is on the word “control.” If a parent owns a subsidiary, but does not control it by, for example, shaping its policies, the parent does not need to be disclosed. FTC, Amended Franchise Rule FAQ’s; see also 72 Fed. Reg. at ¶ 15463 (noting that “it is the control and resulting influence over the director of the franchisor – not mere ownership – that is material to a prospective franchisee”).

68 Road Map, supra note 618 at 107.

69 72 Fed. Reg. at ¶ 15484.

70 Id. at ¶ 15484.

71 Id. at ¶ 15483.

72 Id.
Item 12 of the Amended Rule also requires the franchisor to include a warning that a franchisee will not receive an exclusive territory and might face competition from the franchisor, other franchisees, or the franchisor’s other distribution channels.\textsuperscript{73}

Additionally, Item 12 requires that the franchisor address alternative channels of distribution, such as the right to use the Internet or telemarketing, and other methods of direct sale.\textsuperscript{74} This new disclosure is important for franchisees, as franchisees may face increased pressures from franchisors who seek to market their products through saturation sales, dual branding (e.g., for sales of similar goods by competing franchise systems), the Internet, and/or direct sales.

This new disclosure requirement regarding alternative channels of distribution is important for franchisees. As the world of “e-commerce” grows exponentially, more and more franchisees are facing competition from franchisors marketing their products by using the franchised trademark on websites. Litigation arises as a result. The Amended Rule is specifically designed to address these concerns.\textsuperscript{75}

For example, in Emporium Drug Mart, Inc. v. Drug Emporium, Inc., an arbitration panel found that franchisees were likely to succeed on their claim that franchisors were breaching the franchise agreements’ grant of exclusive territory by operating a website using the franchised marks.\textsuperscript{76} In granting a preliminary injunction in the franchisees’ favor, the panel noted that the franchisor marketed its website as a “full service drugstore” and attempted to build market share by offering prices far below those offered at the “brick and mortar” franchised stores.\textsuperscript{77} Therefore, the panel rejected the franchisor’s argument that the website was an alternative means of distribution permitted under the terms of the franchise agreement.\textsuperscript{78} Rather, the panel concluded that the website violated the terms of the franchise agreement prohibiting the franchisor from operating drug stores in the franchisees’ territory.\textsuperscript{79}

\textsuperscript{73} 16 C.F.R. § 436.5(l)(5)(i). The franchisor must include the language: “You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control.” Id. The former Uniform Franchise Operation Guidelines simply stated that the franchisor was permitted to “establish other franchised or company-owned outlets” that may compete with the franchisee.

\textsuperscript{74} 16 C.F.R. § 436.5(l)(5)(i).

\textsuperscript{75} 72 Fed. Reg. at ¶ 15491.

\textsuperscript{76} Bus. Franchise Guide (CCH) ¶ 11,966 (AAA Sept. 2, 2000).

\textsuperscript{77} Id.

\textsuperscript{78} Id.

\textsuperscript{79} Id. But see In re Arbitration Between Franklin 1989 Revocable Family Trust & H&R Block, Inc., Bus. Franchise Guide (CCH) ¶ 12,473 (AAA Dec. 31, 2002), which held that a tax preparation franchisor did not breach a territorial exclusivity provision by operating online tax preparation services because the language preventing a franchisor from “operating from a location” in the franchisee’s territory was ambiguous. The panel construed the language to mean that the franchisor did not violate the exclusivity provision as long as the online services did not “unreasonably intrude” upon the franchisee’s brick and mortar operation. Two members of the three-member arbitration panel found that the online services did not unreasonably intrude upon the franchisee’s business because the online services were directed toward a different market. The dissenting arbitrator argued that Drug Emporium controlled, and that any ambiguity should be construed against the franchisor who drafted the arbitration agreement.
Disputes like that in *Drug Emporium* may be avoided if franchisors comply with the Amended Rule and affirmatively address restrictions on the franchisee’s rights to utilize alternative channels of distribution.\(^{80}\)

Attorneys representing franchisees might reasonably examine whether the franchisor has adequately disclosed all distribution channels to which it claims exclusive rights.

2. **Item 13 -- Strength of the Trademark**

Because the right to use the franchisor’s mark is one of the central elements of the franchisor/franchisee relationship, prospective franchisees have reason to be interested in disclosures relating to the strength of the franchisor’s claim to the marks that form the foundation of the franchise system.

As was the case under the UFOC Guidelines, the Amended Rule with respect to Item 13 requires that the franchisor must make the following disclosures:

- Whether the trademark is registered with the United States Patent and Trademark Office,\(^{81}\)
- The existence of pending litigation regarding the franchisor’s use or ownership rights in a trademark,\(^{82}\)
- Agreements or superior rights that may limit the franchisee’s use of the trademark,\(^{83}\) and
- The franchisee’s rights in the event the franchisee is required to modify or discontinue use of the trademark.\(^{84}\)

Further, Item 13 now also requires that the franchisor include a more extensive warning when the franchisor’s principle trademark is not registered with the United States Patent and Trademark Office.\(^{85}\) This revised requirement under Item 13 reflects the fact that one of the main reasons a franchisee enters into a franchise system is use of the franchisor’s marks.\(^{86}\)

A franchisor’s failure to disclose the limitations on the franchisor’s claim to its marks may well be fodder for litigation in years to come.

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\(^{80}\) 15 C.F.R. § 436.5(l)(8)(i).

\(^{81}\) *Id.* at § 436.5(m)(2).

\(^{82}\) *Id.* at § 436.5(m)(6).

\(^{83}\) *Id.* at § 436.5(m)(7).

\(^{84}\) *Id.* at § 436.5(m)(8)(vi).

\(^{85}\) *Id.* at § 436.5(m)(4).

\(^{86}\) See 72 Fed. Reg. ¶ 15493.
3. **Item 17 -- Renewal Terms**

Franchisees may find an additional area of litigation in newly required disclosures for the franchisee’s right (or lack thereof) to “renew” their franchise agreements.

Under the Amended Rule’s Item 17 disclosure, a franchisor must specifically define what the term "renewal" means for purposes of the franchise system in question.\(^{87}\) This change is significant because different franchise systems have different applications of the term “renewal.”\(^{88}\) Most franchisors, for example, consider renewal rights to mean a right to enter into a new agreement but only pursuant to the “then-current" terms of the standard form agreement being offered to new franchisees to the system. Some franchisors -- and most franchisees -- consider “renewal" to be the right to extend the existing agreement for a designated period of time.\(^{89}\)

Under the original FTC Rule, franchisees and franchisors would often disagree as to the nature of the “renewal" obligation.\(^{90}\) For its part, the FTC has concluded “that the term ‘renewal' is a franchising term of art, meaning that upon the expiration of a contract, the franchisees may have the right to enter into a new contract, where materially different terms and conditions may apply."\(^{91}\)

That said, going forward, franchisors must define not only whether a “renewal" opportunity is available to the franchisee but what “renewal" means for the franchise system in question.\(^{92}\) Franchisors must affirmatively disclose whether a franchisee shall be required to sign a new contract that contains “materially different terms and conditions than their original contract."\(^{93}\) If so, the franchisor has the flexibility to convey such fact using “a statement of their own choosing as long as it conveys the idea that the renewal agreement may impose materially different terms and conditions than those in the original agreement" between the parties.\(^{94}\)

Because each franchisor’s disclosure with respect to a franchisee’s renewal right will be fact-specific, Item 17 would seem to be an area likely to generate new disclosure claims. Ultimately, franchisors that have not affirmatively disclosed that “renewal” means executing a materially different agreement upon expiration of the initial term will likely face claims from franchisees seeking to renew under those terms set forth in the franchisee’s initial franchise agreement.

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\(^{87}\) 16 C.F.R. § 436.5(q).

\(^{88}\) Compliance Guide, supra note 177, at 81.

\(^{89}\) Id.

\(^{90}\) 72 Fed. Reg. at ¶ 15496.

\(^{91}\) See 16 Fed. Reg. at ¶ 15496.

\(^{92}\) See id.

\(^{93}\) 16 C.F.R. § 436.5(g).

\(^{94}\) Compliance Guide, supra note 177, at 81.
4. **"Franchise Sellers" Defined Broadly**

The Amended Rule not only expands potential claims for franchisees who suffer damages as a result of a franchisor’s disclosure violation; it also widens the spectrum of individuals who may be held liable for damages resulting from disclosure violations.

The Amended Rule defines “franchise seller” broadly as “a person that offers for sale, sells or arranges for the sale of a franchise [including] the franchisor and the franchisor’s employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities.”

As such, agents of the franchisor, in addition to the franchisor itself, may find themselves facing the sorts of “control person” liability previously addressed only as part of a handful of state disclosure statutes.

The definition of “franchise seller” does, however, exclude from the Amended Rule’s coverage a franchisee who is seeking to sell his or her own outlet.

5. **New Prohibitions on Merger and Integration Clauses**

Perhaps most notably, the Amended Rule prohibits franchisors from using merger or integration clauses in franchise agreements in an effort to avoid liability for misrepresentations or omissions in their disclosure documents.

The Amended Rule expressly declares it an unfair practice for a franchisor to require a franchisee to “[d]isclaim or require a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments.”

This provision should effectively regulate an area that had been fodder for litigation between franchisees and franchisors under the original FTC Rule.

In a typical case, the franchisor would assert the existence of an integration clause in the franchise agreement (stating, e.g., that the franchise agreement replaces all prior agreements and understandings between the parties) in order to rebut a franchisee’s assertion that the franchisee was misled as a result of the franchisor’s failure to adequately disclose consistent with UDOC Guidelines.

The Amended Rule’s prohibition on the use of integration clauses in this manner will likely increase the number of disclosure-related claims by franchisees.

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95 72 Fed Reg. at ¶ 15461. The definition of “seller” specifically excludes “existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor.” Id.

96 *Scope and Coverage of the New Rule*, supra note 60.

97 16 C.F.R. § 436.9(h). Notably, disclaiming any written representations in the disclosure document or requiring a franchisee to waive reliance upon the disclosure document is a distinct basis for liability under the Amended Rule.
D. Statutory Disclosure Claims under State Law

Courts are in agreement that the FTC Rule does not provide a private right of action to franchisees harmed by a franchisor’s failure to comply with the requirements of the Rule.98 Because the FTC does not provide for a private cause of action, franchisees alleging disclosure violations typically look to state disclosure laws as a basis for relief.99 Currently, fifteen states have disclosure laws,100 each providing for a private right of action, and most of which incorporate “anti-waiver” language to prevent waiver of the law’s protections (pursuant, e.g., to a choice-of-law clause).102

The FTC Rule only preempts such state disclosure laws to the extent that the state laws are inconsistent or less protective of franchisees.103 The Amended Rule does not prohibit states

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98 See supra note 9.

99 States differ in terms of their definition of a franchise, events triggering a duty to disclose, and territorial reach of the franchise statute. Each of these areas is ripe for litigation, and franchise attorneys should diligently plead that all jurisdictional requirements of a particular statute have been satisfied. In many states, the fact that a business opportunity is not specifically described as a “franchise” does not necessarily mean that the business is exempt from the registration and disclosure requirements of the state statute, if the business otherwise meets the definitional elements of a “franchise”. See, e.g., People v. Kline, 110 Cal. App. 3d 587, 595, 168 Cal. Rptr. 185, 189, Bus. Franchise Guide (CCH) ¶ 7566 (Cal. Ct. App. 1980); Calderon v. Southwestern Bell Mobile Sys., 390 F. Supp. 2d 714, 719-720, Bus. Franchise Guide (CCH) ¶ 13,116 (N.D. Ill. 2005); Quist v. Best Western Int’l, Inc., 354 N.W.2d 656, 660 (N.D. 1984) (noting that definition of “franchise” within the statute was intended to be broadly construed); Blanton v. Texaco Refining & Marketing, Inc., 914 F.2d 188 (9th Cir. 1990) (holding that a stipulation in the parties’ contract that the agreement did not constitute a franchise did not control the determination as to whether the relationship was a “franchise” under Washington law). Additionally, a state franchise statute may reach beyond franchisees or franchisees within the state’s borders. See, e.g., CAL. CORP. CODE § 31013; OR. REV. STAT. § 650.015 (defining when a offer or offer to sell is made in the state).


101 See, e.g., MD. CODE ANN., BUS. REG. § 14-227, IND. CODE § 23-2-2.5-27, MINN. STAT. § 80C.17; N.D. CENT. CODE § 51-19-12(1); VA. CODE ANN. § 13.1-571; WASH. REV. CODE § 19.100.190(2). But see Contential Basketball Ass’n v. Ellenstein, 669 N.E.2d 134, 137, Bus. Franchise Guide (CCH) ¶ 10,961 (Ind. 1996) (noting that the Indiana Act does not provide for a private right of action for violations of the disclosure provisions, but does provide so for violations of the fraud provisions); Lui Ciro, Inc. v. Ciro, Inc., 895 F. Supp. 1365 (D. Haw. 1995) (holding that in Hawaii, courts must look to relevant standing provisions in HAW. REV. STAT. § 480-2(d) to determine if a private right of action exists).


103 FTC Rule Interpretive Guidelines § I.D.2, Bus. Franchise Guide (CCH) ¶ 6,228.
from requiring franchisors to make disclosures in addition to those required by the Amended Rule.\(^{104}\)

1. **Affirmative State Disclosure Statutes**

All of the states with disclosure statutes require affirmative disclosures and registration with a designated state agency.\(^{105}\) For example, the Minnesota Franchise Act requires anyone who offers or sells a franchise in the state to have an effective registration statement consisting of a public offering statement on file with the state.\(^{106}\) The other thirteen states have very similar requirements.\(^{107}\) Failure to register is sufficient to establish liability in these states.\(^{108}\)

In many states, violations of disclosure requirements under federal law also constitute violations of state law – thereby providing a significant avenue for relief for harmed franchisees.\(^{109}\)

2. **Statutory Prohibitions on Misleading Representations**

Disclosure states generally prohibit misleading or fraudulent conduct in connection with the sale of a franchise.\(^{110}\)

For example, the New York statute prohibits making any untrue statement of a material fact in any application, notice, statement, prospectus or report filed with the state, including an omission of a material fact or failure to notify the state of any change in material fact.\(^{111}\)

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\(^{104}\) *Road Map, supra note 61.*


\(^{106}\) MINN. STAT. §§ 80C.02, 80C.04 – 80C.06.


