When Is a Lie Actionable?
Litigating Misrepresentation Claims and the Requirement of Reasonable Reliance

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Misrepresentation Claims Come in Various Forms

• Common Law Fraud/Fraud in the Inducement/Fraud by Omission
• Misrepresentation (Intentional or Negligent)
• Violation of State Franchise Sales/Registration Laws
• Violation of State Unfair and Deceptive Trade Practices Acts
Common Law Fraud/Fraud By Omission/Intentional Misrepresentation

Elements:

(1) A false representation of material fact (or failure to disclose a material fact one party has a duty to disclose)
(2) Knowledge of the falsity by the party making the representation
(3) Intent to deceive
(4) Reasonable reliance by the recipient of the representation
(5) An actual loss or damages suffered by the recipient
Negligent Misrepresentation

Shares many of the elements of intentional common law fraud but:

(1) Some jurisdictions require a duty, as a result of a special relationship, to ensure that reasonable care was taken with respect to the accuracy of any representations.

(2) The intent requirement is relaxed; negligent misrepresentation generally only requires a careless statement of fact.
Violation of State Franchise Sales/Registration Laws

Several states have franchise disclosure laws that provide a private right of action for false or misleading statements (or omissions) within a FDD.
Violation of State Unfair and Deceptive Trade Practices Acts

Elements:
(1) a FTC Rule violation
(2) a particular state’s Little FTC Franchise Act applies
(3) FTC Rule violation serves as predicate for violation of the Little FTC Act
(4) claim is timely
(5) Little FTC Act’s elements are met
Franchise Disclosure Document

- Full of statements that can form the basis for a fraud/misrepresentation or omission claim
- Easy to see how certain Items/disclosures would be more scrutinized than others, particularly Items related to finances:
  - Item 7 (Estimated Initial Investment)
  - Item 19 (Financial Performance Representations)
Item 19: Reasonable Basis

Franchisor must consider how a historical performance representation is likely to be understood by a reasonable prospective franchisee and whether the representation is the “typical experience of the system’s franchisees”

Franchisor should ask: Can a franchisee reasonably be expected to achieve the results of the representation being made?

A representation of past results that are not indicative of future performance, regardless of reason, does not have a reasonable basis.
Common Defenses to these Types of Claims:

(1) Attacking the elements:
   (a) reliance element – actual and reasonable
   (b) actionable statement/fact (past or presently existing facts; not prediction of future performance or opinion)

(2) Integration Clauses within the FA

(3) Warning/Cautionary Language in FDD or FA

(4) Disclaimers in FDD or FA
Hypotheticals
Prospective Franchisee reviews Item 7 . . .

- Asks Franchisor to confirm numbers.
- Franchisor tells franchisee numbers are accurate, provided not a larger/more extravagant store.
- Franchisee’s experience differs from disclosure.

Basis for lawsuit?
Prospective Franchisee reviews Item 7. . .

• Asks Franchisor to confirm numbers.
• Franchisor “verifies” the numbers are accurate . . .
• But knew numbers had increased because it was updating and filing new FDD (but not yet accepted for filing).
• Franchisee’s store fails.

Basis for lawsuit?
Prospective Franchisee reviews Item 7...

• Asks Franchisor to confirm numbers.
• Franchisor does **not** confirm the numbers are accurate . . .
• But is revising its FDD with estimates at least 20% higher for this Item.
• Franchise location fails.

Basis for lawsuit?
Prospective Franchisee reviews Item 7.

- Franchisee performs its own research.
- Research indicates franchisor’s numbers may be underestimated.
- Franchisee still signs the FA.

Basis for lawsuit?
Prospective Franchisee never reviews FDD (including Item 7) . . .

- After execution of the FA, franchisee fails and reviews FDD.
- Franchisee believes franchisor misstated data.
- Franchisor used affiliate data, not data from franchisees.
- Franchisor knew the data was materially different.

Actionable?
Prospective Franchisee Reviews Item 4 . . .

• Franchisor fails to disclose bankruptcy of certain individuals.
• Franchisee files arbitration claim against Franchisor for fraud, seeking, *inter alia*, rescission.
• Franchisor seeks to use integration clause as a defense.

Result?
Prospective Franchisee Reviews Item 11 . . .

- Franchisee’s store fails.
- Franchisee files fraud in the inducement claim premised on disclosures related to training (amount of support).
- Franchisor raises integration clause and franchise questionnaire as defense.

Result?
Prospective Franchisee Reviews Item 8 . . .

- Franchisor indicates it does not derive income from an affiliate.
- But franchisor is in discussions with an affiliate about possible financial arrangement.
- After FA signed, arrangement is finalized and franchisor begins receiving income from affiliate.
Prospective Franchisee Reviews Item 8(cont’d) . . .

• Franchisee fails.
• Franchisee files an action for fraud and unfair/deceptive practices under State Consumer Protection Act. (Massey and Tubby cases)

Actionable as fraud and/or and unfair/deceptive act?
Beware of state franchise acts!

(Especially ones with anti-fraud and/or civil liability provisions)

- Franchisor indicates in Item 20 that it anticipates opening 0-1 new stores in a particular state.
- Franchisee alleges franchisor had no intention of even offering new franchised locations in that state. \((JMF, Inc.)\)

Result?
Prospective Franchisee reviews Item 19 . . .

- Item 19 indicates it is based on data from stores open at least one full year.
- Franchisee purchases a store open less than one full year and it fails.
- Franchisee alleges fraud because of “selective” information in Item 19 and failure to provide information specific to the store purchased.

Actionable?
Prospective Franchisee reviews Item 19 . . .

• Item 19 includes terms such as “gross revenue,” “gross annual billing,” “projected gross revenue per year” and, in other materials, “total income.”
• None of the terms are defined.
• Franchisee alleges fraud based on confusion from terms.

Result?
Prospective Franchisee reviews Item 19 . . .

• Item 19 includes statement: “We do not have information on expenses or costs....”
• Franchisee later sues, arguing this statement was false because franchisor gathers sales information from franchisees.

Result?
In summary, typical claims related to Item 19:

- Numbers not accurate
- Information presented excluded relevant data
- Information not indicative of franchised locations
- Explanatory notes not accurate
- Misleading or no/insufficient definitions
- Verbal representations when no Item 19 disclosure made
What do the Courts say?

• The question of reliance (actual or reasonable) can be highly factual for attempted resolution through dispositive motions
  
• But not impossible on dispositive motions
  
- Yogo Factory -- SJ for franchisor
  
  - disclosed that figures provided were estimates
  
  - opinion or judgments, not past or present facts
  
  - so no reasonable reliance by franchisee
Facts Courts Consider in Determining if There is Actual or Reasonable Reliance

- The element of reliance is vulnerable to attack through different contractual provisions
- Warnings in FDD on variables (size, location, experience of franchisee, etc.)
- Warnings that Franchisees should conduct own investigation
- Disclaimers in FDD or Franchise Agreement
Questions?