\(^{108}\) See, e.g., **Masters v. Loards Ice Cream & Candies**, Bus. Franchise Guide (CCH) ¶ 7557 (Cal. S. Ct. 1980); **Harb, Bus. Franchise Guide (CCH) ¶ 10,231.**

\(^{109}\) See, e.g., **California v. Speedee Oil Change Sys., Inc.**, Bus. Franchise Guide (CCH) ¶ 11,584 (Cal. Super. Ct. March 4, 1997) (holding a franchisor liable for almost $400,000 in damages for failing to disclose lapse of its trademark, making financial misrepresentations, and other violations of the California disclosure law)


\(^{111}\) N.Y. GEN. BUS. L. § 687. See also 815 ILL. COMP. STAT. § 705/16 (requiring that disclosure documents "shall be free from any false or misleading statement of a material fact, shall not omit to state any material fact required to be stated or necessary to make the statement not misleading . . ."); IND. CODE §§ 23-2-2.5-26, 23-2-2.5-27; MD. REGS. CODE tit. 02, § 02.02.08.18; **MINN. STAT. §§ 80C.13, 80C.14; R.I. GEN. LAWS § 19-28.1-17; WIS. STAT. § 553.41; but see Bixby's Food Sys., Inc. v. McKay**, 193 F. Supp. 2d 1053, Bus. Franchise Guide (CCH) ¶ 12,293 (N.D. Ill. 2002)
Additionally, the New York statute prohibits a person, in connection with the sale or offer for sale of franchise, from directly or indirectly: employing "any device, scheme or artifice" to defraud; making any untrue statement or admission of a material fact; or engaging in any act, practice or course of business which operates or would operate as a fraud or deceit.\textsuperscript{112}

In Wisconsin, a franchisor that presents a potential franchisee with historical or projected financial information that is not included in the franchise disclosure document violates the "fraudulent and prohibited practices" section of the Franchise Investment Law because the Law requires that all such information be included in the franchise disclosure document.\textsuperscript{113}

Civil penalties for failure to disclose or register, or the violation of a prohibition of misleading representations, vary by state. Some state statutes provide for the person who has been injured to recover damages, while other statutes will allow the injured person to rescind the transaction.\textsuperscript{114} Additionally, many of the statutes provide for personal liability as to individuals responsible for making the required disclosures.\textsuperscript{115}

E. Litigating Disclosure Claims in Non-Disclosure States

Franchisees – particularly those that do not have the potential protection of a state disclosure statute – may seek to pursue disclosure-related claims under either state common law or “little FTC Acts.”

1. "Rodopoulous" Claims

As discussed above, the FTC Rule does not provide a private cause of action for franchisees injured as a result of a franchisor’s disclosure violations. However, franchisees who cannot claim the protections of a state disclosure statute may still have a claim under the common law. In a handful of reported cases, franchisees have successfully asserted that federal disclosure requirements define a franchisor’s common law disclosure duties to franchisees.

For example, in Rodopoulous v. Sam Piki Enterprises, Inc., the Alabama Supreme Court held that the FTC Regulations were admissible in a fraud action in regard to establishing a franchisor’s duty to disclose.\textsuperscript{116} In that case, the franchisees brought an action alleging fraud arising out of the franchisor’s earnings representations. Although the franchisor argued that the court should have dismissed the franchisee’s “FTC claim” because the Rule does not allow for a

\textsuperscript{112} Id.

\textsuperscript{113} Kinship Inspection Serv., Inc. v. Newcomer, 605 N.W.2d 579, 597 (Wis. App. 1999).

\textsuperscript{114} See, e.g., CAL. CORP. CODE § 31400; HAW. REV. STAT. § 482E-9; 815 ILL. COMP. STAT. § 705/26; IND. CODE § 23-2-2.5-28; MD. CODE ANN., BUS. REG. § 14-227; MICH. COMP. L. § 445.1531; N.Y. GEN. BUS. L. § 691; N.D. CENT. CODE § 51-19-12; WASH. REV. CODE § 19.100.210;

\textsuperscript{115} See, e.g., CAL. CORP. CODE § 31320; IND. CODE § 23-2-2.5-27; MICH. COMP. L. § 445.1532; R.I. GEN. LAWS § 19-28.1-21(b)

\textsuperscript{116} 570 So. 2d 661, 665, Bus. Franchise Guide (CCH) ¶ 9,741 (Ala. 1990).
private cause of action, the court held that the FTC regulations are properly admissible in fraud cases to establish an affirmative duty of disclosure owed to a prospective franchisee. The court reached this decision by analogizing to other cases where federal regulations were admissible to establish standards of care in negligence cases.\textsuperscript{117} In short, Rodopoulos stands for the proposition that a franchisee may use evidence of a franchisor’s failure to disclose in compliance with the FTC Rule as evidence to support a state law fraud claim.\textsuperscript{118} Other courts have reached the same result.\textsuperscript{119}

In \textit{Tubby’s #14, Ltd. v. Tubby’s Sub Shops, Inc.}, the Eastern District of Michigan applied a similar theory in holding that “the failure to comply with the [FTC Rule] constitute[s] a knowing and international failure to disclose material information.”\textsuperscript{120} The court held that a franchisor’s failure to disclose a rebate arrangement in violation of Item 8 requirements was fraudulent. Therefore, the franchisees’ evidence that the franchisor failed to disclose sustained a cause of action for fraud.

Both Rodopoulos and Tubby’s illustrate that a franchisor’s failure to disclose may result in a successful common law fraud claim -- despite the lack of any private right of action under the FTC Rule.\textsuperscript{121}

Franchisees ordinarily seek to establish that the FTC Rule creates a duty enforceable at common law by analogizing to other federal regulations that have imposed such a duty.\textsuperscript{122}

\textit{2. “Little FTC Acts”}

Many states have also enacted deceptive trade practice statutes that mimic the FTC Act and are, accordingly, referred to as “little FTC” Acts. These statutes are patterned after Section Five of the Federal Trade Commission Act and prohibit unfair and deceptive conduct.\textsuperscript{123} Often, little FTC Acts provide for private actions for damages, attorney’s fees, and sometimes multiple damages.\textsuperscript{124}

\textsuperscript{117} \textit{Id.} (citing \textit{Industrial Tile, Inc. v. Steward}, 388 So. 2d 171 (Ala. 1980) and \textit{Osborne Truck Lines, Inc. v. Langston}, 454 So. 2d 1371 (Ala. 1984)).

\textsuperscript{118} \textit{United Consumers Club, Inc. v. Bledsoe}, 441 F. Supp. 2d 967, 988 (N.D. Ind. 2006).

\textsuperscript{119} \textit{See, e.g., TC Tech. Mgmt. Co. v. Geeks on Call America, Inc.}, No. 2:03-CV-714-RAJ, 2004 WL 5154906, *5 (E.D. Va.) (holding that a franchisee could use the FTC Rule is establishing a fraud by omission claim against a franchisor who concealed information relating to earnings claims); \textit{Florida Auto Auction of Orlando, Inc. v U.S.}, 74 F.3d 498, 502 n. 2 (4th Cir. 1993) (rejecting an argument that a duty imposed by federal regulations cannot give rise to a state common law claim); \textit{In re Sabin Oral Polio Vaccine Prod. Litig.}, 984 F.2d 124, 127-128 (4th Cir 1993) (holding that a violation of federal vaccine regulations gave rise to negligence \textit{per se} liability).


\textsuperscript{121} \textit{Rodopoulos}, 570 So. 2d at 665; \textit{TC Tech.}, 2004 WL 5154906, at * 5.

\textsuperscript{122} \textit{See, e.g., TC Tech, 2004 WL 5154906, at * 5} (drawing analogy between a duty of care under the FTC Rule and a duty established by other federal vaccine regulations).

\textsuperscript{123} \textit{See, e.g., CAL. BUS. & PROF. CODE § 17001; DEL. CODE ANN. tit. 6, § 2513; FLA. STAT. ANN. § 501.204; MASS. GEN. LAW. CH. 93A. § 2; N.J. STAT. §§ 56:8-2; N.H. REV. STAT. § 358-A:2; OHIO REV. CODE § 1345.02; TEX. BUS. & COM. CODE § 17.46.}

\textsuperscript{124} \textit{See, e.g., CAL. BUS. & PROF. CODE § 17070 (private cause of action); DEL. CODE ANN. tit. 6, § 2626 (private cause of action), § 2524(c) (damages); FLA. STAT. ANN. § 501.2105 (attorney’s fees); MASS. GEN. LAW ch. 93A § 9 (private
Franchisees may utilize such little FTC “acts to recover for damages caused by a franchisor’s violations of the FTC Rule. For example, the New Jersey Superior Court specifically held that a franchisor’s failure to provide an FTC Rule disclosure constituted a per se violation of the New Jersey Consumer Fraud Act. The New Jersey court reasoned that because the FTC Rule states that failure to provide a written disclosure statement and making earnings claims that are not reflected in the written disclosure statement constitute unfair or deceptive practices, failure to do so also constitutes a violation of the Consumer Protection Act’s prohibition against unconscionable commercial practices, deception, fraud, false pretenses, false promises or misrepresentations. A Texas court reached the same result.

In states that do not recognize failure to comply with the FTC Rule as a per se violation of their little FTC Acts, franchisees can argue that the violation of the Rule amounts to an “unfair” or “deceptive” act under the terms of the particular Act.

Franchisees often must also show that there is a sufficient nexus between the disclosure shortcomings and the damages allegedly suffered. Franchisee attorneys are well advised to carefully allege facts regarding the franchisor’s conduct showing that the franchisor’s disclosure violation falls within the categories of conduct prohibited by the Act allegedly violated.

Litigation regarding potential violations of state little FTC Acts often focuses on whether the particular Act is applicable to the sale of a franchise. Franchisors have asserted that such Acts do not cover the sale of a franchise or business opportunity because franchises do not constitute “merchandise” within the meaning of such Acts. Reported decisions vary with

cause of action); N.H. REV. STAT. § 358-A:10 (private cause of action); OHIO REV. CODE § 1345.09 (private cause of action, damages and treble damages); TEX. BUS. & COM. CODE § 17.50 (private cause of action, damages, treble damages, and attorney’s fees).


126 Id. at 1205-1207.


128 See, e.g., Edible Arrangements Int’l, Inc. v. Notaris, Bus. Franchise Guide (CCH) ¶ 13,487 (C.D. Cal. Oct. 19, 2008) (finding that a franchisor’s failure to disclose a pending lawsuit involving allegations of deceptive practices sufficiently demonstrated that plaintiff was likely to succeed on the merits of its claims for violations of the California Unfair Competition Law); Boyle v. Douglas/Dynamics, LLC, 292 F. Supp. 2d 198, Bus. Franchise Guide (CCH) ¶ 12,703 (D. Mass. 2003), aff’d, 99 Fed. Appx. 243, Bus. Franchise Guide (CCH) ¶ 12,823 (1st Cir. 2004) (noting that a failure to disclose information that could influence a potential franchisee to not enter into a contract could constitute a deceptive practice in violation of the Massachusetts Unfair and Deceptive Practices Act); Cherick Distribution, Inc. v. Polar Corp., 669 N.E.2d 210, Bus. Franchise Guide (CCH) ¶ 10,997 (Mass. App. Ct. 1996) (sustaining a distributor’s claim under the Massachusetts Little FTC Act because the manufacturer’s conduct in terminating a dealer on one day’s notice was unfair, the fact that distributor was not “deceived” was irrelevant). But see Rhino Linings USA, Inc. v. Rocky Mountain Rhino Lining, Inc., 62 P.3d 142, Bus. Franchise Guide (CCH) ¶ 12,510 (Colo. 2003) (holding that a claim that a franchisor violated its exclusivity promise does not constitute a deceptive trade practice without further allegations that the franchisor knowingly made a false representations). Also, in both Washington and Hawaii, an order, judgment, or consent decree entered in an action brought by the FTC can be used as evidence in a private action brought under state law. HAW. REV. STAT. § 482E-8(e); WASH. REV. CODE § 19.100.190(5).


130 See, e.g., Morgan, 510 A.2d at 1202 (holding that the sale of a franchise is included in the New Jersey Consumer Protection Act’s definition of merchandise, which includes “any objects, wares, goods, commodities, services or anything offered, directly or indirectly, to the public for sale); Burgo v. Lady of America Franchise Corp., Bus. Franchise Guide (CCH) ¶ 13,430 (C.D. Cal. Sept. 7, 2006) (holding that the California Unfair Trade Practices Act allows claims by a franchisee against a franchisor).
respect to whether a potential franchisee constitutes a "consumer" under the terms of a particular consumer protection or unfair and deceptive trade practices acts.\footnote{See, e.g., Western Star Trucks, Inc. v. Big Iron Equipment Serv., Inc., 101 P.3d 1047, Bus. Franchise Guide (CCH) ¶ 12,947 (Alaska 2004) (applying Alaska's UTPCPA to a sale of a dealership and noting that the legislature did not indicate a distinction between consumer and commercial sales); Bixby's Food Systems, 985 F. Supp. at 807 (holding that a purchaser of a franchise is a "consumer" for purposes of the Illinois Fraud Act); Kavky v. Herbalife Int'l of Am., 820 A.2d 677 (N.J. Ct. App. 2005); see also Bailey Employment Sys., Inc. v. Clifford Hahn, 545 F. Supp. 62 (D. Conn. 1982) (holding that the protections of the Connecticut Unfair Trade Practices Act extend to franchisees). \textit{But see} Brock v. Baskin-Robbins, USA Co., No. 5:99-CV-274, 2003 WL 21309428, Bus. Franchise Guide (CCH) ¶ 12,585 (E.D. Tex. Jan. 17, 2003), \textit{aff'd}, 155 Fed. Appx. 792 (5th Cir. 2005) (rejecting franchisee's claims under the Louisiana and Texas Little FTC Acts because the franchisees, as purchasers of intangible rights, did not establish that they were "consumers" under the terms of the Acts); \textit{New England Surfaces v. E.I. Du Pont de Nemours & Co.}, 460 F. Supp., 2d 153 (D. Me. 2006) (dismissing a franchisee's claim under the Vermont Consumer Fraud Act because the franchisee did not fall under the Act's definition of consumer, being "any person who purchases . . . goods or services not for resale in the ordinary course of his or her trade or business but for his or her use or benefit"); \textit{Layton v. Aamco Transmissions, Inc.}, 717 F. Supp. 368 (D. Md. 1889) (holding that franchisees are not "consumers" under Maryland's Consumer Protection Act).}

III. ALLEGED DISCLOSURE VIOLATIONS - THE DEFENSES

A. Defenses under the contract

1. \textit{Introduction}

Despite the gloomy scenarios outlined above, all is not lost for the defendant franchisor! There are several valid defenses that can be raised to defeat the franchisee's claim for disclosure violations. First, despite the Amended Rule's "no disclaimer rule", integration clauses and no reliance clauses can (and will) still be used by franchisors in many alleged disclosure violation cases. Second, the traditional defenses of statute of limitations, release, statute of frauds/parol evidence, failure to mitigate, and lack of damages are helpful in defending against disclosure claims. There are also specific defenses available under many little FTC Acts, including lack of consumer status and causation. Finally, choice of law clauses are another effective way to convince a court to dismiss alleged disclosure claims based on another state's law.

2. Integration Clauses

Integration, or merger, clauses in a franchise agreement have traditionally provided franchisors with a potent defense against disclosure-related claims. Integration clauses typically state that the franchise agreement supersedes all previous representations and agreements and that the franchise agreement represents the totality of the parties' understanding. This is essentially a parol evidence rule-enforcing clause, which courts have used to bar into evidence prior representations such as those in a typical disclosure claim case.

In a very recent case that demonstrates this point, \textit{Cottman Transmission Sys., LLC v. Kershner},\footnote{536 F Supp. 2d 543 (E.D. Pa. 2008).} the court held that the franchisees' negligent misrepresentation claim was defeated by a merger clause in the franchise agreement.\footnote{\textit{Id.} at 554.} The franchisees were claiming that the
franchisor made misrepresentations both in the UFOC and otherwise concerning financial performance, training, and franchisee services.\textsuperscript{134} The court held that, "[b]ecause of the merger clause, which states that the Franchisees were not relying on any representations made outside the contract, the Franchisees will be unable to [prove justifiable reliance]."\textsuperscript{135} The court concluded that the integration clause and the parol evidence rule meant that the alleged prior misrepresentations could not be admitted to challenge the franchise agreement.\textsuperscript{136}

It should be noted that an integration clause argument is not always successful. Courts often hold that integration clauses and the parol evidence rule are not applicable to fraudulent inducement claims.\textsuperscript{137} In addition, some state franchise protection laws expressly preclude the use of integration clauses to limit disclosure-fraud liability.\textsuperscript{138}

3. \textbf{No reliance clauses, no representations clauses and disclaimers}

No reliance clauses (otherwise known as no representations clauses or disclaimers) are similar to integration clauses. They essentially state that the franchisee has conducted an independent investigation and has not relied on any previous representations made by the franchisor. As with integration clauses, franchisors may be able to use no reliance clauses to preclude a franchisee’s disclosure claims related to pre-franchise agreement disclosures.

A typical case applying a no reliance clause to bar a disclosure claim is \textit{Hall v. Burger King Corp.}\textsuperscript{139} In \textit{Hall}, the plaintiffs claimed that Burger King misrepresented the profitability of their prospective franchise.\textsuperscript{140} The franchise agreement contained a no reliance clause that stated that the franchisees entered the agreement after their own independent investigation and not upon any representation as to profits or sales, or any other representations not included in the franchise agreement.\textsuperscript{141} The court held that the no reliance clause in the franchise agreement precluded the admission of the alleged representations made by the franchisor.

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\textsuperscript{134} \textit{Id.} at 547, 551-52.

\textsuperscript{135} \textit{Id.} at 554.

\textsuperscript{136} \textit{Id.} at 552-54; \textit{see also} \textit{Cook v. Little Caesar Enters., Inc.}, 210 F.3d 653, 658 (6th Cir. 2000) (holding that "The existence of an integration clause in the franchise agreements made Cook’s alleged reliance unreasonable" for purposes of a Michigan Franchise Investment Law claim); \textit{Shoney’s, Inc. v. Morris}, 100 F. Supp. 2d 769, 779 (M.D. Tenn. 1999) (holding that "the integration clause in the Madisonville license agreement precludes the admission of the alleged representations made by the [franchisor].").

\textsuperscript{137} \textit{See, e.g., Thifty Rent-A-Car Sys., Inc. v. Brown Flight Rental One Corp.}, 24 F.3d 1190, 1195 (10th Cir. 1994) (holding that integration clauses do not bar claims for fraudulent inducement under Oklahoma law); \textit{RadioShack Corp. v. Comsmart, Inc.}, 223 S.W.3d 256, 260-61 (Ky. Ct. App. 2007) ("[F]alse and fraudulent representations made by one of the parties to induce the other to enter into the contract are not merged in the contract.").

\textsuperscript{138} \textit{See N.Y. GEN. BUS. LAW} § 687(5) ("It is unlawful to require a franchisee to assent to a release, assignment, novation, waiver or estoppel which would relieve a person from any duty or liability imposed by this article."); \textit{A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc.}, 162 Misc. 2d 941, 948-49 (N.Y. Sup. Ct. Aug. 23, 1994) (holding that merger and waiver clauses "impermissibly permit defendants to get around the antifraud provisions of the Franchise Act by contracting out of such liability."); \textit{Ernfore Corp. v. Blimpie Assocs., Ltd.}, No. 6-1400/04, Bus. Franchise Guide (CCH) ¶ 13,074 (N.Y. Sup. Ct. March 29, 2005) (holding that an integration clause does not bar the franchisees earnings claim-based fraud allegations).

\textsuperscript{139} \textit{912 F. Supp.} 1509 (S.D. Fla. 1995).

\textsuperscript{140} \textit{Id.} at 1529.

\textsuperscript{141} \textit{Id.}
agreement barred the claim because, "to the extent any representations as to the profitability of the restaurant were made, the were made before the execution of the parties' franchise agreement . . . , are considered merged therein and, as such, could not have been relied upon by the plaintiffs."  

Another recent case from Wisconsin emphasizes the potential importance of no reliance clauses. Westerfield v. Quizno's Franchise Co. involved a class action against a franchisor alleging claims under the Racketeer Influenced and Corrupt Organizations Act ("RICO"), among others. The RICO claim was based on fraud allegations relating to misrepresentations and an alleged failure to disclose material information. The court stated that "[t]he problem with plaintiffs’ claims of fraud, however, is that they are fatally undermined by the express disclosures, disclaimers and non-reliance clauses contained in both the Uniform Franchise Offering Circular (UFOC) . . . and the Franchise Agreement . . . " The court held that the disclaimers and non-reliance clauses in the UFOC and franchise agreements precluded any reasonable reliance on the misrepresentations at issue. As for the alleged material omissions, the court found that the UFOC and franchise agreement disclosed the information the franchisees alleged was omitted, and that to the extent the franchisees alleged omissions contradicted those documents, "[a] party cannot reasonably rely on allegedly fraudulent statements directly contradicted by the terms of a subsequently executed contract."  

The precise wording and breadth of the no reliance clause may be critical. For an example of this, see Lady of America Franchise Corp. v. Malone. The franchisee in Malone argued that the franchisor made false and misleading claims prior to the execution of the franchise agreement relating to items such as average profits and membership expectations. The franchise agreement contained a lengthy disclaimer clause stating that the franchisee agreed that the success of the business would depend largely on the franchisee’s own skill, that the franchisee claimed any promises or representations about the success of the business, and that the franchisee would not rely on any representations made outside the agreement. The franchisee argued that this clause should not bar evidence of fraud in the inducement, citing cases that admitted evidence of prior representations in the face of merger clauses. The court disagreed with the plaintiff's arguments. The court held that this disclaimer clause was "extremely comprehensive and unambiguous," and it addressed all of the franchisee's specific complaints. The court found it significant that the disclaimer clause specifically addressed all the statements the plaintiff sought to introduce. The court held that the clause meant that the franchisee could not show detrimental reliance on the alleged misrepresentations.

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142 Id.
143 527 F. Supp. 2d 840, 844 (E.D. Wis. 2007).
144 Id. at 846.
145 Id. at 846-47.
146 Id. at 849.
147 Id. at 851.
No reliance clauses are not always a successful defense. The court in *Carousel’s Creamery*<sup>150</sup> held that the plaintiff franchisee’s negligent misrepresentation claim was not barred by a disclaimer clause in the franchise agreement.<sup>151</sup> In looking at the circumstances surrounding the clause, the court noted that there was no existing dispute at the time the franchise agreement was signed, the franchisee was not represented by counsel, and there was no evidence of arms-length negotiation.<sup>152</sup>

4. **UFOC vs. FDD?**

As discussed above in Part II.C.6, Section 436.9(h) of the Amended Rule prohibits “franchise sellers from disclaiming or requiring a franchisee to waive reliance on any representation made in a disclosure document or any of its exhibits or attachments.”<sup>153</sup> In the SBP, there is candid discussion of the problems cited by many franchisee advocates by which “sophisticated integration, no representation, and no reliance clauses . . . stripped franchisees of all fraud claims.”<sup>154</sup> Some commenters encouraged a broad prohibition against disclaiming any authorized statement – whether in the UFOC or other promotional materials.<sup>155</sup> The FTC declined to implement this suggestion.<sup>156</sup>

The prohibition against use of disclaimers applies not only to the FDD, but to its exhibits and attachments. Besides financial statements, exhibits include all form agreements a franchisee may sign, including real property leases, equipment leases, financing documents, and software licenses. Some of these documents are provided by third parties.

Despite the Amended Rule, disclaimer of reliance clauses will likely still prove an effective defense in court. The Amended Rule prohibits disclaimer clauses specifically related to representations made in “the disclosure document.” It does not address disclaimer clauses as they relate to other, extra-FDD representations. For claims based on alleged extra-FDD representations, disclaimer clauses may continue to be an effective defense. While most franchisors agree that they do not want to disclaim anything that is contained in their disclosure documents, and have practiced that way for years, the added requirement regarding the prohibition against disclaimers of any third party documents could lead to potential litigation.<sup>157</sup>

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<sup>150</sup> *Carousel’s Creamery, L.L.C. v. Marble Slab Creamery, Inc.*, 134 S.W.3d 385 (Tex. App.—Houston [1st Dist.] 2004, pet. dism’d by agr.)

<sup>151</sup> *Id.* at 393.

<sup>152</sup> *Id.* at 393-94.


<sup>154</sup> *Id.* at 250-58.

<sup>155</sup> *Id.* at 250-258.

<sup>156</sup> *Id.;* see also, Deborah S. Caldwell and Jason J. Stover, *The New Franchise Rule and Litigators*, 26 Franchise L. J. (Spring 2007).

5. **Release**

Franchisors often require franchisees to sign a release in connection with an agreement to re-locate or to terminate a franchise or in connection with various other agreements. These standard releases may also be a bar to disclosure claims. In *Hall v. Burger King Corp.*, the plaintiff franchisees alleged that the franchisor discriminated against them by, among other things, failing to disclose certain information about a franchise they were about to purchase. The plaintiffs had signed several releases with the franchisor in connection with their efforts in purchasing a franchise. The last of these releases was a mutual general release that was executed in connection with a deal between the plaintiffs and the franchisor to let the plaintiffs prematurely terminate one franchise and relocate the restaurant to a new location. The plaintiffs argued that they were fraudulently induced to enter into the last release. The court noted that the plaintiffs were represented by counsel and that a hostile relationship already existed between the parties at the time of the release. The court stated that the plaintiffs had failed to show any proof so as to satisfy their burden to prove fraudulent inducement. The court held that the releases barred the plaintiffs' claims.

6. **Statute of frauds/parol evidence**

The parol evidence rule can be a useful defense to disclosure claims, which by their nature often rely on representations found outside the franchise agreement. A parol evidence rule argument is simply that the franchise agreement constitutes the entire understanding between the parties so that the prior misrepresentations that form the basis of the disclosure claim cannot be admitted into evidence. This defense is very similar to the integration clause defense discussed above, which is essentially an incorporation of the parol evidence rule into the contract itself. Even without an integration clause, however, courts will often use the parol evidence rule to bar introduction of previous extra-contract representations.

In *Cottman Transmission Sys., LLC v. Kershner*, the franchisees claimed that the franchisor made misrepresentations in its UFOC. Specifically, the franchisees claimed that the franchisor misrepresented the average sales and profit for a franchise, the number of franchises that had closed in the past, and the experience necessary to operate a franchise.

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158 See, e.g., *Schubot v. McDonalds Corp.*, 757 F. Supp. 1351, 1356 (S.D. Fla. 1990) ("Clauses releasing parties and disclaiming liabilities . . . overcome any oral representations not contained in the written franchise agreement.").

159 912 F. Supp. at 1509.

160 Id. at 1517.

161 Id. at 1517-19.

162 Id. at 1518.

163 Id. at 1523.

164 Id. at 1524-25.

165 Id. at 1525.

166 536 F Supp. 2d at 543.

167 Id. at 551-52.

168 Id. at 552.
The court held that the parol evidence rule precluded evidence of misrepresentations outside the written franchise agreement, even if the misrepresentations were part of the UFOC.\textsuperscript{169} The court therefore dismissed the franchisees' common law fraud claim, stating that the plaintiffs' could not introduce evidence of the representations of fact in the UFOC to support their claim of fraud in the inducement related to the franchise agreements.\textsuperscript{170}

The parol evidence rule was also effectively used in Randall v. Lady of America Franchise Corp.\textsuperscript{171} This case involved claims by Lady of America franchisees under the Minnesota Franchise Act that the franchisor made false earnings claims about their franchises.\textsuperscript{172} The franchisor's defense invoked an integration clause in the franchise agreement as well as disclaimer language in the UFOC.\textsuperscript{173} The court first discussed whether the parol evidence rule would apply to claims under the Minnesota Franchise Act.\textsuperscript{174} The court noted Minnesota law's very narrow application of the parol evidence rule in fraud cases, particularly with respect to extra-contractual representations such as earnings claims.\textsuperscript{175} The court concluded that even if the parol evidence rule applied to Minnesota Franchise Act claims, it would not exclude the earnings claims at issue.\textsuperscript{176}

7. \textbf{Failure to mitigate}

The failure to mitigate damages is a familiar breach of contract defense that also applies to franchise agreements. Even if a franchisee can prove a technical breach, the franchisor may be able to substantially limit any liability by proving that the franchisee did not take steps to mitigate damages. In general, the franchisor may be able to demonstrate that whatever harm has come to the franchisee, the franchisee could have avoided it by taking reasonably prudent steps.

A good case discussing the duty to mitigate damages in a franchise context is Moran Foods, Inc. v. Mid-Atlantic Development Co.\textsuperscript{177} Moran Foods involved a breach of contract claim against a franchisor, where the franchisor admitted that it breached the franchise agreement by failing to monitor the financial condition of the franchisee's stores and report that information to the franchisee, as it had promised to do in the agreement.\textsuperscript{178} The franchisee eventually filed for bankruptcy after its losses continued to mount.\textsuperscript{179} A jury awarded the

\textsuperscript{169} \textit{Id.} at 553-54.

\textsuperscript{170} \textit{Id.}

\textsuperscript{171} 532 F. Supp. 2d at 1071.

\textsuperscript{172} \textit{Id.} at 1079-80.

\textsuperscript{173} \textit{Id.} at 1082.

\textsuperscript{174} \textit{Id.} at 108-85.

\textsuperscript{175} \textit{Id.} at 1083-84.

\textsuperscript{176} \textit{Id.} at 1085.

\textsuperscript{177} 476 F.3d 436 (7th Cir. 2007).

\textsuperscript{178} \textit{Id.} at 438.

\textsuperscript{179} \textit{Id.} at 437.
franchisee damages based upon the franchisor’s breach. The Seventh Circuit reversed, holding that the franchisee had failed to prove damages. In an opinion by Judge Posner, the court cited the duty to mitigate damages. The court stated that for the franchisee to be entitled to damages, “it had to present evidence from which a reasonable jury could estimate with reasonable objectivity the loss that the breach inflicted.” The court further stated that the franchisee should have presented evidence that it would have taken corrective action had it received the reports when they were due. The franchisee also should have presented evidence of the costs and benefits of the efforts it would have taken to mitigate the ongoing losses. Because there was no proof of what the franchisee might have done to mitigate its losses, actual damages could not be determined.

8. Statutes of limitation

Like the duty to mitigate damages, a statute of limitations defense can be equally appropriate in the franchise context as in any others. Many of the little FTC Act statutes that are used to bring disclosure actions include their own statutes of limitation. Invariably there will be a statute of limitations that addresses common law disclosure-claim vehicles such as fraud or negligent misrepresentation. Finally, courts have upheld contractual limitations periods, where the parties to a franchise agreement have mutually agreed to contractually limit the period within which claims can be asserted.

a. Accrual

A franchise-based statute of limitations defense faces the same issues as in other contexts. A key question to ask when asserting such a defense is accrual, or when the limitations clock starts running. Different limitations statutes may have different time periods for different types of claims, which may accrue at different times. For example, California’s franchise laws include a fairly complex, multi-tiered limitations scheme as described in People v. SpeeDee Oil Change Sys., Inc. This case involved multiple claims against a franchisor based on the California Franchise Investment Law (“CFIL”). The trial court granted a nonsuit as to these claims based on the statute of limitations. The California court of appeal affirmed.

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180 Id.
181 Id. at 442.
182 Id. at 440.
183 Id. at 438.
184 Id.
185 Id. at 439. See also Meg-La, Bus. Franchise Guide (CCH) ¶ 11,190 (franchisee’s continued operation of the franchised business after franchisor breached agreement to take over operation was merely fulfilling non-breaching party’s duty to mitigate damages).
186 See, e.g., Hays v. Mobil Oil Corp., 930 F.2d 96, 100 (1st Cir. 1991) (holding that a 1-year contractual limitations period in the franchise agreement barred a claim under the Massachusetts consumer protection statute); Keating v. Baskin-Robbins USA, Co., No. 6:99-CV-149-BR(3), 2001 WL 407917, at *4, 7 (E.D.N.C. March 27, 2001) (upholding a 1-year limitations period in the franchise agreement relating to fraudulent inducement claims).
188 Id. at 714.
The court first outlined the complex statutes of limitations found in the CFIL.\textsuperscript{191} Briefly, the first statute, Cal. Corp. Code § 31303, provides for a four-year absolute limitations period with a one-year discovery rule (or 90 days if the violation is disclosed in writing to the franchisee), whichever comes first.\textsuperscript{192} This statute covers, among other things, "actions alleging a franchisee’s reliance on misleading statements made in documents filed by the franchisor with the Commissioner of Corporations."\textsuperscript{193} The second limitations statute, Cal. Corp. Code § 31304, governs liability for untrue statements of material fact other than those contained in documents filed with the Commissioner of Corporations.\textsuperscript{194} This statute provides for a two-year absolute limitations period with a one-year discovery rule (or 90 days if the violation is disclosed in writing to the franchisee), whichever comes first.\textsuperscript{195}

In this case, the court noted that the alleged violations of the CFIL all arose from the execution of the franchise agreements and representations made prior to execution.\textsuperscript{196} The court rejected the franchisees’ arguments that (1) their causes of action did not accrue until they suffered damages, (2) that the limitations period did not begin to run as long as the fraud was concealed, and (3) that a conspiracy among various defendants resulted in tolling the limitations period.\textsuperscript{197} The court held that the franchisees were barred from pursuing their CFIL claims under the statutes of limitation, as their franchise agreements were executed more than two or four years (depending on which statute applied) before the complaint was filed.\textsuperscript{198} The court concluded by holding that the two and four-year limitations periods in the CFIL "impose absolute limits" on claims arising under that statute.\textsuperscript{199}

Often, what the term "accrues" means under a particular state's statute of limitations is subject to judicial interpretation. In \textit{Jerry's Service Inc. v. Freshway, Inc.}, the court had to determine the meaning of the word "accrues" in the limitations provision of the Minnesota Franchise Act.\textsuperscript{200} The Minnesota Franchise Act has a three year limitations period. The court stated that the general rule in Minnesota is that a cause of action accrues when a person can bring an action in court. However, the court also noted a Minnesota statute provided for a "discovery rule" in common law fraud cases, where the cause of action "does not accrue until

\textsuperscript{191} ld. at 716.
\textsuperscript{192} ld.
\textsuperscript{193} ld. at 718-22.
\textsuperscript{194} ld. at 718.
\textsuperscript{195} ld.
\textsuperscript{196} ld. at 721.
\textsuperscript{197} ld.
\textsuperscript{198} ld. at 723.
\textsuperscript{199} ld. at 723-24.
\textsuperscript{200} ld. at 725-26.
\textsuperscript{200} ld. at 726-27.
the facts constituting the fraud could and ought to have been discovered with reasonable diligence." The court noted that causes of action under the Minnesota Franchise Act were based on fraudulent practices. The court concluded that the common law fraud discovery rule should apply to the Minnesota Franchise Act.

Even when a state's statute of limitations purports to specifically define when a cause of action accrues, there still may be room for argument. Canal Marine Supply, Inc. v. Outboard Marine Corp. of Waukegan, Illinois,201 involved a dealer bringing suit against two manufacturers based on violations of the Louisiana Unfair Trade Practices Act ("UTPA").202 The UTPA has a one-year limitations period, running from the time of the transaction giving rise to the cause of action.203 The defendants argued that the limitations period began to run when they mailed a letter to the dealer informing it of their decision not to renew its dealership agreement.204 The dealer argued that the limitations period did not begin to run until the actual termination of the agreement because it had not suffered any damages until then.205

The court held that the limitations period began to run when the defendants sent the letter informing of the decision not to renew the dealership agreement.206 The dealer did suffer a loss when it received the letter, if not in money then in incorporeal property.207 Because the dealer did not bring suit until more than one year after the complained-of acts had occurred, the statute of limitations precluded the claims.208 Furthermore, the one-year limitations period was an "absolute, uninterruptable [sic] time period."209

b. Discovery Rule

The discovery rule, as mentioned above, often plays a large part of any statute of limitations defense. The nature of disclosure claims in particular often makes them susceptible to being held "discovered" fairly early in a franchisee's experience. As discussed above, a typical discovery rule will provide that "a cause of action ... does not accrue until the facts constituting the fraud could and ought to have been discovered with reasonable diligence."210 Typical disclosure claims relate to disclosures made in the franchise sale process, before the franchise agreement is executed. It can be argued that facts behind disclosure claims such as earnings claims will or should be discovered fairly early in a franchisee's existence. Therefore,

201 522 So. 2d 1201 (1988).
202 Id. at 1202.
203 Id.
204 Id. at 1202.
205 Id.
206 Id.
207 Id.
208 Id. at 1203.
209 Id.
even though the discovery rule ostensibly helps plaintiffs delay the accrual of a statute of limitations, its help may be somewhat limited in the franchise disclosure claim context.

Another case involving the CFIL’s statute of limitations illustrates how a discovery rule can work against many disclosure claims. In *Athlete’s Foot Marketing Assoc., Inc. v. Inner Reach Corp.*, the franchisee alleged that the franchisor made misrepresentations in the nature of misleading earnings claims in statements and documents, including UFOCs, delivered before the franchise agreements were executed. The court found that all of these claims were barred by the statutes of limitation. One claim in particular was barred by the one-year discovery rule in the CFIL. The franchisee claimed that he did not discover misleading expense estimates in the UFOCs until several years later. However, the court noted that many of the costs that the franchisee complained about were start-up costs that would have been discovered soon after the franchises opened. Moreover, the court stated that it did not matter if the franchisee could not determine the exact amount that his expenses exceeded the UFOC estimates. The franchisee’s claims were barred by the statute of limitation.

Although a discovery rule is a common feature in Little FTC Acts, it should be noted that not all state disclosure statutes include a discovery rule in their statutes of limitation. In *Brosahd of Milwaukee, Inc. v. Dion Corp.*, the plaintiffs brought various disclosure claims under the Wisconsin Franchise Investment Law (“WFIL”). The WFIL has a three-year statute of limitations commencing “after the act or transaction constituting the violation upon which the liability is based or 90 days after delivery to the franchisee of a written notice disclosing any violation . . . .” The court rejected the plaintiffs’ broad interpretation of this statute, stating that the “act” in question must occur in the franchise sales process. The court held that the limitations period accrued when the plaintiffs signed the franchise agreements, and rejected the plaintiffs’ attempts to impose a discovery rule.

9. **Little FTC Act Defenses**

In addition to broadly applicable defenses such as mitigation of damages and statute of limitations, there may be defenses to little FTC Act claims based on the statute itself.

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212 See, e.g., *Mackey v. Judy’s Foods, Inc.*, 867 F.2d 325, 328-29 (6th Cir. 1989) (applying the discovery rule to a claim under the Tennessee Protection Act); *KPMG Peat Marwick v. Harrison County Fin. Corp.*, 988 S.W.2d 748, 749 (Tex. 1999) (noting that the discovery rule applies to Texas Deceptive Trade Practice and Consumer Protection Act claims).


a. **Lack of “Consumer” Status**

Little FTC Acts typically apply only to a “consumer” as defined by the statute.\(^{215}\) Consequently, a primary defense under a typical little FTC Act is that a franchisee is not a “consumer” as the statute defines the term.\(^{216}\) As discussed below, cases can go both ways, depending on the facts as well as the particular state’s definition of a consumer. It is also important to note that although the cases below discuss whether a franchisee has standing to sue under a little FTC Act based on consumer status, other states may frame the issue differently. For example, in New Jersey, the relevant question is whether a franchise sale constitutes a sale of “merchandise” under the New Jersey Consumer Fraud Act.\(^{217}\)

i. **Franchisee is a Consumer**

Courts in Texas have gone both ways determining whether a franchisee is a consumer under the Texas Deceptive Trade Practices -Consumer Protection Act (“DTPA”). In *Texas Cookie Co. v. Hendricks & Peralta, Inc.*\(^{218}\), a franchisee brought an action against the franchisor for violations of the Texas DTPA.\(^{219}\) The franchisor argued that a franchise and the collateral services that go with it were not “goods” or “services” under the statute, but rather were intangible property rights not covered by the DTPA.\(^{220}\) The court held that while the DTPA excluded transactions conveying wholly intangible property rights, the goods and services associated with the franchise relationship in this case were sufficiently integral to the transaction that it was covered by the DTPA.\(^{221}\) Specifically, the court cited the training program, operations manual, and the franchise “system” as evidence of services that were central to the franchising transaction.\(^{222}\)

ii. **Franchisee is Not a Consumer**

Several years after *Texas Cookie Co.* was decided, the Fifth Circuit held that a Texas franchisee was not a consumer within the Texas DTPA. In *Meineke Discount Muffler v. Jaynes*,\(^{223}\) a franchisor sued two former franchise owners for violating the covenant not to

\(^{215}\) The Texas Deceptive Trade Practices-Consumer Protection Act’s definition of “consumer” is illustrative: “‘Consumer’ means an individual, partnership, corporation, this state, or a subdivision or agency of this state who seeks or acquires by purchase or lease, any goods or services, except that the term does not include a business consumer that has assets of $25 million or more, or that is owned or controlled by a corporation or entity with assets of $25 million or more.” TEX. BUS. & COM. CODE ANN. 17.45.

\(^{216}\) Note that not all consumer fraud protection statutes contain a separate definition of “consumer.” See *Carlock*, 719 F. Supp. at 851 (construing the Idaho Consumer Protection Act and stating that the statute does not contain a separate definition of “consumer,” and that the statute is not otherwise limited by its terms to actions by consumers).

\(^{217}\) See *Kavky*, 820 A.2d at 680 (concluding that a sale of a franchise can come within the statute’s protection).

\(^{218}\) 747 S.W.2d 873.

\(^{219}\) Id. at 876.

\(^{220}\) Id.

\(^{221}\) Id. at 877.

\(^{222}\) Id.

\(^{223}\) 999 F.2d 120 (5th Cir. 1993).
compete in the franchise agreement. The franchisees filed a counterclaim under the Texas DTPA. The court first noted that the DTPA, "has been applied to franchise situations where the collateral services provided to a franchisee formed the basis of the DTPA claim." In this case, however, the court held that the franchisee was not a "consumer" under the DTPA, and, therefore, did not have standing to sue under that statute. The basis of the DTPA complaint concerned the validity and ownership of the franchisor's trademarks and service marks, which are intangible property rights that the court noted were not covered by the DTPA. The Fifth Circuit did not attempt to distinguish Texas Cookie Co.

A federal district court in Texas again addressed the issue of whether a franchisee is a consumer under the DTPA. In Brock v. Baskin Robbins, more than forty franchisees from multiple states sued the franchisor, alleging, among other things, claims under the Texas DTPA. The court held that the franchisees were not "consumers" under the statute, stating that while the franchisees made general allegations concerning the purchase of goods (ice cream products), the franchisees failed to prove that the purchase of goods or services was an objective of the purchase. The court thus distinguished Texas Cookie Co. in dismissing the DTPA claim.

This series of cases demonstrates that there definitely may be room to argue the threshold question under many little FTC Acts; that is, whether a franchisee is a consumer with standing to sue under the act. Even in a state where one court has ruled that a franchisee is a consumer, another court may be persuaded on slightly different facts that a franchisee is not in fact a consumer. Such an argument may be well worth making in light of the fact that a successful outcome will mean dismissal of the entire little FTC Act claim.

b. Other Defenses under State Acts

In addition to the threshold issue of whether a franchisee has standing as a consumer (or whatever term is used) to sue under a state's consumer fraud statute, there are various other defenses that may be applied depending on the statute and the facts involved.

Disclosure claims relating to an existing franchise that the plaintiff franchisee purchased from another franchisee may not be actionable under a little FTC Act. For example, in Hall v. Burger King Corp., discussed above, the court held that the plaintiffs failed to state a claim under the Florida Franchise Act with respect to misrepresentations related to a specific

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224 Id. at 122.
225 Id. at 125.
226 Id.
227 Id.
229 Id. at *6.
230 Id.
231 Id.
232 912 F. Supp. at 1509.
restaurant because the plaintiffs acquired that restaurant from another franchisee.\textsuperscript{233} Therefore, the act did not apply.\textsuperscript{234}

i. \textbf{Reliance and Causation}

Another potentially important defense to disclosure claims under little FTC Acts is causation. Little FTC Acts often require some form of proof of causation.\textsuperscript{235} This can be an effective defense for franchisors, who can argue that the franchisee's damages were a result of the franchisee's own negligence in operating the franchise as opposed to the alleged bad acts by the franchisor.

An example of a successfully applied causation defense in a franchise setting is \textit{Carousel's Creamery, L.L.C. v. Marble Slab Creamery, Inc.}\textsuperscript{236} In \textit{Carousel's Creamery}, the court held that the plaintiff franchisee's Texas DTPA claim could not stand because the plaintiffs failed to show "producing cause."\textsuperscript{237} Under the DTPA, producing cause "requires that the acts be both a cause-in-fact and a 'substantial factor' in causing the injuries."\textsuperscript{238} The franchisor presented expert testimony that the franchisee made multiple business mistakes and was unreasonable in relying on the UFOC.\textsuperscript{239} The court held that there was sufficient evidence to support a finding that producing cause was lacking for the plaintiff's DTPA claims.

In certain circumstances, an effective defense to a statutory cause of action may even relate to the specific type of disclosure claim being asserted. \textit{Hardee's of Maumelle, Arkansas, Inc. v. Hardee's Food Sys., Inc.}\textsuperscript{240}, involved claims by plaintiff franchisees that the franchisor violated the disclosure provisions of the Indiana Franchise Act ("IFA") by failing to substantiate earnings claims or provide an offering circular.\textsuperscript{241} The Seventh Circuit noted that Indiana courts have interpreted the IFA to only include a private right of action for fraud, deceit, or

\textsuperscript{233} \textit{Id.} at 1529.

\textsuperscript{234} \textit{Id.}; see also \textit{Schubot}, 757 F. Supp. at 1357-58 (holding that the Florida Sale of Business Opportunities Act and the Florida Franchise Disclosure Act did not apply to a transfer from one franchisee to another).


\textsuperscript{236} 34 S.W.3d 385.

\textsuperscript{237} \textit{Id.} at 399.

\textsuperscript{238} \textit{Id.}

\textsuperscript{239} \textit{Id.} at 399-403.

\textsuperscript{240} 31 F.3d 573 (7th Cir. 1994).

\textsuperscript{241} \textit{Id.} at 577.
misrepresentation claims, and not for failure to disclose claims. The court therefore held that the plaintiffs could not assert disclosure claims under the IFA.

Under some state acts, while reliance may not be an element of the cause of action, it may still be relevant to eventual recovery. For example, under the Texas DTPA, “a consumer is not required to prove reliance as an independent element to recover . . . , but reliance may be a factor in deciding whether the defendant’s conduct was a producing cause of damages to the plaintiff.” “A misrepresentation cannot theoretically be a producing cause of injury if it was not at all relied upon.”

A franchise case demonstrating these points is Simos v. Embassy Suites, Inc. Simos involved the WFIL, which incorporates the FTC Rule standards for disclosure. The franchisees brought claims under the WFIL alleging that the franchisor made false statements in the UFOC relating to the franchisor’s willingness to allow the franchisee to self-manage its hotel franchise. The court stated that “the element of detrimental reliance usually essential in a common law fraud case is not necessarily required under [the WFIL].” The court went on, though, to say that, “[h]owever, the enforcement provisions of the WFIL essentially write the element of detrimental reliance into the statute.” Under the WFIL, the defendant can avoid liability by proving that the plaintiff knew the underlying facts “concerning the untruth or omission.” The court held that this meant that the franchisees could not succeed on their WFIL fraud claim because they knew the facts behind the alleged misrepresentation before they actually received the franchise.

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242 Id. at 577-78.
244 Century 21 Real Estate Corp. v. Hometown Real Estate Co., 890 S.W.2d 118, 130 (Tex. App.—Texarkana 1994, writ denied).
246 983 F.2d 1404 (7th Cir. 1993).
247 Id. at 1408.
248 Id.
249 Id. at 1410.
250 Id.
251 Id.
252 Id.
B. Choice of Law

1. Preclusion of Other State's Law Claims

Choice of law provisions in franchise agreements are often an effective way for a franchisor to persuade a court to dismiss disclosure claims based on another state’s laws. For example, a franchisor may be sued in state A by franchisees based in state B, who assert state B's franchise protection laws. The franchisor may be able to point to a choice of law provision in the franchise agreement specifying that state A’s law will apply, and therefore the claims based on state B law should be dismissed. This issue has been analyzed in a number of opinions, and a representative sample is discussed below.

   a. Cases that Preclude Claims from other States Based on Choice of Law Clause

      In Armstrong Bus. Servs., Inc. v. H & R Block,\(^{253}\) tax-preparation franchisees sued H&R Block for alleged violations of the territorial exclusivity provisions of their franchise agreements.\(^{254}\) The franchise agreements contained choice of law clauses specifying that Missouri law governed their interpretation.\(^{255}\) The franchisees argued that the state laws of the locations of the franchises should apply.\(^{256}\) The franchisees argued that those states had “a materially greater interest in this controversy” and that those states' franchise-related statutes should apply.\(^{257}\)

      The court applied Missouri's conflict of law doctrine, which follows the Restatement (Second) of Conflict of Law.\(^{258}\) Under the Restatement, the court would look to the state with the most significant relationship to the issues.\(^{259}\) If the court found that the state regulated franchise agreements and provided that those regulations could not be waived, then the court would apply that state’s law.\(^{260}\) Otherwise, the court would honor the contractual choice of law provision.\(^{261}\)

      The “most significant relationship” test under the Restatement involves examining several factors. These include: (a) the place of contracting, (b) the place of negotiation of the

\(^{253}\) 96 S.W.3d 887 (Mo. Ct. App. 2002).

\(^{254}\) Id. at 870.

\(^{255}\) Id. at 871-72.

\(^{256}\) Id. at 872.

\(^{257}\) Id.


\(^{259}\) Id.

\(^{260}\) Id.

\(^{261}\) Id.
contract, (c) the place of performance, (d) the location of the subject matter of the contract, and
(e) the domicile, residence, nationality, place of incorporation and place of business of the
parties. In this case, the court found that Missouri had the most significant relationship to the
transaction. Missouri was where H&R Block was incorporated and had its headquarters.
Missouri was the place of part of the contractual performance of the franchisees, the parties
expected to litigate in Missouri based on the choice of law provision, and the goals of
predictability and uniformity would be met by applying Missouri law to all of the franchisees.
Because Missouri law upholds choice of law provisions in franchise agreements, Missouri law
would apply to the case.

Texas Taco Cabana involved claims by New Mexico franchisees that the Texas
franchisor violated the New Mexico Unfair Practices Act and the Texas DTPA, among other
statutes. The franchisor moved to dismiss the New Mexico Unfair Practices Act claim,
arguing that Texas law applied because of the choice of law provision in the franchise
agreement. As with Armstrong Bus. Servs., the court applied the Restatement (Second) of
Conflict of Laws. The choice of law provision would be enforced, "unless the chosen law has
no substantial relationship to the parties or the transaction or application of the law chosen
would be contrary to a fundamental policy of a state that has a materially greater interest than
the chosen state in the determination of a particular issue."

In applying the Restatement’s most significant relationship test, the court determined
that, “although the injury occurred in New Mexico, the conduct causing the injury occurred in
Texas and the relationship between the parties is centered in Texas.” The court also
emphasized the importance of uniformity and predictability: “To require that each dispute be
settled under the law of the franchisees, which may be in a variety of states, may create
different results stemming from the same contract with the same Franchisor.” Also, “the
certainty, predictability and uniformity of result of contracts will be protected by focusing on the
single state which will have a substantial relationship to every contract involving the Franchisor

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262 Id. (citing Restatement (Second) of Conflict of Law § 188(2) (1971)).
263 Id. at 873.
264 Id.
265 Id.
267 Id. at 906.
268 Id. at 908.
269 Id.
270 Id.
271 Id. at 909.
272 Id. at 910.
and Franchisee.\footnote{273} Texas law applied and the court dismissed the New Mexico Unfair Practices Act claim.\footnote{274}

In \textit{Brenco Enters., Inc. v. Takeout Taxi Franchising Sys., Inc.},\footnote{275} the franchisees or former franchisees of the Takeout Taxi franchise system from around the country sued the franchisor in Virginia state court, alleging violations of multiple states' franchise and consumer protection statutes. The franchisor moved to dismiss the foreign state statutory claims based on the Virginia choice of law clause in the plaintiffs' franchise agreement. The court held that, "Virginia courts will apply choice of law provisions of an agreement where (1) the choice of law provision was not obtained by unfair means; (2) the state law selected has a reasonable relation to the contract or the parties have a reasonable basis for choosing a particular state's law; and (3) the law of the state chosen is not contrary to the public policy of the state whose law would otherwise govern." Because the plaintiffs' claims would not exist if it were not for the underlying franchise agreements, the court would apply a contract-based choice of law analysis, as opposed to a tort-based analysis. The court noted that all of the contracts at issue clearly contemplated the application of Virginia law. The contracts specifically excluded any action "based exclusively upon breaches of laws of foreign jurisdictions. The court concluded by stating that even under a tort-based conflicts analysis, the plaintiffs' allegations all concerned actions by the franchisor in Virginia, so Virginia law would apply regardless.

\textit{Banek Inc. v. Yogurt Ventures U.S.A., Inc.}\footnote{276} discussed the effect of a Georgia choice of law provision in a franchise agreement in a case in Michigan brought by a Michigan franchisee.\footnote{277} The court first analyzed whether the choice of law provision amounted to a prohibited waiver of rights under the Michigan Franchise Investment Law ("MFIL").\footnote{278} The court noted that in contrast to forum selection clauses, the MFIL did not include choice of law clauses in a list of void provisions.\footnote{279} Therefore, the court concluded that the choice of law clause could be enforced under Michigan law.\footnote{280}

The court then undertook a conflict of law analysis, using the Restatement (Second) of Conflict of Laws.\footnote{281} The parties did not dispute that there was a substantial relationship with Georgia, but the franchisee argued that applying Georgia law would violate Michigan public policy as expressed in the MFIL.\footnote{282} The court noted that in this case, the franchisee had

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\begin{itemize}
\item \footnote{273}{\textit{Id.}}
\item \footnote{274}{\textit{Id.}}
\item \footnote{275}{No. 177164, Bus. Franchise Guide (CCH) ¶12,595 (Va. Cir. Ct. Jan. 13, 2003). Co-Author Deborah S. Coldwell was one of the lead attorneys for defendants in this matter.}
\item \footnote{276}{6 F.3d 357 (6th Cir. 1993).}
\item \footnote{277}{\textit{Id.} at 359.}
\item \footnote{278}{\textit{Id.} at 360.}
\item \footnote{279}{\textit{Id.}}
\item \footnote{280}{\textit{Id.}}
\item \footnote{281}{\textit{Id.} at 361.}
\item \footnote{282}{\textit{Id.}}
\end{itemize}
negotiated several changes in the franchise agreement, so that this was not an adhesion contract. The Court went on to note that the franchisee did not show a substantial difference between Georgia and Michigan franchise law, such that application of Georgia law was not shown to be contrary to Michigan’s public policy. The court affirmed the district court’s decision to dismiss the plaintiff’s MFIL claim.

b. Cases that Do Not Preclude Other State Law Claims Based on Choice of Law Clauses

Burgo v. Lady of America Franchise Corp., involved claims brought by California franchisees against a Florida franchisor. The franchise agreement contained a Florida choice of law provision. The court noted that there was a substantial relationship with Florida because the franchisor was located in Florida and many franchisees attended training in Florida. However, the court found that enforcement of the Florida choice of law provision would violate California public policy. Specifically, the court pointed to the antiwaiver provision of the CFIL. In so doing, the court noted that choice of law provisions “requiring the application of another state’s laws force California citizens to give up their statutory rights” cannot be waived under the statute. The court also noted that Florida law provided substantially fewer protections to franchisees than California law. The court concluded by stating, “because applying Florida law to this action runs contrary to California’s fundamental public policy of providing expansive and unwaivable protection to potential franchisees, and because California has a materially greater interest in the determination of the issue, the Court holds that the choice of law provision is unenforceable, and that the governing law in this case is California’s.”

In Instructional Systems v. Computer Curriculum Corp., the Supreme Court of New Jersey held that New Jersey law would apply to a franchise agreement, despite the fact that the agreement itself specified California law. The court applied the Restatement (Second) of Conflict of Laws analysis. Because the franchisor was headquartered in California, California had a substantial relationship to the case. However, the court found that New Jersey had a “strong policy of protecting its franchisees,” and that New Jersey had significant contacts with the transaction. The court held that New Jersey law applied.

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283 Id.
284 Id. at 362.
285 Id. at 363.
286 Bus. Franchise Guide (CCH) ¶13,367.
288 Id. at 341-46, 614 A.2d at 133-35.
289 Id. at 341-42, 614 A.2d at 133.
290 Id. at 342, 610 A.2d at 133.
291 Id. at 345-46, 610 A.2d at 135.
292 Id. at 346, 610 A.2d at 135.

Many little FTC Acts contain so-called "anti-waiver" provisions. These usually state that any waiver of rights under those statutes is unenforceable. 293 Courts often apply these provisions to counter choice of law provisions. 294 However, it may be possible to argue in an appropriate situation that the anti-waiver statute should not apply. For example, in First Mutual, Inc. v. Rive Gauche Apparel Distrib., Ltd., 296 the plaintiff franchisees brought a claim against the franchisor under the Massachusetts Consumer Protection Act for disclosure violations under the FTC Rule. The court noted that Massachusetts courts have held that a party can waive its rights under the Consumer Protection Act "if that waiver would not frustrate the public policies underlying the statute." The court held that the waiver provision in the franchise license agreements barred the plaintiffs' claims in this case. The court noted that the dispute was between business entities engaged in a commercial transaction, and decided that the waiver in the franchise agreement did not violate Massachusetts public policy.

IV. Remedies

When a franchisee brings a disclosure claim, the remedies are often an afterthought, both for the parties and the court. The bulk of a typical disclosure case is spent trying to establish or disprove the merits of the alleged violation, whether any disclosure statute was actually violated, whether the undisclosed facts were material, and whether the franchisee would have acted differently with full knowledge. A franchisee plaintiff usually wants to be absolved of contractual obligations and to get its money back, but may also want compensation for time spent to develop the franchised business, lost opportunities, and losses suffered by the franchised business during operation. Franchise disclosure statutes can be confusing, often seeming to allow recovery on mutually exclusive grounds, such as rescinding the contract but also granting damages as if the contract had been breached. Monetary recovery is especially confusing, particularly because courts and parties often draw no distinction between monetary awards that are inherent in the rescission of a contract and monetary awards based on traditional damages models.

This portion of the paper discusses the variety of remedies that may be available for disclosure violations, how courts have awarded them, and how those awards have led to confusion in many instances.

293 See, e.g., CONN. GEN. STAT. § 42-133(f) ("Any waiver of the rights of a franchisee under sections 42-133f or 42-133g which is contained in any franchise agreement entered into or amended on or after June 12, 1975, shall be void."); 5 ME. REV. STAT. ANN. tit. 5, § 214 ("Any waiver by a consumer of the provisions of this chapter is contrary to public policy and shall be unenforceable and void.").

294 See Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128, 131-34 (7th Cir. 1990) (holding that the anti-waiver provision of Indiana's franchise law prohibited enforcing a choice of law provision specifying New York law); see also Physicians Weight Loss Centers of America v. McLean, No. 90-CV-2065, Bus. Franchise Guide (CCH) ¶9,837 (N.D. Ohio June 28, 1991) (holding that the anti-waiver statutes of the Connecticut Franchise Law, the Maine Business Opportunity Act, and the Indiana Deceptive Franchise Practices Law nullify a choice of law clause in a franchise agreement).

A. Civil Remedies

1. Rescission

Rescission is probably the most commonly sought remedy for a franchisor’s alleged violation of disclosure obligations. Virtually all state statutes requiring disclosure explicitly allow rescission as a remedy for disclosure violations.296 Rescission may also be available as a common law remedy, which is useful where state law does not require or regulate franchise disclosure.297

In its simplest terms, rescinding a contract is intended to unwind the parties’ commercial relationship and return them both to their pre-contract positions. In the early stages of a franchise relationship, that can be simple and straightforward, because, at most, the parties have executed an agreement and the franchisee has made an initial payment to the franchisor. To rescind, the money is returned and the contract and all its rights and obligations are canceled, including the non-competition restriction in the franchise agreement.

As the life of a franchise agreement progresses, rescission becomes more difficult on a practical level, because the parties have become so intertwined and their relationship so complex that there is no easy way to pull them apart and restore them to the status quo ante. Over time, franchise relationships typically lead to unrecoverable payments to third parties (such as brokers, vendors, suppliers, and employees), irreversible consumption of goods and services (such as the franchisee’s sale of the franchisor’s products), and substantial investments in buildings and equipment. Moreover, the facts of each situation will vary, and returning the parties to a reasonable facsimile of their pre-contract status is rarely the same from one situation to the next. As a result, there is no simple formula for courts to follow when unwinding these relationships.

This section examines several issues central to the remedy of rescission: limitations on the time within which the franchisee must seek rescission; the franchisee’s obligations upon or prior to seeking rescission; the effect of the franchisee’s unclean hands or knowledge of the facts underlying the franchisor’s violation; and the financial mechanics of unwinding a franchise relationship.

a. Time Limitations

Rescission is not available indefinitely. The franchisee will lose its right to rescission if it waits too long to exercise that right after discovering the facts underlying the disclosure violation. Regardless of the discovery of the violation, rescission claims will eventually be barred by the statute of limitations.

Rescission is an equitable remedy, so courts generally take into account the franchisee’s actions when considering a rescission request. One basis that courts often cite in denying


rescission requests is that the franchisee should not be allowed to wait and see whether the franchised business will be profitable before bringing its claim. For instance, in *Layton v. AAMCO Transmissions, Inc.* 298 the court held that granting rescission after a two-year delay would allow the franchisees to play a game of "heads, we win, tails, you lose," effectively making the franchisor a guarantor of the success of the franchise—if the franchisee was prospering, it would continue on with the agreement; if the franchised business was failing, the franchisee would rescind. Even if the franchisor had committed a disclosure violation, the court would not grant the franchisee that kind of blank check. In similar fashion, where the franchisee uses the fact that the franchisor failed to register to negotiate concessions from the franchisor, the franchisee will not later be able to rescind the agreement. 299 In general, any substantial delay in time will preclude rescission. 300

But a short delay will not preclude a rescission remedy, and whether a delay is unreasonably long will depend on the circumstances of each case. 301 Whether a franchisee has sought rescission promptly is a question of law, and should be decided by the court. 302

In certain state remedial statutes, the time limit on a franchisee’s right to seek rescission can be substantially reduced if the franchisee discovers the facts underlying the violation or the franchisor discloses the violation to the franchisee. For instance, under California law, a franchisee normally has four years to bring a rescission claim after the act or transaction constituting the violation. However, at the point the franchisee discovers the facts constituting the violation, that time limit drops to one year from the date of discovery, and if the franchisor delivers a written notice disclosing the violation, it drops to 90 days from the franchisee’s receipt of that notice. 303

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298 717 F. Supp. 368, Bus. Franchise Guide (CCH) ¶ 9471 (D. Md. 1989). See also *Meg-La, Inc. v. Uniforms for America*, Bus. Franchise Guide (CCH) ¶ 11,910 (Henn. Ct. Dist. Minn., July 28, 2000) (allowing the franchisee to delay seeking rescission would provide the franchisee the benefit of the bargain until that bargain were no longer profitable, which would be inequitable).


301 *Uncle John’s of Hawaii v. Mid-Pacific Restaurants*, 794 P.2d 614 (Haw. 1990) (one year delay not too long); *Sterling Vision DKM, Inc. v. Gordon*, 976 F. Supp. 1194 (E.D. Wis. 1997) (7 months not too long); but see *Kirkham v. Smith*, 23 P.3d 10, Bus. Franchise Guide (CCH) ¶ 12,082 (Wash. Ct. App., May 14, 2001) (7 months is too long; party’s actions must be consistent with intent to rescind promptly, and where franchisee made substantial additional investment after learning information underlying misrepresentation claim, franchisee had no intent to rescind until business losses later mounted).

302 *Nielson v. McCabe*, 442 N.W.2d 477, 481, Bus. Franchise Guide (CCH) ¶ 9432 (S.D. 1989) (finding a delay of five years, by which point the agreement had expired on its own terms, was too long to seek rescission; the franchisee’s "lack of promptness, in effect, affirmed the contract between the parties").

303 CAL. CORP. CODE § 31303. See also ILL. COMP. STAT. § 705/27 (3 years/1 year/90 days); HAW. REV. STAT. § 482E-10.5(b) (time reduced to 2 years upon franchisee’s discovery of facts constituting violation); VA. CODE § 13.1-565 (if franchisee is unregistered, franchisee must seek rescission within 72 hours after discovering and within 90 days after executing franchise agreement; if franchisee does not receive disclosure documents, franchisee must seek rescission
Alternatively, remedial statutes may reduce the time limit upon the franchisor’s delivery of a written rescission offer to the franchisee. If the franchisee does not accept the rescission offer—usually within a relatively short time period—the franchisee waives the right to seek rescission later.\(^{304}\)

Where the franchisee claims that the franchisor did not disclose the franchisee’s contractual obligations, the clock starts to run upon the franchisee’s execution of the franchise agreement, because the franchisee will be deemed to know the content of a contract it has executed.\(^{305}\) When the claim is based on the franchisor’s failure to register, the clock likewise begins to run upon execution, because the franchisee’s duty of diligent inquiry will require it to perform at least a rudimentary investigation of whether the franchisor has registered with the state, which is relatively easy to determine in most registration states.\(^{306}\)

b. **Franchisee’s Obligations upon Seeking Rescission**

A franchisee seeking rescission must, at a minimum, offer to return to the franchisor all benefits susceptible to transfer. The tender of restoration generally must be “of the specific thing received in substantially as good a condition as when received if that is possible.”\(^{307}\)

The benefits and property susceptible to transfer include the rights under the franchise agreement to use the trademark or trade dress, to act as franchisee within an exclusive territory, and to hold oneself out as affiliated with the franchisor, and any trademarked, confidential, or proprietary materials provided by the franchisor.\(^{308}\)

It is usually a straightforward matter to return a franchisor’s confidential or proprietary materials. However, removing trademarks and trade dress can be a time-consuming and expensive process, and it will typically be unreasonably burdensome to require a franchisee to take those steps prior to the franchisor’s confirmation that it will grant the rescission requested. In many instances, de-identification would require a franchisee to remove signs, repaint its retail site and vehicles, and even alter buildings that are inherently associated with a franchisor’s brand. For that reason, franchisees will usually be able to offer to remove marks, etc., but to condition the actual removal upon the franchisor’s accepting the rescission demand.\(^{309}\)
Reisscission disputes often focus on whether the franchisee has truly tendered the full benefits it has received under the franchise agreement, because certain benefits provided by the franchisor simply cannot be returned in the same form. These types of benefits include confidential information, know-how, training, and industry experience. The franchisee cannot remove those benefits from his or her brain, and limiting the franchisee's ability to use them could punish the franchisee inequitably when the rescission was based on the franchisor's wrongdoing. Courts generally recognize the difficulty created by this situation, and reject requirements that the franchisee somehow return those benefits.310 In other instances, however, courts have allowed franchisors to recover the value of those intangible benefits upon or as a condition of rescission.311

The franchisee's obligation to return the benefits received is not affected by whether the franchisee made a profit in the franchised business. In other words, even if the business did not have “value” in the sense that it was not profitable, the benefits conferred by the franchisor still had independent value, and the franchisee must return them.312 Also, as long as the franchise agreement remains in effect, the franchisee must continue paying royalties and any other amounts due, even if the franchisee is entitled to rescind.313

A franchisee cannot tender to the franchisor what the franchisee no longer possesses. Thus, to be entitled to rescission, a franchisee must be capable of tendering the franchise back to the franchisor. If the franchisee has transferred the franchise agreement to another party, the franchisee no longer has the right to rescind.314

c. Clean Hands and Knowledge of Violation

Rescission is an equitable remedy, so a franchisor can defend a franchisee's request for rescission with equitable defenses. Typically, a franchisee will not be entitled to rescission if the franchisee is itself in default under the franchise agreement.315

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311 Interstate Automatic Transmission Co. v. Harvey, 350 N.W. 2d 907 (Mich. Ct. App. 1984) (franchisee's rescission was contingent on crediting the value of the training provided to franchisee).


315 Two Men and A Truck, 949 F. Supp. 500 (franchisees not entitled to rescission in part because they had to pay royalties due under franchise agreement); In re Dynamic Enterprises, Inc., 32 B.R. 509 (M.D. Tenn. Bkrtcy. 1983) (rescission not available because franchisee failed to make required payments). But see Martino v. Cotman Transmision Systems, Inc., 554 N.W.2d 17, Bus. Franchise Guide (CCH) ¶ 11,384 (Mich. Ct. App., July 30, 1996) (franchisee's unclean hands do not affect entitlement to rescission); My Pie International, Inc. v. Deboldt, Inc., 887 F.2d 919, 924 (7th Cir. 1982) (estoppel is not a defense under an Illinois Franchise Disclosure Act case). See also Dollar Systems, Inc. v. Avcar Leasing System, Inc., 673 F. Supp. 1493, 1504 (C.D. Cal. 1987) (in this unusual instance, the court held that the franchisee had "often acted irresponsibly in the conduct of its business," and though that did not rise to the level of "unclean hands" or preclude rescission, the court denied the franchisee's request for consequential damages in the form of business losses).
Many remedial statutes prohibit a franchisee from obtaining rescission if the franchisee knew the truth of the misrepresentation or omission, or if the franchisor could not have known the facts creating the misrepresentation or omission, even with the exercise of reasonable care.\textsuperscript{316}

A few state remedial statutes condition rescission on the franchisee’s showing that the franchisor’s violation was willful.\textsuperscript{317} In that context, “willful” means knowing and intentional, but does not necessarily require that the franchisor intended to violate the law or had an evil motive.\textsuperscript{318}

d. \textbf{Financial Mechanics of Rescission}

Rescission generates a variety of complications from a financial and accounting standpoint. In general, state statutes granting rescission rights do not specify a separate private right to “restitution,”\textsuperscript{319} the payment of money to offset certain losses suffered. Nevertheless, the financial and accounting complications involved in rescinding a franchise agreement have led courts to “adjust the equities between the parties” by ordering restitution as part of a rescission remedy.\textsuperscript{320}

This balancing of equities was considered in detail by the trial court in \textit{Dollar Systems, Inc. v. Avcar Leasing System, Inc.}\textsuperscript{321} The case concerned a rental car franchise for airport locations, which the franchisee took over from existing operators. The franchisor failed to provide the required disclosures, but the franchisee did not act perfectly itself, failing to file monthly reports, failing to pay fees on time (or at all), and failing to pay certain creditors. The court held that the sale was unlawful because of the franchisor’s failure to comply with disclosure obligations, and granted the franchisee’s request for rescission. In unwinding the parties’ relationship, the court granted the franchisee the return of its initial payment and promissory note payments made for the right to enter into the franchise agreement, its payment for the final month’s rent and security deposit, payments for improvements at one airport site, its payments for reservation fees, system fees, supplies, rent and taxes, gas, and “green stamps,” and an amount for additional payments that had not been allocated to any particular expense. From that total, the court offset the amount by the value of: the car fleet and furniture that the franchisee had received at the outset of the franchise agreement, the airport facility used by the franchisee, the reservations made on the franchisee’s behalf, the supplies provided to the franchisee, the rent and taxes relating to the business, and the gas and “green stamps” provided to the franchisee. The court also required the franchisor to indemnify the franchisee and its guarantors from any liability arising out of the franchisee’s assumption of the car fleet. Although that liability would have been to a third party (GMAC), the court held that this award of “consequential damages” was appropriate “because these guarantees were inextricably


\textsuperscript{318} \textit{Dollar Systems}, 890 F.2d 165.

\textsuperscript{319} \textit{But see Md. Code Ann.} § 14-227(c) (allowing court to order franchisor to “make restitution” in private civil claim).

\textsuperscript{320} \textit{Dollar Systems}, 890 F.2d at 174.

\textsuperscript{321} \textit{Dollar Systems}, 673 F. Supp. 1493.
intertwined with the execution of the license agreement which the Court has rescinded." The appellate court justified the indemnity because, in the trial court's determination of offsets, it had credited the franchisor with the remaining equity in that fleet of cars. Having been credited with the value of the cars, it was only fair to impose the remaining liability associated with that asset. 323

In Paghman Chicken, Inc. v. Loghar Restaurant Corp., 324 the court granted the franchisee rescission of the franchise agreement, and included in its award a return of the franchisee's application fee, down payment, and all amounts paid to the franchisor on a series of promissory notes used to secure the remaining initial balance for establishing the franchised business. The court also awarded what it characterized as "damages" in the form of a return of all royalty payments made to the franchisor, all rent payments made to the franchisor to the extent they exceeded the franchisor's own lease payments to the property owner, and the franchisee's lease security deposit. Finally, the court also awarded the franchisee its security deposit paid to its utility company, despite the lack of any indication that the franchisor had received or benefited from that utility deposit. This expansive award was based on the court's intent to deprive the franchisor of any unjust enrichment resulting from its disclosure violation. 325

Calculating the amount of a restitution award includes a number of possible offsets in the amount owed by the franchisor. For instance, courts generally allow a franchisor to offset its restitution payment by the amount of income or profits the franchisee received during the operation of the franchised business. 326 Courts are split on whether a rescinding franchisee is entitled to any compensation for wages the franchisee might have earned in other pursuits. 327

In their remedial statutes, certain states specify that, in making a rescission offer, franchisors are entitled to account for depreciation or amortization of substantial investments in buildings or equipment. 328 That effectively grants franchisors an offset to account for the loss of value of those assets during the life of the franchise, reflecting the value that was "used up" by

322 Id. at 1505.
323 Dollar Systems, 890 F.2d at 175.
324 Bus. Franchise Guide (CCH) ¶ 8554.
325 See also Little Caesar Enterprises, 219 F.3d 547 (awarding as part of franchisee's restitution the profits obtained by franchisor during operation of rescinded franchise agreement).
327 Runyan, 466 P.2d at 693 (court awarded franchisee his income lost during the period the franchise agreement was in effect, but offset by the gross income the franchisee received from operating the franchise); Young v. T-Shirts Plus, Inc., 1984 WL 180476 (Wis. Ct. App., March 27, 1984) (rescission award can include value of lost wages from time spent working in franchised business); Fox v. Dynamark Security Centers, Inc., 1989 WL 106802 (4th Cir. 1989) (franchisees are not entitled to compensation for wages they would not have earned, so lost wages should not be granted to franchisees who were unemployed at the time they executed their franchise agreements).
the franchisee. On occasion, courts will even grant rescission of contracts between the franchisee and a party other than the franchisor.

2. **Damages and Their Measure**

Most statutes that regulate franchise disclosure also allow a private right to recover damages for a franchisor's violation of those disclosure requirements. However, demonstrating and measuring damages is not always clear-cut, especially for disclosure violations, when franchisees often simultaneously seek rescission and damages, and it is easy for courts to mix concepts between granting restitution and granting actual damages. Disclosure claims are unlike claims brought under franchise relationship statutes, where a franchisee can draw a relatively simple connection between the prohibited conduct and its negative economic effect. In disclosure claims, demonstrating damages typically requires the franchisee to show how the franchisee was affected by information it did not know or that (as a result of the franchisor's misrepresentation) it did not understand correctly, which inherently involves some degree of speculation or inference.

Damages for routine disclosure violations are usually calculated based on actual losses of the franchisee, often referred to as “out of pocket” expenses. In *Young v. T-Shirts Plus, Inc.*, the court ordered that a franchisee, who had given up a full-time job she had held for over twenty years to become a franchisee, was entitled to receive her out of pocket expenses, as well as the wages she had forgone in entering into the franchise agreement, less any income or profits she received as a franchisee. The court stressed, however, that she was not entitled

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329 *But see Martin Distributors v. Vander Bie*, 269 N.W.2d 868, 876 (Minn. 1978) (franchisor not entitled to any offset upon repaying a franchisee for an item purchased if there is “no significant redeemable value” remaining in the item at the time of rescission, regardless of whether the franchisee returns it to the franchisor), which is consistent with the RESTATEMENT OF RESTITUTION § 66(5): "Where the subject matter has deteriorated or a portion of it has been destroyed or transferred, restitution is granted only upon the return or offer to return of what remains, if of any value."

330 *Chase Manhattan Bank v. Clusiau Sales & Rental*, 308 N.W.2d 490 (Minn. 1981) (bank that assumes agreement from franchisor may not enforce it against franchisee where franchisee is entitled to rescission of underlying franchise agreement).

331 ARK. CODE ANN. § 4-72-208(a); CAL. CORP. CODE § 31300; FLA. STAT. § 817.416 (allowing recovery of “all moneys invested in such franchise”); HAW. REV. STAT. § 482E-9(c); ILL. COMP. STAT. § 705/28; IND. CODE § 23-2-2.5-28 (allowing recovery of “any consequential damages”) MD. CODE ANN. § 14-227(b); Mich. Comp. L. § 445-1531(1); MINN. STAT. § 80C.17; N.Y. GEN. BUS. L. § 691; N.D. CENT. CODE § 51-19-12; R.I. GEN. LAWS § 1928.121; S.D. CODIFIED LAWS § 37-5A-83; VA. CODE § 13.1-571; WASH. REV. CODE § 19.100.190; WIS. STAT. § 553.51. But damages may not be available only when it is registered and not violation of disclosure requirements. *Lulling v. Barnaby’s Family Inns, Inc.*, 499 F. Supp. 1353, Bus. Franchise Guide (CCH) ¶ 7617 (E.D. Wis., Oct. 20, 1980) (failure to register gave rise only to rescission right, which franchisees rejected).

332 See *Martin Distributors*, 269 N.W.2d 868, 875-76 (“Some confusion was generated by the mischaracterization of this award as damages. . . . In effect, [the franchisee was not granted damages but rather rescission of its contract with restitution of sums expended in setting up a business under the contract in order to place both parties at status quo ante the contract.”); *Fox*, 1989 WL 106802 (recognizing that the incoherence of trial outcome was based in part on jury instructions that failed to distinguish between “mutually exclusive remedies” of rescission and damages in disclosure misrepresentation case); *Dollar Systems*, 673 F. Supp. at 1504 (awarding “restitutory damages” based on payments franchisee had made to franchisor and “consequential damages” in the form of requiring the franchisor to indemnify the franchisee for the remaining debt on the fleet of cars assumed by the franchisee when taking on the franchise); *Masters*, Bus. Franchise Guide (CCH) ¶ 7794 (instructing jury that it may rescind the franchise agreement and award damages “suffered as a consequence of having entered into the franchise agreement”).

333 1984 WL 180476.
to the benefit of the bargain; by netting her forgone wages by her franchisee income, the court effectively placed her in the position she would have been in had she stayed in her prior position and never entered into the franchise agreement (the would-be “bargain”). In similar fashion, the court in Brader v. Minute Muffler Installaton, Ltd. 334 refused to award the franchisee its business losses, despite finding it appropriate to rescind the franchise agreement and award the franchisee its franchise fees and a portion of its expenditures to open its store. Holding that the franchisee’s business losses had not benefited the franchisor, the franchisor should not be required to compensate the franchisee for them. 335

In some circumstances, most notably when the franchisor has committed fraud, the measure of damages will be the “benefit of the bargain.” 336 In other words, a defrauded franchisee may be entitled to the difference between the value of what the franchisor represented and what the franchisor actually delivered. 337

Lost profits may also be available where an award limited to of out-of-pocket costs would “fail to return [the franchisees] to their condition” before the misrepresentations, such as when the franchisor’s misrepresentation induced the franchisee to give up its business without compensation. 338 But lost future profits, even if available, require the franchisee to show a period of successful operation; otherwise, they are too speculative. 339 The required degree of certainty includes evidence to support “both ends” of a benefit of the bargain calculation; that is, the value of the franchise as represented and as actually delivered. If both can be shown with reasonable certainty, then the franchisee can recover the benefit of the bargain. 340

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335 But the court noted that it may have held otherwise if the franchisor had committed fraud, rather than simply failed to register and make required pre-sale disclosures.
336 Fox, 1989 WL 106802.
337 Id.; Masters, Bus. Franchise Guide (CCH) ¶ 7734 (if fraud shown, franchisee is entitled to “any loss of profits which were reasonably anticipated and would have been earned from the franchise had the franchise possessed the characteristics fraudulently attributed to it by the party or parties committing the fraud”).
338 Hughes v. Sinclair Marketing, Inc., 389 N.W.2d 194, 198-99 (Minn. 1986) (awarding lost profits where franchisor misled franchisee and franchisee gave up renewal right, leading to loss of franchised business). See also Blaske v. Burger King Corp., Bus. Franchise Guide (CCH) ¶ 10,490 (D. Minn. 1994) (on fraudulent misrepresentation claim, jury instructed to award out of pocket losses to franchisee, but permitted to “consider such other damages as were naturally caused by the fraudulent misrepresentation” if those out of pocket expenses “will not fully compensate” the franchisees).
339 Mallari v. Western Auto Parts Supply Co., 1988 U.S. Dist. LEXIS 13723 (M.D. Fla. 1988); Fox, 1989 WL 106802 (noting that the availability of benefit of the bargain damages depended in part on the "degree of certainty by which [they] can be proved," and that those damages were properly denied because the franchisee "did not produce sufficient evidence, largely because of the newness of their businesses, so that lost profits could be proved to a "reasonable certainty"); Hughes, 389 N.W.2d at 199-200 (allowing lost profits after years of operation; "we have not required absolute certainty in the damage calculations, but reasonable certainty"); Blaske, Bus. Franchise Guide (CCH) ¶ 10,490 (instructing the jury that "you may award damages for the value of future profits which the [franchisees] prove with reasonably certainty. You may not award lost profits based on speculation or conjecture.").
340 Crues v. KFC Corp., 729 F.2d 1145, 1151-52 (8th Cir. 1984).
As with rescission remedies, a franchisee seeking damages must do so promptly after discovering the facts underlying the fraud.\footnote{341}

3. Connection Between Violation and Remedy

As discussed in more detail in Section III of this paper, a franchisee’s right to a remedy is predicated on a proximate connection between the disclosure violation and the injury alleged. Courts generally will not grant a remedy when the franchisee is unable to show how the violation actually caused the purported injury. Thus, franchisees typically will receive no relief when the franchisor is alleged to have committed a technical violation of registration or disclosure regulations when there is no clear indication of any direct consequences of that violation.\footnote{342} Some disclosure statutes expressly require detrimental reliance before a franchisee will be entitled to a remedy.\footnote{343}

In the disclosure context, a franchisee can best show a connection between the violation and the injury by demonstrating that the misrepresentation or omission played a role in the franchisee’s investment decision.\footnote{344}

On occasion, however, courts will grant remedies to franchisees based simply on the franchisor’s violation, without requiring any proximate connection.\footnote{345}

A defendant franchisor may also argue that the franchisee has not suffered any actual injury or damages. Although the plaintiff franchisee would have the burden of proof to show damages, the defendant franchisor should be prepared to demonstrate deficiencies in the

\footnote{341}{See Magna Weld Sales Co. v. Magna Alloys & Research Pty, 545 F.2d 668 (8th Cir. 1977) (court reversed damage award to distributors who claimed supplier fraudulently induced them to enter into agreement; distributors admitted that they knew of true facts years before bringing claim, but did not complain, continued purchasing inventory, and did not seek to terminate agreement).}


\footnote{343}{See, e.g., Wis. Stat. § 553.51 (franchisee seeking either rescission or damages must show reliance).}

\footnote{344}{Layton, 717 F. Supp. 368, Bus. Franchise Guide (CCH) ¶ 9471 (franchisee cannot show fraud where it has admitted that it did not rely on franchisor’s misrepresentations); Dunkin Donuts, 181 A.D.2d 711, 581 N.Y.S. 2d 363 ("a misrepresentation on a matter that is shown to have had a negligible effect on the [franchisees'] business cannot be said to be material"); BMW Co. v. Workbench, 1988 WL 45594 (S.D.N.Y., April 29, 1988) (rescission cannot be granted where non-disclosure was not material to investment decision); Carrel v. George Weston Bakeries Distribution, Inc., 2006 WL 1005041 (S.D. Ind., April 13, 2006) (in claim for violation of franchise disclosure statute, franchisee must allege reliance on franchisor’s representation).}

\footnote{345}{Masters, Bus. Franchise Guide (CCH) ¶ 7734 (instructing the jury that, "[i]f you determine that the defendant corporation willfully sold to plaintiffs a franchise which was not properly registered, then plaintiffs are entitled to rescission [sic], regardless of whether or not the failure to register was the cause of their damages"); Little Caeser Enterprises, 219 F.3d at 553 n.4 (franchisee would be entitled to rescission even if it cannot demonstrate any harm from franchisor’s failure to register).}
franchisee’s damages model. For example, if the franchisor can show that the franchisee operated a successful franchise despite the disclosure claims, such a showing may preclude a significant damages award.

Although not strictly a disclosure case, *Dunkin’ Donuts of America, Inc. v. Minerva, Inc.* provides a good example of how a franchisor may avoid liability by arguing that the franchisee has not been damaged. In *Dunkin’ Donuts*, the franchisor brought suit against the franchisee for failing to report all sales in the franchisee’s two stores. The franchisees counterclaimed, alleging, among other things, that the franchisor breached the implied duty of good faith in the franchise agreements. A jury found that the franchisor did breach the implied duty of good faith, but the trial judge limited the franchisee’s damages to nominal damages. The Eleventh Circuit affirmed, holding that while the evidence supported finding the franchisor liable for breach of contract, the franchisee did not prove damages. The franchisee’s stores remained profitably operating, even after the franchisor’s breach occurred. The court held that the franchisee was entitled to “lost profits or future profits related to her ongoing operation caused by Dunkin’s breach.” However, the franchisee had no evidence that her profits had been damaged by the franchisor’s conduct. Therefore, the court affirmed the trial court’s award of $2 in nominal damages.

*Century 21 Real Estate Corp.* is a case under the Texas Little FTC Act where the question of whether the franchisee had suffered damages was explored in detail. In the end, the court held that the plaintiff franchisee had presented sufficient evidence to support the jury’s damage award. The franchisee real estate agency alleged that the franchisor misrepresented its intention to place another franchise in close proximity to the plaintiff. The franchisor argued that the franchisee’s business was performing well and that the second franchise actually helped the plaintiff’s business. However, the franchisee attributed its good year to

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346 In this regard, it is instructive to understand just what it takes for a franchisee to prove damages. For a general overview of this topic, see Diane Green-Kelly, Steven Kelly, and Tamika Langley Tremaglio, *The Nuts and Bolts of Proving Damages*, American Bar Association Forum on Franchising, Oct. 19-21, 2005.

347 956 F.2d 1566 (11th Cir. 1992).

348 *Id. at 1566.*

349 *Id.*

350 *Id. at 1569.*

351 *Id. at 1573.*

352 *Id. at 1571.*

353 *Id. at 1573.*

354 *Id.*

355 *Id. at 1569, 1573.*

356 890 S.W.2d 118.

357 *Id. at 131.*

358 *Id.*

359 *Id.*
lower interest rates helping the real estate market, and put on expert testimony from an economist that the new franchisee hurt the plaintiff.\textsuperscript{360} The court found that the plaintiff introduced sufficient evidence to show that the defendant's misconduct was a producing cause of the plaintiff's injuries.\textsuperscript{361} Although the franchisee in this case was ultimately able to prove damages, the lengths the franchisee went to in order to prove damages show the potential significance of this issue.

4. \textbf{Punitive Damages}

Some state statutes allow franchisees to recover increased damages for disclosure violations. These are typically triple ("treble") damages.\textsuperscript{362} They are intended to punish the franchisor's conduct and to deter other franchisors from doing the same.

In other states, courts have awarded punitive damages, even where they are not explicitly authorized under a franchise disclosure statute, or have been ambiguous about whether punitive damages are available for disclosure violations. For instance, Florida courts have denied punitive damages in certain cases,\textsuperscript{363} but granted them in others.\textsuperscript{364} Minnesota courts have similarly rejected punitive damages for violations of the state's registration and disclosure statute,\textsuperscript{365} but have held that punitive damages may be available based on a franchisor's fraudulent inducement of a franchisee's entry into a franchise agreement, which itself would violate the disclosure statute.\textsuperscript{366} In Illinois, courts have said both that punitive damages are available on a disclosure claim,\textsuperscript{367} but are not available under the state's franchise act.\textsuperscript{368} In general, court awards of punitive damages occur only where the franchisor has committed clear fraud or has egregiously and intentionally violated its disclosure obligations.

\textsuperscript{360} Id.

\textsuperscript{361} Id.

\textsuperscript{362} ARK. CODE ANN. § 4-72-208(a) (treble); HAW. REV. STAT. § 482E-9(c) (treble); S.D. CODIFIED LAWS § 37-5A-85 (treble) (but see Fritzmeier v. Krause Gentle Corp., 669 N.W.2d 699 (S.D. 2003) (upholding award of punitive damages that ranged from 1.31 to 3.19 times individual franchisees' compensatory damages)); WASH. REV. CODE § 19.100.190(3) (treble).


\textsuperscript{364} Griffin v. Swim-Tech Corp., 722 F.2d 677 (11th Cir. 1984) (upholding punitive award, but not necessarily upon disclosure claim).


\textsuperscript{366} Team Tires, Bus. Franchise Guide (CCH) ¶ 12,820.


5. **Attorneys’ Fees**

In addition to punitive damages, state disclosure laws typically permit a prevailing franchisee to recover its reasonable attorneys’ fees and costs incurred in pursuing the claim.\(^{369}\)

On the statutory side, this is generally a one-way street—franchisors who successfully defend a disclosure claim generally do not have any entitlement to their fees or costs.\(^{370}\) But in the absence of a statutory fees claim, a franchisor who has entered into a franchise agreement with the franchisee and successfully defends a disclosure claim can rely on a contractual fees provision to support a fee claim.

6. **Reach of Liability: Parents, Parents’ Parents, Owners, Officers, and Directors**

Most disclosure statutes allow for liability beyond the franchisor entity itself, and typically make jointly and severally liable a wide range of officers, owners, and managers who were involved in committing the fraud, making the misrepresentation, or omitting the required disclosure, or who controlled those who did. At the same time, most statutes also allow such a person to defend that claim on the grounds that he or she did not know the truth of the matter and could not have known the truth even with the exercise of reasonable care.\(^{371}\) A corporate officer or owner asserting such a defense will have the burden of proving it once the violation is established.\(^{372}\)

Although these statutes potentially encompass virtually anyone working on behalf of or with an ownership interest in the franchisor entity, courts have been much more lenient and realistic in imposing personal liability. In general, courts have held that individual defendants must have personally participated in the fraud or materially aided in the violation to be held liable.\(^{373}\)

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\(^{370}\) But see Wash. Rev. Code § 19.100.190(3) (allowing prevailing party to recover fees if claim is brought for damages).


\(^{373}\) Checkers Drive-In Restaurants, Inc. v. Tampa Checkmate Food Services, Inc., 805 So. 2d 941, 944, Bus. Franchise Guide (CH) ¶ 12,207 (Fla. Dist. Ct. App. 2001); To-Am Equipment Co., Inc. v. Mitsubishi Caterpillar Forklift Am., Inc., 913 F. Supp. 1148, 1152 (N.D. Ill. 1996); aff’d 152 F.3d 558, Bus. Franchise Guide (CH) ¶ 11,456 (7th Cir. 1998); But see Kehr v. Gropp and Lehman Enterprises, Bus. Franchise Guide (CH) ¶ 8124 (6th Cir. 1983) (holding officers and shareholders jointly and severally liable for failure to register or disclose; court cited old saw that ignorance of the law is not a defense, when in fact it is a defense in most states for the violation alleged).
Several states have expansive definitions that make the reach of potential liability even broader. For instance, Washington's franchise statute defines "person" (in the context of an entity) to "include any other entity which has a majority interest in such an entity or effectively controls such other entity as well as the individual officers, directors, and other persons in act of control of the activities of each such entity."\(^{374}\) Thus, when it imposes liability on a "person" who violates the disclosure provisions, and that "person" is the franchisor, then a strict reading of the statute would extend liability not just to the franchisor and its officers and directors, but also to any parent company and its officers, directors, and anyone else effectively in control of it. By allowing such defendants to assert their own individual lack of knowledge or reason to know, other states eliminate this potentially vast pool of liable defendants.\(^{375}\) Washington remains an outlier in this respect, because it imposes these expansive definitions but does not explicitly allow the defense of absence of knowledge.

7. **Other Relief**

State disclosure statutes offer a few other forms of miscellaneous relief. Several states explicitly allow a franchisee to recover interest, either from the date of the franchisee's purchase or from the date of a judgment on a successful suit.\(^{376}\)

One remedial statute specifically allows a franchisee to recover its expert fees after successfully pursuing a disclosure claim.\(^{377}\)

8. **Overlap and Election of Remedies**

The two most common forms of remedy for disclosure violations—rescission and damages—are typically mutually exclusive; that is, a wronged franchisee may obtain one, but not both.\(^{378}\) However, that is not always the case.\(^{379}\) In some cases, the court will grant both rescission and damages—or at least what it terms "damages."\(^{380}\)

A franchisee may jeopardize its entitlement to certain remedies if it pleads its claim too broadly, particularly in the absence of a statutory right. If a franchisee seeks damages at the

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374 WASH. REV. CODE § 19.100.010. Hawaii and Rhode Island employ similar definitions. HAW. REV. STATE. § 482E-2; R.I. GEN. LAWS § 1928.13.

375 See, e.g., HAW. REV. STAT. § 482E-9(c); R.I. GEN. LAWS § 1928.121.

376 MICH. COMP. LAWS § 445.1531 (12% interest from the date of purchase); N.Y. GEN. BUS. L. § 691 (6% interest from the date of purchase); IND. CODE § 23-2-2.5-28(2) (8% interest from the date of judgment).


378 Robinson v. Perpetual Services Corp., 412 N.W.2d 562 (Iowa 1987); Dynamic Enterprises, 32 B.R. 509, Bus. Franchise Guide (CCH) ¶ 8054 (party cannot rescind after electing to go forward under contract); Interstate Automatic Transmission, 350 N.W.2d 907, Bus. Franchise Guide (CCH) ¶ 8174 (franchisee entitled to rescission or damages as a result of non-disclosure).

379 See VA. CODE § 13.1-571 (franchisee who has declared franchise void under rescission provision may also bring action to recover damages sustained).

380 See Dollar Systems, 890 F.2d 185, Bus. Franchise Guide (CCH) ¶ 9498. Again, because damages and restitution are often difficult to distinguish in cases involving disclosure claims, courts often do not use these terms consistently.
same time it seeks rescission, the franchisee may inadvertently concede that an adequate remedy at law exists, thereby precluding its own rescission claim.\footnote{381}

Most disclosure statutes also preserve any available common law claims and remedies.\footnote{382} Thus, even where a specific remedy is not granted by a disclosure statute, a franchisee may seek that remedy under a common law theory.

9. \textbf{Economic Loss Rule}

The Economic Loss Rule is intended to preclude tort claims for parties to a contract when the subject of the claim is intertwined with the contract, absent any bodily injury or physical property damage. The rationale is that the parties have had an opportunity to allocate the risk for those “economic losses” between them through their contract, so a party will not be allowed to impose non-contractual duties on the other except for those duties that exist between any two people, such as the duty not to act negligently in a manner that would cause bodily injury or physical damage.

The Economic Loss Rule is always a confusing legal doctrine, but that confusion heightens when the asserted duty is based in statute, which is the usual basis for franchise-related disclosure claims. Where the statute allows a private right of action for disclosure violations, courts have generally ignored the Economic Loss Rule.\footnote{383}

In the disclosure context, the Economic Loss Rule should bar a tort claim alleging that the franchisor fraudulently induced the franchisee by representing that the franchisor would fulfill its obligations under the agreement. If the franchisor in fact fails to fulfill contractual obligations, then the franchisee has an adequate remedy in breach of contract, or had the opportunity to obtain such a remedy when the contract was negotiated. For instance, a hotel franchisee’s claims that its franchisor did not list the franchisee’s site on its system quickly enough, did not generate sufficient reservations, and did not provide beneficial management support, are “interwoven and indistinct from the heart of the contractual agreement” and are therefore barred by the Economic Loss Rule.\footnote{384}

B. \textbf{Federal Remedies}

The federal government regulates franchise disclosure obligations through the Federal Trade Commission under the “FTC Act.”\footnote{385} Through its “Franchise Rule,”\footnote{386} the FTC has

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  \item \textit{Half}, 912 F. Supp. 1509, Bus. Franchise Guide (CCH) ¶ 10,799 (where face of complaint shows adequate remedy at law, “there is no jurisdiction in equity”).
  \item \textsc{Cal. Corp. Code} § 31306; \textsc{Ill. Comp. Stat.} § 705/28; \textsc{Mich. Comp. Laws} § 445.1534; \textsc{Minn. Stat.} § 80C.17; \textsc{N.Y. Gen. Bus. Law} § 691; \textsc{N.D. Cent. Code} § 51-19-12; \textsc{Or. Rev. Stat.} § 650.085; \textsc{R.I. Gen. Laws} § 1928.123; \textsc{S.D. Codified Laws} § 37.5A-82; \textsc{Va. Code} § 13.1-571; \textsc{Wash. Rev. Code} § 19.100.910; \textsc{Wis. Stat.} § 553.51.
  \item Which usually is not raised by counsel in that context. \textit{But see Shipman}, 446 F.Supp.2d 812, Bus. Franchise Guide (CCH) ¶ 13,402 (E.D. Ill. 2006) (statutory disclosure duty takes claim for non-disclosure out of confines of contract, so Economic Loss Rule will not bar claim).
\end{itemize}}
prescribed mandatory disclosures applicable to all non-exempt franchisors. Violation of those disclosure requirements can result in federal enforcement actions and in private actions under certain state laws.

The FTC Act empowers the FTC to investigate and prosecute persons or entities who violate disclosure requirements. The potential penalties and remedies include temporary, preliminary and permanent injunctive relief, rescission and reformation of contracts, restitution, damages, disgorgement of funds, appointment of a receiver, and other equitable relief, in addition to any other penalties available under any other state or federal law.387

The FTC pursues to conclusion 10-20 civil suits against violators each year.388 These actions tend to involve franchisors who fail to provide any disclosure documents to prospective franchisees. In general, where the franchisor has provided a facially compliant disclosure document, the FTC will leave disputes over the adequacy of individual disclosures to be resolved through private actions by the aggrieved party.

C. State Remedies

State-enforced penalties for disclosure violations run the gamut from serious to mild, and include criminal liability, fines and other monetary penalties, cease and desist orders that enjoin further violations, revocation of an existing registration, and conditions or restrictions placed on future sales. In most cases, state regulators are entitled to combine these penalties as they see fit to address the severity of the violation.

1. Criminal

Most disclosure statutes empower the regulating agency to prosecute franchisors and their control persons for violating registration or disclosure laws, including for making false or misleading statements in the offer or sale of franchises.389 Actual criminal prosecutions for disclosure violations remain rare, but they are not without precedent.390

2. Civil and Regulatory Penalties

States that impose disclosure requirements on franchisors also allow themselves a wide range of civil and regulatory penalties for franchisors who violate those requirements or who

385 16 CFR Part 436.
388 Summaries of concluded cases are available, as of the publication of this paper, at http://www.ftc.gov/bcp/franchise/caselist.shtml.
390 People v. Carter, 454 N.E.2d 189, Bus. Franchise Guide (CCH) ¶ 7912 (Ill. App. Ct. 1982) (Chairman of the Board was convicted for sale of unregistered franchise, failing to provide disclosure document, failing to place initial fees into escrow, and failing to register salespersons); criminal charge reported at State v. Baum, Bus. Franchise Guide (CCH) ¶ 8394; People v. Ganda, 188 Cal. Rptr. 295 (Cal. Ct. App. 1983).
otherwise fail to observe regulatory restrictions. Those penalties include fines and monetary penalties, and orders prohibiting the objectionable conduct, and orders revoking or suspending the franchisor’s registration. Some states also allow their regulatory agency to obtain court orders requiring the franchisor to rescind the franchise agreement and provide restitution to the franchisee. Attached as Appendix A are state-by-state charts identifying statutory remedies and other data.

V. CONCLUSION

The Amended FTC Rule is not a sea change, but it introduces a variety of new wrinkles and nuances into disclosure obligations, and as of the date of this paper, there has been virtually no litigation to test new claims or defenses. Nevertheless, practitioners preparing disclosure documents and litigators representing both franchisees and franchisors should understand how these changes will affect disclosure documents and the disclosure process, and will alter the claims and defenses available to their clients.

One fact is clear: As long as states and the federal government impose extensive disclosure obligations, and as long as franchisees continue to invest large sums of money in franchised businesses, franchisees and franchisors will continue to litigate disclosure disputes.


## APPENDIX A

### DISCLOSURE VIOLATIONS - PRIVATE REMEDIES

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<td>Ind. Code §23-2-2.5-28(2): 8% interest from date of judgment</td>
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<td>Minn. Stat. §80C.12: not more than $10,000</td>
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BIOGRAPHIES

John D. Holland is a partner at Dady & Garner, P.A. John has a nationwide litigation practice and has successfully resolved disputes involving disclosure violations, unlawful termination, encroachment, and other violations of state franchise and dealership laws.

He is a member of the American Bar Associations' Forum on Franchising and has been repeatedly recognized as a "Rising Star" by Minnesota's Law & Politics Magazine and as a "Legal Eagle" by Franchise Times Magazine. John graduated with honors from the University of Minnesota Law School (1998) and St. Olaf College (1995) and resides in St. Paul, Minnesota with his wife, Trina, and daughters, Amelia and Anika.

Deb Coldwell is a business litigator who focuses on franchise, distribution, and contract disputes, and business tort litigation. She has successfully tried jury trials, bench trials and arbitrations on behalf of franchisors and distributors and has sought and received preliminary and permanent injunctive relief for franchisors. She has a practical approach to litigation and assists clients to find a workable strategy in each case she handles.

Deb is the editor in chief of the ABA Franchise Law Journal. She has recently been nominated to serve on the ABA Forum on Franchising Governing Committee. She was a chapter author of The Franchise and Distribution Termination Handbook, ABA Section of Antitrust, 2004. Deb was plenary co-speaker and author of Judicial Update I - Compliance and Relationship Issues, International Franchise Association 36th Annual Legal Symposium, 2003, plenary co-speaker and author of Dealing With System Change In a High Tech World: Early Tremors, Early Warning, ABA Forum on Franchising 2001 Annual Forum, and co-author of the annual Franchise Update, SMU L. Rev. (1999-2008.)

Deb is ranked nationally in Chambers USA as a franchise litigator. She has also been listed in the International Who's Who of Franchise Lawyers and as one of the top franchise lawyers in America by Franchise Times. Deb has been recognized by her peers as a Texas Super Lawyer in Texas Monthly and as one of the top lawyers in franchise and distribution law in Dallas, Texas in D Magazine.

Deb is a member of the ABA Forum on Franchising, the Women’s Foodservice Forum, and the Women’s Franchise and Distribution Forum. Education: J.D., The University of Texas School of Law; M.A.T., The Colorado College; B.A., Colorado State University.

David Byers is a shareholder at Graham & Dunn PC and is a member of the firm's Hospitality, Beverage, Franchise & Distribution industry team. David prepares franchise agreements, disclosure documents, regulatory filings, and other agreements for franchisors, and he advises franchisors on issues relating to regulatory compliance, franchise and distribution systems, and franchisee relations. David has also represented franchise clients in litigation, and he continues to consult with other members of the industry team on litigation matters.

David is a co-host of the International Franchise Association’s Franchise Business Network (Northwest Region), and is a member of the editorial board of the Franchise Law Journal. David graduated from Claremont McKenna College in 1995 and Duke University Law School in 1998, and he has been recognized as a Rising Star by Washington Law & Politics in each of the last four years.
David and his wife Lacey live in Seattle, where he grew up.